

UNDERSTANDING THE IMPLICATIONS: WHY THE CHINESE ECONOMY IS
CRITICAL TO THE UNITED STATES REALIZING ITS DESIRED
END STATE FOR SOUTH EAST ASIA

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MASTER OF MILITARY ART AND SCIENCE
General Studies

by

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ABSTRACT

UNDERSTANDING THE IMPLICATIONS: WHY THE CHINESE ECONOMY IS CRITICAL TO THE UNITED STATES REALIZING ITS DESIRED END STATE FOR SOUTH EAST ASIA, by Major James E. Harris IV, 123 pages.

China has become an economic force whose influence must be considered not only in Asia but the world. The United States has now re-focused its attention on Asia and the operational environment must be framed to understand the influence China's economy exerts on all relevant countries in South East Asia. This thesis attempts to quantify the second and third order effects of China's economy on the overall operational approach and lines of effort the United States is pursuing as it attempts to re-establish its national influence and protect national interests in Asia.

The research examines China's effects on the U.S. economy, U.S. South East Asian allies economies, and the tensions which exist preventing greater cooperation between the U.S. and China as they both attempt to shape economic development in the region.

The research finds that the U.S. will be unable to fully realize its desired end state for Asia if China and the U.S. are unable to negotiate a common vision for the future. The U.S. must accept that idealism is relevant early on in shaping operational variables, but that idealism cannot ignore the realities of a mature current operational environment.

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TABLE OF CONTENTS

	Page
MASTER OF MILITARY ART AND SCIENCE THESIS APPROVAL PAGE	iii
ABSTRACT.....	iv
ACKNOWLEDGMENTS	v
TABLE OF CONTENTS.....	vi
ACRONYMS.....	viii
ILLUSTRATIONS	ix
TABLES	x
CHAPTER 1 INTRODUCTION	1
Primary Research Question	5
Secondary Research Questions	5
Assumptions.....	5
Key Definitions.....	6
Scope.....	7
Limitations	8
Study Significance	8
CHAPTER 2 LITERATURE REVIEW	12
Historical Context	12
Diplomatic Context.....	17
Economic Context.....	28
CHAPTER 3 METHODOLOGY	40
Purpose.....	40
Secondary Research Questions.....	40
Research And Design Methodology	40
CHAPTER 4 ANALYSIS	46
China's Effects on the U.S. Economy	47
Trade	47
Foreign Direct Investment	51
Protection of U.S. Economic Interests.....	52
China's Currency Manipulation.....	52

China's Non-Compliance with WTO Regulations	62
Export Regulation	63
Foreign Bank Access	66
Transparency Through Translation.....	68
Asian Infrastructure and Investment Bank (AIIB).....	69
The Trans-Pacific Partnership (TPP)	73
Protection of U.S. South East Asian Allies Economic Interests.....	78
Republic of South Korea.....	79
Thailand	83
Republic of the Philippines	86
CHAPTER 5 CONCLUSION.....	100
Lessons Learned.....	100
Implications of the Theory	100
Issues for Further Research.....	105
BIBLIOGRAPHY	107

ACRONYMS

APEC	Asian Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
ATP	Advanced Technology Products
CDA	Collective Defense Agreement
CPC	Chinese Communist Party
FDI	Foreign Direct Investment
FMF	Foreign Military Financing
FTAAP	Free Trade Area of the Asia Pacific
GDP	Gross Domestic Product
IMET	International Military Education and Training
IMF	International Monetary Fund
LGFV	Local Government Financing Vehicles
MDB	Multi-lateral Development Bank
MT	Metric Ton
NATO	North Atlantic Treaty Organization
PBOC	People's Bank of China
SEA	South East Asia
SED	Strategic Economic Dialogue
SOE	State Owned Enterprise
TPP	Trans-Pacific Partnership
VER	Voluntary Export Restraint
WTO	World Trade Organization

ILLUSTRATIONS

	Page
Figure 1. Chinese Constitution Government Structure	18
Figure 2. Chinese Communist Party Constitutional Government Structure	19
Figure 3. U.S. Agricultural Trade with China: 1990-2013	50
Figure 4. Annual Percent Change in the Yuan/Dollar Exchange Rate: 2005 to 2012 (percent)	57
Figure 5. China's Current Account Balance, Merchandise Trade Balance, and Annual Change in Foreign Exchange Reserves: 2001-2012 (billions).....	59
Figure 6. Trans Pacific Partnership Countries.....	75

TABLES

	Page
Table 1. Top US State Exporters to China, 2014.....	49
Table 2. Estimated World REM Reserves as of January, 2011	64
Table 3. U.S. Goods Trade with TPP Countries, 2014	76

CHAPTER 1

INTRODUCTION

The United States welcomes the rise of a stable, peaceful, and prosperous China. We seek to develop a constructive relationship with China that delivers benefits for our two peoples and promotes security and prosperity in Asia and around the world. We seek cooperation on shared regional and global challenges such as climate change, public health, economic growth, and the denuclearization of the Korean Peninsula. While there will be competition, we reject the inevitability of confrontation.

— President Obama, *2015 U.S. National Security Strategy*

Modern warfare is by no means merely a matter of military operations. Economic affairs stand together with them in the first rank of the factors of importance.

— Chiang Kai-Shek

Can the United States protect its economic national security interests while managing China's economic influence in South East Asia (SEA)? China's economic growth is decreasing after years of unparalleled expansion under the critical eye of a communist government. During China's economic expansion, China quietly entrenched in the economies of a preponderance of SEA nations as well as the U.S. What are the effects of a faltering or marginalized Chinese economy on U.S. national interests, the U.S. economy, and its desired end state for SEA?

In 1979, total bilateral trade (exports and imports) between the U.S. and China were estimated at a value of \$2 billion. As of 2013, total trade grew to \$562 billion. China is the second largest U.S. trading partner (Canada being first), and third largest U.S. export market.¹ In 1980, the U.S trade balance was a \$2.7 billion surplus. Today it is a -\$318.4 billion deficit.²

China is the largest foreign holder of U.S. Treasury Securities in the world. In 2002, China held \$118 billion; as of 2013, they held \$1.3 trillion. China now owns twenty-three percent of the world's foreign investment in U.S. backed securities. A majority of these securities were purchased by China during the 2008 financial crisis allowing the U.S. to fund the budget deficit.

In order to frame the significance of China's economic growth in relevant terms, a gross domestic product (GDP) comparison is required. The United States is the largest economy in the world with a GDP of \$17.4 trillion. China is the second largest, with a GDP of \$10.36 trillion. Japan is third with \$4.6 trillion.³ When China began its economic expansion in 1979, its GDP was \$194.4 billion. The U.S. GDP in the same year was \$3.2 trillion.⁴ China's growth rate has been ten times that of the United States since the early 1980s.

China's economic development has been impressive, but its underpinnings reflect three significant themes: The Communist Party of China's (CPC) consistent attempts to manipulate economic conditions and constrain the free market; authoritarian control of the banking industry and over-investment in industrial production; and a lack of state government oversight of China's twenty-three provincial economic investment policies and implementation. Combined, these factors laid the foundation for China's estimated debt-to-GDP ratio of 280 percent today.⁵

China's governmental control of its economy was inconsistent over the last three decades. In 1978, the GDP per capita was \$155.⁶ That year, the 11th Central Committee released their Third Plenum legislation which broke ties with former regime mandates on economic processes. Until this point, the government controlled allocation of resources,

set production quotas, and managed the distribution of goods.⁷ The Third Plenum decision to allow free market principles to begin affecting the market created a situation where farmers were no longer mandated a production quota, but instead incentivized by personal profit from their production efforts. As a result, the agricultural productivity surged, leading to a surplus in agricultural goods and labor within the Chinese economy. Fueled by this surplus of labor, provincial governments began heavily investing in industrial capacity leading to local factories springing up across the country. The Chinese industrial revolution took hold its roots deeply entrenched themselves.

From 1980 to 2004, China's economic growth averaged 10.4 percent annually. In this period the CPC continually experimented with the effects of a free market on the economy. They began to de-regulate control of local economies and empowered provincial governments to act independently from the state in economic development. While economic policymaking was further delegated to the Chinese provincial governments, the CPC maintained its influence by controlling the lending decisions of the state run banks, which sparingly facilitated capital for provincial economic development. Left to their own devices, provincial governments began to look to alternative methods of financing local business development. This effort brought about opaque lending entities known as Local Government Funding Vehicles (LGVF).

Since 1979, Chinese provinces over-investment in the industrial manufacturing sector created a dependency on exports to generate revenue. Today, China faces a staggering positive trade deficit in which its revenue streams are now significantly constrained due to decreased international demand for Chinese goods. Consumption as a

part of GDP remains stagnant, and China must grow its service sector and revitalize household consumption to prevent further economic erosion.

Presently, China has leveraged debt to a sum of 280 percent of GDP; the majority of which lies at the provincial government level.⁸ Because China's transparency in economic data is opaque at best, reports vary about the actual amount of debt the Chinese provincial governments have accumulated. It is believed to be no less than 40 percent of China's GDP.⁹ Compounding the problem has been the reliance of the provinces borrowing from the questionable LGVFs for a preponderance of their debt, making it more difficult for the CPC to fully quantify.¹⁰ With declining GDP this year, the major concern for China is whether the federal reserves will be able to sustain an economy in significant decline as its revenue streams are minimized.

In response to the deteriorating situation, the CPC conducted a massive debt bailout for the Chinese provinces in June of 2015, issuing 2.6 trillion Yuan (\$419 billion dollars) from the government reserves. These government bonds were used as a payment by the Chinese provinces to settle the more mature debt held at higher interest rates by the LGVFs. This action effectively absorbed the provincial debt burden at the state government level on behalf of the provinces.¹¹

The concern still exists that China is overleveraged and unable to generate revenue to pay its debts. In February of 2016, China is again pushing for increased lending from the People's Bank of China (PBOC) by reducing the required reserves subsidiary banks must hold in an attempt to inject liquidity within the Chinese lending market.¹² China must find growth opportunities through economic reform and greater cooperation with the world if it is to avert economic calamity. The second and third order

effects of China's economic conditions with respect to U.S. security interests and the overall stability of Asia will be more fully examined in this thesis.

Primary Research Question

Can the United States achieve its desired end state in South East Asia without Chinese economic cooperation?

Secondary Research Questions

1. What effects does China have on the U.S. economy?
2. What are the primary economic interests the U.S. wishes to protect with respect to China?
3. What South East Asian allies' economic interests does the U.S. wish to protect with respect to China?

Assumptions

There are several assumptions required for this study to be completed. Many consider China an enemy and direct threat to the U.S. This stance tends to be anchored in a history of clashes between Chinese and American values, priorities, and a tepid relationship spanning decades. The assumption must be made that the U.S. and Chinese governments are willing to overlook the past perceptions and engrained beliefs for the potential of a prosperous future.

It must be assumed that both countries are willing to negotiate their current positions, and both are willing to move with discretion towards a relationship motivated by common interests

The author assumes that China will be willing to consider economic prosperity over governmental control and authoritarian mandates. This is not a un-feasible given Chinese leaders have toyed with the idea of a free market in order to restore China's greatness throughout its history.

An assumption must be made that the U.S. true motivation is the economic development and stability of Asia and not an attempt to counter-balance China's economic competition. Everything published by the U.S. regarding the relationship is one of hope for fostering relations with mutual respect for China, but many political leaders assess U.S. actions as counter to their words.

Lastly, it has to be assumed that China is legitimately interested in economic growth and prosperity, and is not pursuing a policy of territorial expansionism.

Key Definitions

Consumption: the use of goods and services by households. The study of consumption behavior plays a central role in both macroeconomics and microeconomics. Macroeconomists are interested in aggregate consumption for two distinct reasons. First, aggregate consumption determines aggregate saving, because saving is defined as the portion of income that is not consumed. Because aggregate saving feeds through the financial system to create the national supply of capital, it follows that aggregate consumption and saving behavior has a powerful influence on an economy's long-term productive capacity. Second, since consumption expenditure accounts for most of national output, understanding the dynamics of aggregate consumption expenditure is essential to understanding macroeconomic fluctuations and the business cycle.¹³

Industry is organized economic activity concerned with manufacture, extraction and processing of raw materials, or construction.¹⁴ Within the scope of this thesis, industry references are linked to the Chinese economies reliance on taking raw goods and manufacturing them into finished products for exportation. Major Chinese industries include manufacturing, metallurgical processing, mining, and machinery. China is the world's leading manufacturer of chemical fertilizers, cement, and steel.

A State Owned Enterprise is a legal entity that is created by the government in order to partake in commercial activities on the government's behalf. SOEs can be either wholly or partially owned by a government and is typically earmarked to participate in commercial activities.¹⁵

A trade deficit is an economic measure of a negative balance of trade in which a country's imports exceeds its exports. A trade deficit represents an outflow of domestic currency to foreign markets.¹⁶

Scope

The scope of this thesis is limited to framing the operational environment and problem of how significant of an effect China has on the economic stability and prosperity in South East Asia. It will not attempt to frame direct solutions, but rather attempt to shed light on the effects China can have on the U.S. desired end state for SEA given its pivot to the region.

When considering U.S. economic national interests affected by China, the author refined those discussed in this paper to the following:

1. U.S. and Chinese economic interdependence
2. Protection of U.S. economic interests

3. Protection of U.S. Allie's economic interests
4. Maintaining U.S. international economic influence

Tensions abound between the U.S. and China and for the purposes of this thesis, the author chose to refine the scope of those tensions to the following:

1. China's Currency Manipulation
2. China's non-compliance with World Trade Organization (WTO) regulations
3. The Asian Infrastructure and Investment Bank (AIIB)
4. The Trans-Pacific Partnership (TPP)

Limitations

The diplomacy and political interaction between the U.S. and China is fluid and possesses a potential for rapid change. This study has an established thesis at the time of initiation and could be dramatically changed by international events which may occur during this writing. Future events could present a challenge in completely disproving or altering the author's original thesis statement during the production of this work.

Study Significance

This research is significant because it frames the Operational Environment (OE) with respect to economic considerations. It will examine and the impact China's economic power projection has on U.S. National Security Interests. Many Americans immediately assume that national security relates primarily to a nation's military power projection. Protecting economic influence is a critical U.S. national security interest. Through its economy, the U.S. funds its defense spending, enforces sanctions, delivers humanitarian aid, and enjoys significant standing in the international market. Diplomacy,

information, and military forms of power are routinely highlighted by the media, but rarely are the economic strategies and implications fully acknowledged or understood.

Vital U.S. interests examined by this thesis will include:

1. China's effects on the U.S. economy
2. Protection of U.S. economic interests
3. Protection of U.S. Allie's economic interests
4. Maintaining U.S. international economic influence

As the United States "pivots" its attention to Asia, China's economic condition is paramount in the minds of senior foreign policy strategists. China has established itself as a major sustainer of smaller countries within the SEA region and its failure may ultimately undermine or prevent the U.S. desired end state of economic stability and prosperity being achieved within the region. China has reached a pinnacle of demand for its exports leading to excess capacity, sunk costs, and excess supply. Due to decreased international demand, China will struggle to generate adequate revenue if it is unable to reform and pursue economic growth outside of industry. Given these constraints, China continues its attempts to gain a competitive advantage on the world market, and takes actions which disadvantage other nations economies and foster economic dependency from countries.

The United States and China both express a desire to pursue a partnership, but there is a large degree of separation between both countries on four key U.S. economic interests

1. China's currency manipulation
2. China's non-compliance with WTO regulations

3. The Asian Infrastructure and Investment Bank (AIIB)

4. The Trans Pacific Partnership (TPP)

These tensions must be understood to fully comprehend the ever-shifting operational variables that affect the U.S. ability to reach its desired end-state in SEA.

Shaping of U.S. foreign policy with China must also be evaluated in light of the U.S. Collective Defense Agreements (CDA) with the following SEA countries:

1. Republic of South Korea

2. Thailand

3. Philippines

In both the 2015 U.S. National Security Strategy and the 2015 Chinese Military Strategy, both countries specifically note development and cooperation with one another as a significant priority. Consideration must be given to the possibility that neither the U.S. nor China may be able to achieve their strategic end states in SEA without cooperation. Unilateral action by both countries may be the most direct path to strategic failure. The U.S must fully appreciate the economic operational variables which China can affect when considering the application of operational art and design within the region.

¹ Wayne M. Morrison, *China-U.S. Trade Issues* (Washington, DC: Congressional Research Service, December 15, 2015), accessed April 2, 2016, <https://www.fas.org/sgp/crs/row/RL33536.pdf>.

² Ibid.

³ The World Bank, “GDP (Current US\$),” January 2015, accessed October 31, 2015, <http://www.worldbank.org/en/about/annual-report>.

⁴ Ibid.

⁵ Ana Swanson, “China’s Increase in Debt Is Massive and Unsustainable,” *The Washington Post*, February 11, 2015, accessed September 28, 2015, <https://www.washingtonpost.com/news/wonk/wp/2015/02/11/chinas-increase-in-debt-is-massive-and-unsustainable/>.

⁶ Matthew P. Goodman and David A. Parker, *Navigating Choppy Waters* (Washington, DC: Center for Strategic and International Studies, March 15, 2015), accessed September 23, 2015, http://csis.org/files/publication/150327_navigating_choppy_waters.pdf.

⁷ Ibid.

⁸ Swanson.

⁹ S. R. Shanghai, “Defusing a Bomb,” *The Economist*, March 11, 2015, accessed September 28, 2015, <http://www.economist.com/blogs/freeexchange/2015/03/china-s-local-government-debt>.

¹⁰ Ibid.

¹¹ Shen Hong, “China’s Plan for Local Debt Amounts to a Bailout,” *The Wall Street Journal*, June 23, 2015, accessed September 28, 2015, <http://www.wsj.com/articles/chinas-plan-for-local-debt-amounts-to-a-bailout-1434998702?mg=id-wsj>.

¹² Wei Lingling, “China Frees Banks to Boost Lending, in Shift on Yuan Stance,” *The Wall Street Journal*, February 29, 2016, accessed February 29, 2016, <http://www.wsj.com/articles/china-cuts-reserve-requirement-for-banks-1456741479>.

¹³ Christopher C. Carroll, “Consumption,” last modified January 27, 2015, accessed November 15, 2015, <http://www.britannica.com/topic/consumption>.

¹⁴ The Free Dictionary, “Industry,” last modified 2003, accessed November 15, 2015, <http://www.thefreedictionary.com/industry>.

¹⁵ Investopedia, “State-Owned Enterprise SOE,” last modified 2015, accessed November 15, 2015, <http://www.investopedia.com/terms/s/soe.asp>.

¹⁶ Investopedia, “Trade Deficit,” last modified 2015, accessed November 15, 2015, http://www.investopedia.com/terms/t/trade_deficit.asp.

CHAPTER 2

LITERATURE REVIEW

Historical Context

The Center for Strategic and International Studies produced a report titled “Navigating Choppy Waters” which provides a comprehensive historical overview of the Chinese economy from its initial humble origins to the powerful economy of today.

In 1989, General Secretary (President) Deng Xiaoping replaced former General Secretary Zhao Ziyang as a result of the fallout from the Tiananmen Square events. Deng Xiaoping is remembered as the most powerful Chinese leader in modern times. He set the conditions for Chinese 14th Party Congress to officially endorse a socialist market economy and to create a modern corporate system. He was the architect of a new brand of socialist thinking, combining the Communist Party's socialist ideology with a pragmatic adoption of market economy practices.¹ Xiaoping's progression toward a market driven version of economics was a result of his political prowess, the ongoing collapse of the Soviet Union, and Xiaoping's empowerment of the Chinese provincial governments to foster economic development.² Most notably, Xiaoping's policies enhanced Chinese reliance on an export based growth model fueled by significant expansion in industrial production. He was the predominant figure in charting China's course for significant economic expansion, but also planted the seeds for the problems it faces today with over-investment into that industrial growth, minimal consumption rates, and a profound level of debt.

President Zhu Rongji succeeded President Xiaoping in 1998 leading China's efforts to assess into the World Trade Organization (WTO). Having served as Vice

Premier under Xiaoping from 1993-1998, Rongji aggressively carried out the reform process initiated by his predecessor, and utilized the WTO's mandates for admission as leverage to ensure CPC member's compliance in pursuing economic reform.³ During his tenure, he reformed the Chinese tax code, fueled privatized business expansion, and established more coherent and comprehensive national economic regulatory policies. China, supported by the United States, was accepted into the WTO in 2001 and was more poised to capitalize on its economic reform process.⁴

President Hu Jintao became President of China in 2002 and served in this position until 2012. His policies negated many of the policies Xiaoping implemented and he reinstituted greater government control over the economy. Jintao discouraged the state owned banks lending to private sector businesses, which lead to the establishment of LGFVs and enabled the Chinese provinces to amass historical and unmanageable debt levels held today.⁵ He doubled down China's dependence on exports in order to facilitate economic growth and failed to balance industrial production with service industry growth required for a balanced economy. As a result, SOEs were encouraged to borrow money in order to invest in the industrial production capacity necessary to deliver on the surging demand from countries around the world. Jintao was also the first Chinese leader to devalue the Chinese Yuan in order to inflate demand for Chinese exports and maintain a significant trade advantage.⁶ Consumption dropped off rapidly due to these measures, and the Chinese consumer began to save excessively as they found the purchasing power of their currency in decline; effectively minimalizing national consumption. The Chinese government, with an undervalued currency and deluge of export revenue saved almost

forty percent of its GDP per year from 2002 to 2012 leading to a massive surplus of almost \$4 trillion Yuan.

Elected in 2013, President Xi Jinping leads China in an attempt to reorient the Chinese economy. Months after his election, the Central Committee released its Third Plenum Reform Agenda on November 12, 2013. The Third Plenum Reform Agenda highlighted center-local fiscal reform; competition policy reform; financial system reform; foreign trade and investment reform; state-owned enterprise reform; land policy rationalization; labor and shared welfare; environmental policy reform; and innovation policy reform.⁷ Many analysts believe that Jinping is the most powerful leader since Deng Xiaoping and he has repeatedly communicated his intent to allow greater free market influence within the Chinese economy.⁸

The study closes with a strategic synopsis of recommended actions the U.S should take moving forward with China. Many of the recommendations are in alignment with the persuasive theme of this thesis. They are as follows:

1. Support China's economic reforms where they align with U.S. interests
2. Challenge Beijing when its policies are out of step with U.S. interests
3. Ensure that Beijing engages at an appropriate political level
4. Establish an informal back channel between the White House and Zhongnanhai
(the Chinese "White House")
5. Pay more attention to center-local relationships
6. Maintain but streamline the Strategic and Economic Dialogue (S&ED)
7. Keep Bi-Lateral Trade negotiations high on the trade agenda
8. Pursue a robust regional and global economic strategy

9. The White House prepares a Presidential strategy document on China with a deliberate and comprehensive way ahead.⁹

Ultimately, this study allowed the author to frame China's current day economic struggles through the lens of historical analysis. Woven throughout China's story of economic growth are critical decisions and policies adopted by its leadership which must be appreciated in order to study the present.

The historical precedents leading to today's financial regulation entities; the International Monetary Fund and World Bank, are imperative in understanding the author's discussion of China's currency exchange rate manipulation. The International Monetary Fund website and history page account enabled the author to better understand why the IMF and World Bank exist today and why the U.S. is diametrically opposed to China's exploitation of the Bretton Wood's system founded primarily with U.S. leadership on influence.

Fiat Currency "currency that a government has declared to be legal tender, but is not backed by a physical commodity. The value of fiat money is derived from the relationship between supply and demand rather than the value of the material that the money is made of."¹⁰ All nations utilize a fiat currency today. The U.S. began using a fiat currency in 1933 when the U.S. economy was in a downward spiral during the Great Depression. With exorbitant interest rates required for borrowing money due to a finite gold backed revenue supply, President Franklin Roosevelt suspended the gold standard policy and authorized the Treasury Department to create money in order to artificially increase the monetary supply. This break from the gold standard decreased interest rates

and stimulated loans as citizens were able to more easily borrow; which in turn stimulated economic growth.

The Great Depression followed by World War II were catalysts for the creation of the International Monetary Fund (IMF). The IMF, also known as the Fund, was conceived at a UN conference in Bretton Woods, New Hampshire, United States, in July 1944. The 44 countries at that conference sought to build a framework for economic cooperation to avoid a repetition of the competitive devaluations that had contributed to the Great Depression of the 1930s. The IMF's primary purpose is “to ensure the stability of the international monetary system—the system of exchange rates and international payments that enables countries (and their citizens) to transact with each other. The Fund's mandate was updated in 2012 to include all macroeconomic and financial sector issues that bear on global stability.”¹¹ The IMF was formally conceived in 1945 when the first twenty-nine members signed the Articles of Agreement.¹² Coinciding with the creation of the IMF at Bretton Woods, the International Bank for Reconstruction and Development (IBRD) was created to provide financial assistance for the reconstruction of countries after World War II and assist with the development of immature national economies.¹³ The IBRD is known today as the World Bank.

The Bretton Woods System was founded in 1958, and was the first currency conversion system which derived its currency valuations from the U.S. dollar. Under this system, international countries settled their debts in U.S. dollars which were convertible to gold at a fixed exchange rate of \$35 an ounce. The U.S. held responsibility for maintaining the fixed value of gold via increasing and decreasing the supply of dollars in circulation. In 1971, significant U.S. spending on President Johnson's Great Society

Programs and the Vietnam War led to a persistent inability of the U.S. to maintain the fixed gold valuation as the foreign-held supply of U.S. dollars exceeded the actual gold supply. In essence, the U.S. was printing more dollars than the gold they had to back those dollars in order to pay its debts.¹⁴ As a result, in 1971, President Nixon formally suspended the dollar's convertibility to gold (i.e. the gold standard) and by 1973, major international currencies began to float against each other according to economic forces.

Diplomatic Context

Understanding the Chinese Communist Party's governmental structure and hierarchy is imperative. The Congressional Research Service's report "China's Political Institutions and Leaders in Charts" was immensely helpful in digesting the network of positions and dualities that many Chinese political leaders hold within the government system.

China's first state constitution was adopted in 1982 and in its third chapter entitled "Structure of the State", China's unicameral legislature and overall government structure is defined.¹⁵ The State Council is the "highest organ of state power" and oversees the State Council, State Central Military Commission, Supreme People's Court, and the Supreme People's Procuratorate.¹⁶ Figure 1 represents the state constitution's delineation of their national level political structure.

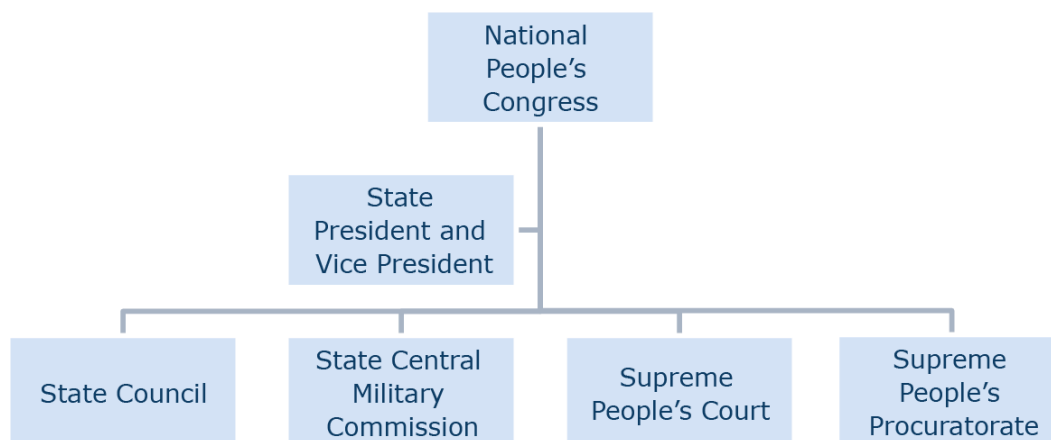


Figure 1. Chinese Constitution Government Structure

Source: Susan V. Lawrence, *China's Political Institutions and Leaders in Charts* (Washington, DC: Congressional Research Service, November 12, 2013), accessed October 30, 2015, <https://www.fas.org/sgp/crs/row/R43303.pdf>.

The Chinese Communist Party (CPC) has 85 million members; represents 6 percent of China's 1.35 billion citizens, and is the largest political party in the world.¹⁷ The CPC has their own constitution, independent of the Chinese State Constitution, and provides more detail about Communist Party leadership of the political system, economy, and society at large. The Party Constitution states, "the Party commands the overall situation and coordinates the efforts of all quarters, and the Party must play the role as the core of leadership among all other organizations at corresponding levels."¹⁸ In current practice, the actual Chinese government structure is reflected in figure 2.

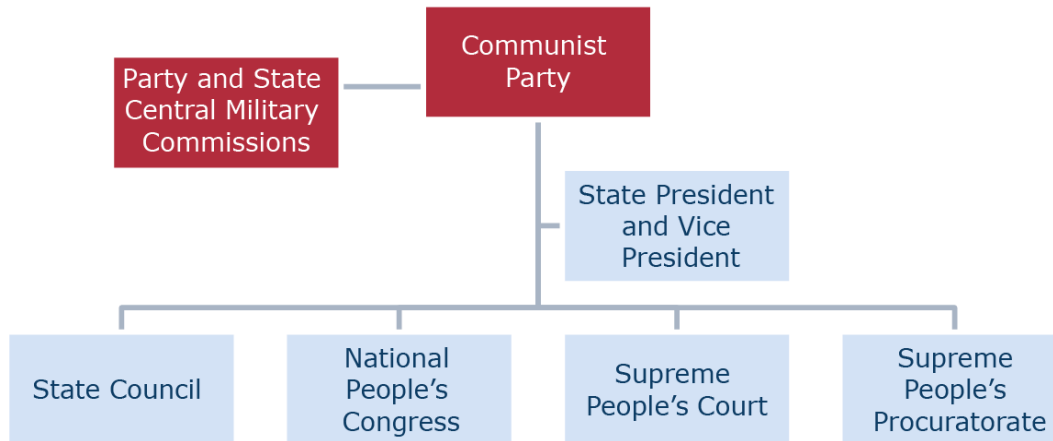


Figure 2. Chinese Communist Party Constitutional Government Structure

Source: Susan V. Lawrence, *China's Political Institutions and Leaders in Charts* (Washington, DC: Congressional Research Service, November 12, 2013), accessed October 30, 2015, <https://www.fas.org/sgp/crs/row/R43303.pdf>.

The National People's Congress (NPC) legislates on a five- year timeline for elections and government policy decisions. The most recent election was held in November of 2012 where the Chinese Central Committee was appointed. The Central Committee is the legislative branch of the CCP. The current Central Committee is composed of 205 full time members and 171 alternate members.¹⁹ Each meeting of the Central Committee is referred to as a “plenum” and after an NPC appointment; the Central Committee’s first priority is to elect (from amongst themselves) a Politburo (25 members), the Politburo Standing Committee (7 members), and a Party General Secretary. This Party General Secretary manages the daily operations of the Politburo, its Standing Committee, and Central Committee departments and commissions. The State President is China’s head of state. The literal translation for the name for the office of state president would be “chairman”, but China’s official translation is President.²⁰ The

President is the highest state office, but the office is primarily ceremonial and the “face” of the CCP. In an attempt to reflect a distribution of power, the Chinese State Constitution dictates that the President is subordinate to the National People’s Congress (ref. figure 1). However, China’s President, Xi Jinping is also the Party General Secretary under the CPC structure and has oversight and direction of the NPC (ref. figure 2).²¹ In essence, the President controls executive and legislative powers concurrently. This point is essential in understanding that while China is a progressive communist government, control is the essence of its structure. It is also imperative that the reader understands the significance of China’s current President, Xi Jinping’s autocratic and authoritative power over China’s economic and political processes.

China is composed of 23 provinces with a provincial government representing their respective province at the state government level. Provincial government structures mirror a paired down version of the state government structure.²² Provincial representation is conducted via Party Committees run by provincially appointed Party Secretaries. Indicative of China’s communist foundation, many Party Secretaries hold concurrent positions within the State Council, legislature, State Owned Enterprises, public institutions, universities and hospitals.²³

China’s government structure, on its surface, appears counter-intuitive to the traditional “stove-pipe” control of communist organization governments. When proper analysis is conducted, it is apparent this is merely a deception of expanded representation where senior officials can hold multiple positions within varying levels of government ensuring lasting Communist control.²⁴

The article titled “China’s National Security Commission Holds First Meeting” reveals the significance of economic development to President Xi Jinping as he is quoted, “Development is the foundation for security, and security is a condition for development. Only a prosperous country can have a strong military, and only a strong military can protect the country.”²⁵ This quote by Jinping is a powerful indicator of China’s focus as a nation on economic development and reform, as well as its criticality in the Jinping’s mind on ensuring national security.

China published its first Military Strategy in 2015. There had been no similar document produced by China to date, and mirrors the United States National Security Strategy. The word “development” as it relates to economic development is mentioned twenty two times throughout the nineteen-page document. In the opening paragraph, four critical statements are made:

China will:

1. “Pursue an independent foreign policy of peace and a national defense policy that is defensive in nature
2. Unswervingly follow the path of peaceful development
3. Oppose hegemonies and power politics in all forms
4. Never seek hegemony or expansion”²⁶

This document alone significantly speaks to the question of whether China’s motivation is economic development or territorial expansion. One can also infer that China is specifically speaking too the United States regarding its comments on “hegemonism” and its rejection of any actions in such pursuit.

The United States 2015 National Security Strategy directly addresses the end state which the U.S. seeks regarding China and SEA. “The United States welcomes the rise of a stable, peaceful, and prosperous China. We seek to develop a constructive relationship with China that delivers benefits for our two peoples and promotes security and prosperity in Asia and around the world. We seek cooperation on shared regional and global challenges such as climate change, public health, economic growth, and the denuclearization of the Korean Peninsula. While there will be competition, we reject the inevitability of confrontation.”²⁷

National Security Advisor Tom Donilon delivered a series of remarks in a visit to the Center for Strategic and International Studies in 2012. These remarks were given shortly after President Obama directed the strategic “pivot” to the Asia Pacific. His remarks were a concise description of the intent of the U.S. shifting its focus to Asia, the desired end state, and the lines of effort to achieve that end state.

As Donilon explained, “It was clear that there was an imbalance in the projection and focus of American power. It was the President’s judgment that we were over-weighted in some areas and regions, such as our military commitments in the Middle East. At the same time, we were underweighted in other regions, such as the Asia Pacific. Guided by these determinations, we set out to rebalance our posture in the world. And so you saw, first and foremost, a preeminent focus on recovering from the Great Recession and restoring American economic strength, which is the bedrock of American power. We set out to revitalize key alliances—our deep network of treaty allies from the Atlantic to the Pacific, which are a uniquely American asset. We decided to engage more deeply in international and regional organizations, which advance our interests.”²⁸

“Our approach is grounded in a simple proposition: the United States is a Pacific power whose interests are inextricably linked with Asia’s economic, security and political order. America’s success in the 21st century is tied to the success of Asia. Economically, it’s impossible to overstate Asia’s importance to the global economy and to our own. Asia accounts for about a quarter of global GDP at market exchange rates, and is expected to grow to nearly 30 percent by 2015. The region is estimated to account for nearly 50 percent of all global growth outside the United States through 2017. The region accounts for 25 percent of U.S. goods and services exports, and 30 percent of our goods and services imports. An estimated 2.4 million Americans now have jobs supported by exports to Asia, and this number is growing. In short, robust U.S. trade and investment in Asia will continue to be critical for our economic recovery and our long-term economic strength.”²⁹

Donilon’s address succinctly and comprehensively addressed the U.S. national security interests in the Asia Pacific, the interdependence of the Chinese and U.S. economies, and the fact that these two considerations are paramount in driving national security policy.

“China Under Xi Jinping: Alternative Futures for U.S.-China Relations” was a series of addresses by former Australian Prime Minister, Honorable Kevin Rudd. His lectures had a strong influence in shaping this thesis. In his speech, Hon. Rudd elaborates on the historical divergence of U.S. and Chinese cultures, the source of long held distrust amongst nations, as well as the unique opportunities he sees for future engagement with a newly empowered President Jinping.³⁰

Honorable Rudd opens his address with the following points to emphasize the significance Chinese economic growth.

According to the Organization of Economic Cooperation and Development (OECD)

1. China will become a bigger economy than the United States using GDP at market exchange rates within a decade.
2. In 2009, China became the world's largest exporter.
3. In 2013, China became the world's second-largest importer.
4. In 2013, China became the world's largest trading nation.
5. According to the CIA World Fact Book, China is the number-one trading partner of 128 countries, compared with 76 for the United States.
6. The World Bank projects that by 2030, China will account for 40 percent of total global capital outflows, more than the United States and Europe combined.

Following these figures, Hon. Rudd makes a profound comment in the address, and one that directed this author towards the premise for his thesis. "I may well be wrong, in which case little is lost. Other than to say if China were to fail against its various national objectives, the negative consequences for the region and the world would be considerably worse than a fear of China's success. Particularly if we reflect on the possible impact on regional security, global employment, and uncontrollable global warming – not to mention mass people movements in response to domestic or regional political instability."³¹

The presentation then attempts to answer three significant questions that address the heart of diplomacy between the U.S. and China.

1. If China continues to rise, what judgments can we make about China's longer-term intentions for its role in the region and the world?
2. What strategy could the United States embrace with China, and China with the United States, that does not result in the long-term conflict but that preserves the peace in a manner that also sufficiently accommodates each other's interests?
3. If so, does this bear any relationship with President Xi Jinping's concept of "A New Type of Great Power Relationship"?³²

Regarding the first question, Hon. Rudd expresses the requirement to see the world as viewed through the lens of the Chinese based on their traditional and deeply embedded values of Confucianism. Confucian values emphasized reciprocal relationships between the emperor and heaven, the emperor and his subjects, father and son etc. Daoism and Buddhism emerged, but never fully replaced China's Confucius roots. Hon. Rudd's ultimate point is that none of these religions emphasized an opinion or worldview beyond the borders of China. China refutes the liberal expansionist actions they believe are tied to the Christian religion, and drove what they deem as expansionism in the Crusades and other such historical events. As Hon Rudd put it, "In summary, not only do Chinese leaders see their traditional hierarchical values as being in deep contrast with those of the liberal democratic West, they also see their own tradition as one which does not make universalist claims beyond China. Which once again they hold in contrast to what they perceive to be an arrogantly, irrepressibly, evangelizing West."³³

China's "The Five Principles of Peaceful Coexistence" list the following as China's self perception of required absolutes in foreign policy and are reflective of the Confucian principles Hon. Rudd alluded to.

1. Mutual respect for political sovereignty and territorial integrity
2. Mutual nonaggression
3. Mutual noninterference in each other's internal affairs
4. Equality and mutual benefit
5. Peaceful coexistence

Hon. Rudd then addresses China's perception of U.S. Strategic pursuits in their conduct internationally. He contends that these perceptions under President Xi Jinping are not necessarily becoming more positive, but potentially more negative.

Chinese Leader's perception of U.S. Strategic Intent with respect to China:

1. To isolate China
2. To contain China
3. To diminish China
4. To internally divide China
5. To sabotage China's Leadership³⁴

These perceptions are based on a "cocktail" of factors:

1. U.S. "pivot" to Asia
2. The intensity and proximity of U.S. spy flights to the Chinese coast
3. The indictment by the U.S. Department of Justice of Chinese officials for cybercrime against U.S. firms
4. The perceived reinforcement and expanding scope of the U.S.-Japan alliance

5. The perceived emerging strategic partnership between the U.S., Japan, India, and Australia
6. The Trans-Pacific Partnership (TPP), which Beijing concludes is a geopolitical counterweight against China
7. The recent terrorist attacks across China by Xinjiang separatists, where China believes the United States has been relatively silent
8. The anti-Chinese protests in Taiwan and prodemocracy protests in Hong Kong, where China has accused the United States and the United Kingdom of complicity³⁵

Given the wealth of obstacles laid out in the address, it is easy to see why the selection of a strategy between these two countries will have monumental impacts in the foreseeable future. Hon. Rudd proposes an approach he titled “constructive realism.” He portrays both the U.S. and China as extreme realists in their views of foreign policy and international affairs and there will be many disputes, which will deny “any ready resolution” no matter the diplomacy.³⁶ Hon. Rudd contends that instead of utter failure for well-foreseen disagreements, these “unsolvable” disputes cannot be magically fixed, but instead managed. They must be acknowledged, addressed, and then clearly identified and prevented from destroying any and all progress possible surrounding such contentious issues.³⁷

As a framework for managing future interactions, Rudd conveys that success in his version of “constructive management” will build and support forward momentum; and such success will have intrinsic motivators for further cooperation. As the great Deng

Xiaoping once said, “To cross the river, it is important to feel the stones step by step with your feet.”³⁸

Hon Rudd’s analysis of the relationship between China and the U.S. was unbiased, and one in which his countries’ welfare will ultimately be directly affected by the success or failure of foreign policy between the two global super powers. His address was extremely informative and directed its focus in its entirety to the current points of contention and possible solutions between the U.S. and China.

Economic Context

“China’s Economic Ties with ASEAN: A Country-by-Country Analysis” was a report produced in March of 2015 by the U.S.-China Economic Security Review and Commission. This relationship between China and its ASEAN neighbors is a major consideration of this thesis as a primary U.S. national interest is to protect its allies. China is not a member of ASEAN, but has signed a Free Trade Agreement (FTA) with ASEAN and has leveraged this agreement to become a dominant figure in South East Asia trade as a result.³⁹ The U.S. has signed Collective Defense Agreements (CDA) with many of the nations impacted by China’s expansion and this must be taken into consideration when considering U.S. national interests.

“Today, the complex relationship between China and ASEAN combines aspects of cooperation and tension. China’s aggressive posturing in the South China Sea illustrates its increasing naval capabilities and willingness to deploy them, whether to secure offshore hydrocarbons and fisheries or to exact leverage over its smaller neighbors to the south. At the same time, China’s rise exerts a powerful pull on ASEAN economies, from component manufacturing in Malaysia to banking in Singapore and copper mining

in Burma. At once a manufacturing hub and an important source of capital, China has the potential to buoy the ASEAN economies, but also to create structural imbalances that damage the region in the long run.”⁴⁰

This report was critical to helping the author to understand the proportionality with which China exerts its influence on surrounding nations in the Asia Pacific through trade. The report, through statistical analysis, identifies the trade surplus and deficit with which China trades and invests with ASEAN member countries and ASEAN FTA signatories. It provided a historical narrative through present day of the development and growth of the trade relationships in South East Asia and their significance to present day international relations within the region.

The Congressional Research Services report entitled “China-U.S. Trade Issues” identified the extent with which China and the U.S. economies are mutually supporting. The report also delves into the U.S. trade deficit established with China, the aggressive emergence of Chinese Foreign Direct Investment in the U.S., and the volume of U.S. securities held by the Chinese government today. Directly relevant to the thesis study, the article lists four major U.S.-China trade issues:

1. The extensive network of Chinese industrial policies which seek to promote and protect domestic sectors and firms, especially SOEs, deemed by the government to be critical to the country’s future economic growth
2. China’s failure to provide adequate protection of U.S. intellectual property rights (IPR)
3. China’s mixed record on implementing its obligations in the World Trade Organization (WTO)

4. China's intervention in currency markets to limit the appreciation of the Yuan against the dollar in order to make China's exports more globally competitive.⁴¹

Lastly, in validating the significance of China's SOEs the report states, "Not only are SOEs dominant players in China's economy, many are becoming quite large by global standards. In 2013, 84 Chinese companies (excluding Hong Kong firms) made Fortune Magazines Global 500 list of the world's largest firms based on revenues. Of the 84 Chinese companies listed, 77 firms or 88.1 percent were state-owned or state-controlled enterprises."⁴² The report definitively demonstrates the degree to which the Chinese and U.S. economies are complimentary as well as the direct impact a failing Chinese economy could have on the U.S. economic interests.

The United States Trade Representative released the "2014 Report to Congress On China's WTO Compliance" in 2015. The report is 154 pages long and covers every Chinese industry in relation to its compliance to World Trade Order mandates on an annual basis. The report highlights the areas in which China's WTO compliance has stagnated and is creating tensions between the U.S. and other WTO nations. The report identifies CPC's tendency to manipulate economic forces in order to gain an advantage in the world market place. As quoted from the report, "If China is going to deal successfully with its economic challenges at home, it must allow market forces to operate, which requires altering the role of the state in planning the economy. Economic reform in China is also strongly in the United States' interest, not only because the Chinese government's interventionist policies and practices and the large role of state-owned enterprises in China's economy are principal drivers of trade frictions, but also because a sustainable

Chinese economy will lead to increased U.S. exports and a more balanced U.S.-China trade and investment relationship will help drive global economic growth.”⁴³ The report clearly establishes the case against China; portraying them as a country that benefits from its WTO membership, but grudgingly abides by the requirements and implements mandated policy changes ordered by the WTO. Major points of contention within the report include Intellectual Property Rights, Barriers to Foreign Direct Investment (FDI) in Chinese corporations, China’s industrial policies, and China’s constrained service sector (specifically banking).⁴⁴

“Despite ongoing revisions of laws and regulations relating to intellectual property rights, and greater emphasis on rule of law and enforcement campaigns in China, key weaknesses remain in China’s protection and enforcement of intellectual property rights, particularly in the area of trade secrets. Intellectual property rights holders face not only a complex and uncertain enforcement environment, but also pressure to transfer intellectual property rights to enterprises in China through a number of government policies and practices.”⁴⁵ China’s lack of protection for and overt theft of trade secrets, pharmaceutical patents, software piracy, counterfeit goods, and overall protection of intellectual property rights has gained increased scrutiny amongst the WTO members in the last decade. This lack of protection for intellectual property rights and the Chinese government’s failure to enforce criminal laws regarding their theft has presented a significant barrier to open and gregarious flow of exports and investment between the U.S. and China.⁴⁶

“China seeks to protect many domestic industries through a restrictive investment regime, which adversely affects foreign investors in services sectors, such as financial

services, telecommunications services, Internet-related services, legal services and express delivery services, as well as in certain manufacturing industries and the agricultural sector. China can readily impose additional constraints on investment through its foreign investment approval processes, where Chinese government officials can use vaguely defined powers on an ad hoc basis to delay or restrict market entry. For example, foreign enterprises report that Chinese government officials may condition investment approval on a requirement that a foreign enterprise conduct research and development in China, transfer technology, satisfy performance requirements relating to exportation or the use of local content, or make valuable, deal-specific commercial concessions.”⁴⁷ The flow of FDI between the U.S. and China as well as China and all other nations is very one directional. In an attempt to prop up state owned enterprises and protect their existence, China has emplaced a significant obstacle belt and discretionary system which constricts significant international FDI into Chinese corporations.⁴⁸ China has benefited greatly from the U.S. allowing significant Chinese FDI in U.S. corporations, but there has been extremely limited reciprocation in the interest of China’s protection of their SOEs.

“China continued to pursue industrial policies in 2014 that seek to limit market access for imported goods, foreign manufacturers and foreign service suppliers, while offering substantial government guidance, resources and regulatory support to Chinese industries. The principal beneficiaries of these policies are state-owned enterprises, as well as other favored domestic companies attempting to move up the economic value chain.”⁴⁹ China seeks to gain any economic advantage possible regardless of the effects of its self-serving policies. Common policies implemented by the government include

export restraints in the forms of export quotas, minimum export prices, and export duties and restrictions. All of these policies benefited the Chinese coffers, but significantly increased the price of end products in the world market. It is not a coincidence that under such conditions, U.S. and other international corporations found it more financially practical to relocate their factories in China, allowing them to bypass the export policies effects on prices of manufactured goods.

According to the report, China's excess capacity has also been a detriment to international business as their manufacturing industry continues massive production regardless of supply and demand shifts. From 2000 to 2013, China accounted for more than 75 percent of global steelmaking capacity growth.⁵⁰ Currently China's capacity exceeds the combined steelmaking capacity of the European Union (EU), Japan, the United States, and Russia. As described in the report, "Excess capacity in China – whether in the steel industry or other industries like aluminum – hurts U.S. industries and workers not only because of direct exports from China to the United States, but because lower global prices and a glut of supply make it difficult for even the most competitive producers to remain viable."⁵¹

China's industrial sector is extremely disproportionate to its service sector. The service sector is one of the few where the U.S. continues to realize a surplus in trade with China.⁵² The service industry is one where the U.S. holds a significant advantage, but as the report states, "While China has implemented most of its services commitments, concerns remain in some service sectors. In addition, challenges still remain in ensuring the benefits of many of the commitments that China has nominally implemented are available in practice, as China has continued to maintain or erect restrictive or

cumbersome terms of entry or internal expansion in some sectors. These barriers, often imposed through non-transparent and lengthy licensing processes, prevent or discourage foreign suppliers from gaining market access through informal bans on entry, high capital requirements, branching restrictions or restrictions taking away previously acquired market access rights.”⁵³

The Congressional Research Services report titled “China’s Economic Rise: History, Trends, Challenges, and Implications for the United States” addressed the thesis sub-question: How can the Chinese economy affect U.S. national security? The report articulates China’s growing “soft power” it is building on the international stage causing concern that this soft power will begin to usurp U.S. power and influence.⁵⁴ “China’s emergence as major global economic and trading power has made it increasingly relevant in the global economy and this trend will likely continue as long as it continues to maintain rapid economic growth. China’s continued economic risk may lead it to seek a larger role in setting global trade rules and economic policies, which may not always coincide with U.S. goals.”⁵⁵ China has undertaken a number of initiatives that could boost its soft power around the world. For example:

1. In July 2014, China, along with Brazil, Russia, India, and South Africa, announced the creation of a \$100 billion “New Development Bank”, to be headquartered in Shanghai, China. The new bank would be aimed at assisting developing countries.
2. China’s announced plans in 2013 for a Silk Road Economic Belt and a 21st Century Maritime Silk Road (together, referred to as the “One Belt, One Road Initiative)

3. In October 2014, China launched the creation of a new \$100 billion Asian Infrastructure Development Bank (AIIB), reportedly to be headquartered in Beijing, aimed at funding infrastructure projects in Asia. Fifty-seven nations joined as founding members. U.S. officials have expressed concerns over the AIIB in terms of governance and environmental standards and it is unclear whether or not the United States will eventually join the AIIB.
4. In November 2014, China announced that it would contribute \$ 40 billion to a new Silk Road Fund designed to improve trade and transport links in Asia.
5. In April 2015, China announced that it would invest \$46 billion in infrastructure development in Pakistan.⁵⁶

As the report directly quotes, “China’s growing economic power has made it a critical and influential player on the global stage on a number of issues important to U.S. interests, such as global economic cooperation, climate change, nuclear proliferation, and North Korean aggression.”⁵⁷ There is obvious consideration by the author of the report of the strategic implications and considerations the U.S. must face in dealing with a growing Chinese economic influence.

Foreign Direct investment (FDI) into China was also addressed in the article as FDI has strongly contributed to China’s growth in the world economy. According to the United Nations, annual FDI flows into China grew from \$2 billion in 1985 to \$128 billion in 2014.⁵⁸ From a U.S. strategic standpoint, three of the top seven investing countries are allies of the U.S.: Japan, Taiwan, and South Korea.⁵⁹ The U.S. itself has historically been the fourth largest FDI provider to China since 1979.⁶⁰

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- ¹ Goodman and Parker.
- ² Ibid.
- ³ Ibid.
- ⁴ World Trade Organization, “WTO disputes,” updated 2016, accessed January 31, 2016, https://www.wto.org/english/tratop_e/dispu_e/find_dispu_cases_e.htm?year=none&subject=none&agreement=none&member1=USA&member2=CHN&complainant1=true&complainant2=false&respondent1=false&respondent2=true&thirdparty1=false&thirdparty2=false#results.
- ⁵ Goodman and Parker.
- ⁶ Ibid.
- ⁷ Ibid.
- ⁸ Ibid.
- ⁹ Rudd, Kevin, “China Under Xi Jinping: Alternative Futures for U.S.-China Relations,” October 1, 2014, accessed September 23, 2015, <http://csis.org/publication/china-under-xi-jinping>.
- ¹⁰ Investopedia, “Fiat Money,” last modified 2016, accessed April 2, 2016, <http://www.investopedia.com/terms/f/fiatmoney.asp>.
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- ¹² Sandra Kollen Ghizoni, “Establishment of the Bretton Woods System,” *Federal Reserve History*, last modified November 22, 2013, accessed April 2, 2016, <http://www.federalreservehistory.org/Events/DetailView/28>.
- ¹³ Ibid.
- ¹⁴ Ibid.
- ¹⁵ Susan V. Lawrence, *China’s Political Institutions and Leaders in Charts* (Washington, DC: Congressional Research Service, November 12, 2013), accessed October 30, 2015, <https://www.fas.org/sgp/crs/row/R43303.pdf>.
- ¹⁶ Ibid.
- ¹⁷ Ibid.

¹⁸ Ibid.

¹⁹ Ibid.

²⁰ Ibid.

²¹ Ibid.

²² Ibid.

²³ Ibid.

²⁴ Ibid.

²⁵ Shannon Tiezzi, “China’s National Security Commission Holds First Meeting,” *The Diplomat*, April 16, 2014, accessed November 4, 2015, <http://thediplomat.com/2014/04/chinas-national-security-commission-holds-first-meeting/>.

²⁶ State Council Information Office of the People’s Republic of China, “China’s Military Strategy 2015,” May 2015, accessed October 26, 2015, <https://news.usni.org/2015/05/26/document-chinas-military-strategy>.

²⁷ Barrack H. Obama, *The 2015 National Security Strategy* (Washington, DC: The White House, February 2015).

²⁸ Tom Donilon, “Remarks by National Security Advisor Tom Donilon--As Prepared for Delivery” (Remarks, Center for Strategic and International Studies, November 15, 2012), accessed April 24, 2016, <https://www.whitehouse.gov/the-press-office/2012/11/15/remarks-national-security-advisor-tom-donilon-prepared-delivery>.

²⁹ Ibid.

³⁰ Rudd

³¹ Ibid.

³² Ibid.

³³ Ibid.

³⁴ Ibid.

³⁵ Ibid.

³⁶ Ibid.

³⁷ Ibid.

³⁸ Ibid.

³⁹ Nargiza Salidjanova and Iacob Koch-Weser, *China's Economic Ties with ASEAN: A Country-by-Country Analysis* (U.S.-China Economic and Security Review Commission, March 17, 2015), accessed September 28, 2015, <http://origin.www.uscc.gov/sites/default/files/Research/China's%20Economic%20Ties%20with%20ASEAN.pdf>.

⁴⁰ Ibid.

⁴¹ Morrison, *China-U.S. Trade Issues*.

⁴² Ibid.

⁴³ United States Trade Representative, *2014 Report to Congress on China's WTO Compliance*, December 2014, accessed October 26, 2015, <https://ustr.gov/sites/default/files/2014-Report-to-Congress-Final.pdf>.

⁴⁴ Ibid.

⁴⁵ Ibid.

⁴⁶ Ibid.

⁴⁷ Ibid.

⁴⁸ Ibid.

⁴⁹ Ibid.

⁵⁰ Ibid.

⁵¹ Ibid.

⁵² World Trade Organization, "World Trade Organization Disputes."

⁵³ United States Trade Representative.

⁵⁴ Wayne M. Morrison, *China's Economic Rise: History, Trends, Challenges, and Implications for the United States* (Washington, DC: Congressional Research Service, October 21, 2015), accessed October 26, 2015, <https://www.fas.org/sgp/crs/row/RL33534.pdf>.

⁵⁵ Ibid.

⁵⁶ Ibid.

⁵⁷ Ibid.

⁵⁸ Ibid.

⁵⁹ World Trade Organization.

⁶⁰ Morrison, *China's Economic Rise: History, Trends, Challenges, and Implications for the United States*.

CHAPTER 3

METHODOLOGY

Purpose

The purpose of this thesis is to examine how U.S. economic and national security interests are affected by China's economy, and to determine to what extent China's economic stability affects the U.S. achieving its desired end state in SEA.

Secondary Research Questions

In order to answer the primary research question, the author has formulated four sub questions supporting the research. Answering these questions directly support answering the primary research question and sequentially frame the OE in a systems approach clarifying operational variables affecting the overall environment.

1. What effects does China have on the U.S. economy?
2. What are the primary economic interests the U.S. wishes to protect with relation to China?
3. What South East Asian allies' economic interests does the U.S. wish to protect with relation to China?

Research and Design Methodology

This thesis is founded on the strategic framework of the Army Design Methodology (ADM) in ATP 5-0.1 and the elements of national power taught at the U.S. National War College. From the methodology the author intends to frame the OE of SEA with respect to the Chinese and U.S. economies, and frame the problem the U.S. faces in moving from the current OE to the desired end state.

Elements of national power: Military, Information, Diplomacy, Legal, Infrastructure, Finance, and Economic (MIDLIFE) is a more modern examination of the elements of national power in today's current environment (as opposed to the more simplistic DIME model).

This study will directly reference many aspects with which the U.S. and China are attempting to exert power on one another. Of the forms of power listed in MIDLIFE, the focus of this thesis is the examination Economic, Legal, and Financial elements of national power.

ADM is comprised of the following steps:

1. Framing Operational Environments
2. Framing Problems
3. Framing Solutions
4. Assessment and Reframing

Framing and understanding the operational environment is the foundation of operational design. As ATP 5-0.1 states on PG 1-15, "There is no one-way prescribed set of steps to employ ADM. There are, however, several activities associated with ADM including framing an operational environment, framing problems, framing solutions, and reframing when necessary."¹ Framing is deliberately selecting, organizing, interpreting, and making sense of interrelated variables and relevant actors in an operational environment.² The entire structure of this thesis is to provide an accurate environmental frame the U.S. must consider in its foreign policy with respect to SEA.

"An OE is a composite of the conditions, circumstances, and influences that affect the employment of capabilities and influencing the decisions of the commander. An OE

includes physical areas (air, land, maritime, and space domains) and cyberspace. It also includes the information that shapes conditions in those areas and enemy, friendly, and neutral aspects relevant to operations. The OE is not isolated or independent but interconnected by various influences (for example, information and economics) from around the globe. No two OEs are the same.”³

It is not static but evolves and redefines itself in potentially unpredictable ways. This evolution results from humans interacting in an OE and from their ability to learn and adapt. The operational environment changes as people and organizations take action in the OE. Some of these changes are anticipated while others are not. Some changes are immediate and apparent while other changes are delayed or hidden. The complex and dynamic nature of an OE makes determining the relationship between cause and effect difficult and contributes to the uncertainty of military operations.⁴

The acronym RAFT (Relationships, Actors, Functions, and Tensions) is often used to facilitate a more comprehensive understanding of the major components affecting the OE. These individual components are networked through the process of systems thinking. Systems thinking is a process of understanding how parts of a system work and influence each other as part of a greater whole. It is an approach to problem solving that views problems as part of the greater system and that these problems are interrelated. By understanding components and problems in a system in relation with each other (as opposed to in isolation), problem solvers are better equipped to develop a holistic approach to solving or managing identified problems.⁵ Systems thinking is critical in framing an operational environment. RAFT must be considered in concert with the

operational variables: political, military, economic, social, information, infrastructure, physical environment, and time (PMESII-PT).

An environmental frame is the product of the OE framing process in ADM. The environmental frame describes and depicts the context of the OE—how the context developed (historical and cultural perspective), how the context currently exists (current conditions), and how the context could trend in the future (projected future conditions). The environmental frame also includes a description of what the OE should look like at the conclusion of an operation (desired end state conditions).⁶ Significant to the environmental frame is the consideration of the past and what shaped the operational environment to its current day state.

Mr. Tom Donilon, U.S. National Security Advisor to President Obama, gave remarks in 2012 specifically addressing the U.S. Design Methodology in the pivot to Asia. He identified and communicated the U.S. desired end state for South East Asia, and specific lines of effort the U.S. is undertaking to achieve that end state.

End State: “This objective stems from our long-term vision of Asia. We aspire to see a region where the rise of new powers occurs peacefully; where the freedom to access the sea, air, space, and cyberspace empowers vibrant commerce; where multinational forums help promote shared interests; and where citizens increasingly have the ability to influence their governments and universal human rights are upheld. This is the future we seek, in partnership with allies and friends.”⁷

U.S. Lines of Effort (LOE) in achieving the desired end state in South East Asia:

1. Strengthen and modernize U.S. security alliances across the region
2. Forge deeper partnerships with emerging powers

3. Engage more deeply in institutes-global and regional-in order to promote regional cooperation, the peaceful resolution of disputes, and adherence to human rights, and international law
4. Pursue a stable and constructive relationship with China
5. Advance the regions economic architecture⁸

Given the U.S. desired end state, and its LOEs, the thesis will attempt to synthesize information gathered during research in the following manner:

1. Actors: The United States, China, South Korea, Thailand, Philippines
2. Relationships: Interrelationship of economic ties between all countries and collective defense agreements (CDA) between the U.S. and its SEA allies
3. Functions: China's economic influence in SEA; and the U.S. intent to maintain economic influence, develop economic infrastructure, and foster stability in the region
4. Tensions: China's currency manipulation, the Asian Infrastructure Investment Bank (AIIB), China's WTO mandate compliance, and the Trans Pacific Partnership (TPP)
5. The operational variables focused on for the purpose of this thesis will be Political, Economic, and Infrastructure. Combining RAFT with select portions of PMESII-PT will produce an environmental frame which sufficiently informs the reader of historical, as well as current OE with respect to China's economic power in SEA, and how this variable affects the ability for the U.S. to achieve its desired end state in the region.

In conclusion, the environmental frame will lend itself to the framing of the problem dictated for the purposes of this thesis:

Proposed Problem Statement: Can the U.S. achieve its desired end-state in Southeast Asia without cooperation with China's economy given: a Chinese economy over-invested in industrial infrastructure and reliant on exports for revenue; U.S. SEA allies economic dependence on China; China's potential effects on the U.S. economy, and a Chinese perception that the U.S. is pursuing hegemonism and isolation strategies?

¹ U.S. Department of the Army, Army Training Publication 5-0.1, *Army Design Methodology* (Washington, DC: U.S. Department of the Army, July 2015).

² Ibid.

³ Ibid.

⁴ Ibid.

⁵ Ibid.

⁶ Ibid.

⁷ Donilon.

⁸ Ibid.

CHAPTER 4

ANALYSIS

Our approach is grounded in a simple proposition: the United States is a Pacific power whose interests are inextricably linked with Asia's economic, security and political order. America's success in the 21st century is tied to the success of Asia.¹

— Tom Donilon, U.S. National Security Advisor

The foundation for this study is to define significant U.S. economic interests that China is able to effect. "Interests are based on cultural or national values and historical experiences. The goal of a strategy is to advance or protect one's interests. Before developing any strategy one must clearly understand what is in one's interest, and of those interests, which are vital and which are secondary."² Interests of a nation are published in strategic documents are clearly defined (e.g. U.S. National Security Strategy). National interests fall into one of three categories:

1. Vital Interests: interests involve survival and safety issues that must be protected.
2. Important Interest: interests where survival is not the issue, but maintaining or improving the quality of life for a society is. Access to energy or markets, or regulation of international trade which promotes economic well-being could be important interests.
3. Peripheral Interests: interests are optional and are more often based on resources available and how they will affect important and vital interests.³

The U.S. interests affected by China are primarily important interests. It must be considered that important interests for the U.S. may very well be vital interests for its

allies. For the purposes of this thesis, the author has chosen to address the following interests the U.S. wishes to protect:

1. China's effects on the U.S. economy
2. Protection of U.S. economic interests
3. Protection of U.S. Allie's economic interests
4. Maintaining U.S. international economic influence

China's Effects on the U.S. Economy

Trade

The U.S. and China are indelibly linked economically and this is a stark reality of the OE. The U.S. has grown in its reliance on China to import cheap technology products, manufactured goods, and fund the government deficit through selling Treasury bonds to China. China has become strongly dependent on the U.S. for imports of agricultural products to feed their growing population. Both countries have steadily become more dependent upon one another behind the curtain while formally renouncing each other's economic policies on the world stage. Neither country is strictly reliant on the other for its economic welfare, but both countries can become a significant detriment to each other's prosperity if cooperation is not properly balanced.

Prior to China's economic rise in power, the U.S. trade balance with China was a \$2.7 billion surplus. In 2015, the U.S imported \$2.24 trillion and 21.5 percent of that total was represented by imports from China.⁴ The U.S. is the number one consumer of Chinese made goods in the world.⁵ The U.S. Trade Bureau reports that the U.S. real goods trade deficit with China was \$-366 billion in 2015.⁶ In contrast, the U.S. has historically maintained a service based export surplus with China of \$26.8 billion. Major

Chinese import categories by precedence in the U.S. were machinery and electric goods; capital goods; and consumer goods. In all of these categories, China delivers an average of 45 percent of these products to the U.S.⁷

A growing concern within the U.S. is the imbalance in Advanced Technology Products (ATP) the U.S. is importing from China. According to the U.S. Census Bureau, the following criteria differentiate ATPs from other product categories:

1. The code contains products whose technology is from a recognized high technology field (e.g., biotechnology).
2. These products represent leading edge technology in that field.⁸

These ATPs accounted for 33.1 percent of all U.S. imports from China in 2014 (\$154.6 billion). In 2003, ATP imports totaled \$29.3 billion. In comparison, in 2014, U.S. ATP exports to China totaled only \$30.8 billion.⁹ This growing ATP trade imbalance not only underscores the overall growth of the U.S. trade deficit with China, but also raises concerns among some experts that China is becoming a more competitive market for ATPs. Department of Defense programs are now realizing that many military weapon systems now have critical computer chips manufactured in China as major components of their hard wear. Historically, low value, low labor products comprised the bulk of Chinese exports to the U.S., but the ATP trade balance shift gives pause for consideration.

China has been a significant source of economic development for the U.S. China is the U.S.'s 3rd largest export market. In the past decade, China has become the fastest growing destination for U.S. growing 198 percent.¹⁰ According to the WTO, major U.S. exports in 2015 in order of precedence were manufactures (72 percent), fuels and mining

products (12 percent), and agricultural products (11 percent).¹¹ Forty-two states experienced at least triple-digit export growth to China since 2005; and in 2014, thirty-one states exported more than \$1 billion to China.¹² Below is a table representing the trade revenue realized by leading individual U.S. states.

Table 1. Top US State Exporters to China, 2014

	State	Exports	2005-2014 Growth
1.	Washington	\$15.3 billion	365%
2.	California	\$14.9 billion	93%
3.	Texas	\$10.3 billion	101%
4.	Illinois	\$6.0 billion	281%
5.	South Carolina	\$4.3 billion	622%
6.	Oregon	\$4.0 billion	424%
7.	New York	\$3.9 billion	92%
8.	Michigan	\$3.9 billion	425%
9.	Ohio	\$3.9 billion	252%
10.	Minnesota	\$3.2 billion	235%
11.	Georgia	\$3.2 billion	193%
12.	Alabama	\$3.0 billion	579%
13.	Iowa	\$2.9 billion	391%
14.	North Carolina	\$2.7 billion	222%
15.	Indiana	\$2.6 billion	329%

Source: US-China Business Council, *US State Exports to China (2005-2014)* (2015), accessed February 14, 2016, https://www.uschina.org/sites/default/files/USCBC%20State%20Export%20Report%202015_0.pdf.

The U.S. has also become the largest international provider of agricultural imports for China. In 2015, the U.S. exported \$170 billion of agricultural products to China.¹³ As stated in a 2015 United States Department of Agriculture report, “The United States accounted for over 24 percent of the value of China’s agricultural imports during 2012-13, a larger share than any other country. U.S. agricultural sales to China doubled from

2008 to 2012, reaching nearly \$26 billion in annual sales. China has overtaken Japan, Mexico, and Canada to become the leading export market for U.S. agricultural products.”¹⁴ This is not a surprise given the size of the Chinese population and their emphasis on industrial capacity. Some estimates indicate China’s middle class in 2022 may include up to 630 million households.¹⁵ This information confirms recent reports that 20 percent of China’s arable land, 60 percent of underground water, and 33 percent of surface water are now polluted.¹⁶ China faces a significant challenge in feeding its growing population with the current environmental conditions and limited cultivatable land.

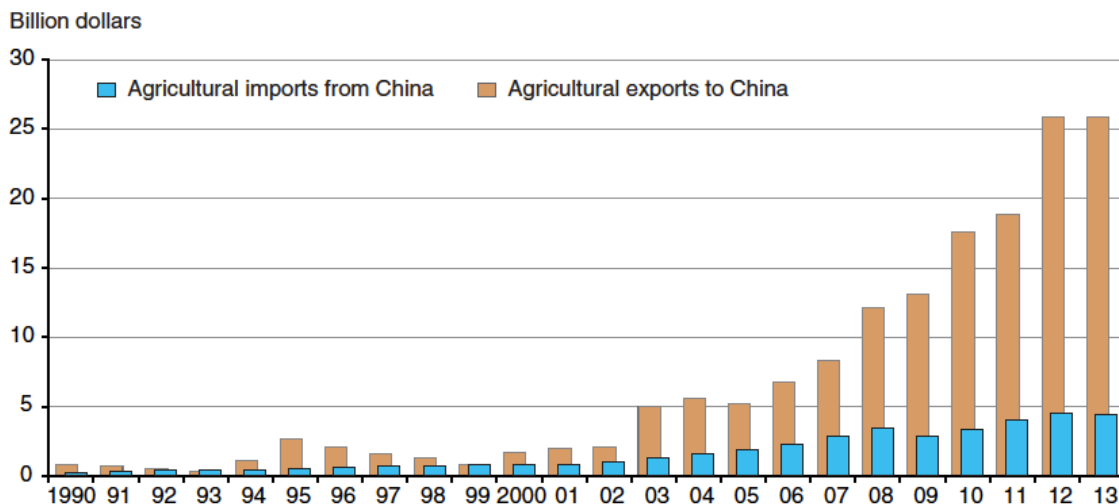


Figure 3. U.S. Agricultural Trade with China: 1990-2013

Source: Fred Gale, James Hansen, and Michael Jewison, *China’s Growing Demand for Agricultural Imports* (Washington, DC: Department of Agriculture, February 2015), accessed February 14, 2016, <http://www.ers.usda.gov/media/1784488/eib136.pdf>.

It is evident that China is becoming more dependent upon the U.S. for agricultural and food stock exports, and this demand has contributed to significant growth in the U.S. agricultural industry and state commerce. If China were to decrease this demand in a precipitous fashion, the impacts would be felt across the U.S. as excess capacity would quickly build. The second order effect would be decreased production of agricultural and manufactured goods at individual state levels, contributing to increased prices and fewer jobs nationwide.

Foreign Direct Investment

Foreign Direct Investment between the U.S. and China must be considered when addressing the significant links between the two economies. The U.S. Treasury has estimated that 70 percent of China's total holdings of U.S. securities are Treasury securities.¹⁷ China has invested an estimated \$1.8 trillion in U.S. and private securities as of 2014.¹⁸ This amount has grown so considerably that the U.S. National Defense Authorization Act of 2012 included a provision in the attached conference report that required the Secretary of Defense, Hon. Robert Gates, to assess the potential threat to national security represented by the vast amount Chinese owned Treasury securities. "Noting the strategic challenges associated with a rising China, the Conference Report takes concrete steps to ensure that the United States is fully prepared to defend our vital interests against an emerging competitor. The bill requires the Secretary of Defense, in consultation with other key departments and agencies, to assess the threat posed by the amount of US national debt held by China"¹⁹ This assessment was initiated due to concerns that China might attempt to sell large shares of U.S. debt securities as a coercive or punitive action in retaliation for policy disagreements with the U.S. The report stated,

“Attempting to use U.S. Treasury securities as a coercive tool would have limited effect and likely would do more harm to China than to the U.S. As the threat is not credible and the effect would be limited even if carried out, it does not offer China deterrence options, whether in diplomatic, military, or economic realms and this would remain true both in peacetime and in scenarios of crisis or war.”²⁰

Regardless of study results or differing opinions on China’s holdings of U.S. Treasury securities, this issue is a liability. The potential leverage it provides China in influencing U.S. security is what is debated, not whether this debt is truly a risk which undermines U.S. policy or goals. The U.S. is in significant debt to its greatest economic competitor.

Protection of U.S. Economic Interests

Evidence of China and U.S. competition for economic influence is portrayed in tensions in the OE as a result of competing interests in economic policy. The author has chosen to focus only on the most salient economic/political tensions.

1. Currency manipulation
2. China’s non-compliance with WTO regulations
3. The Asian Infrastructure and Investment Banks (AIIB)
4. The Trans Pacific Partnership treaty (TPP)

China’s Currency Manipulation

In order to understand the other major frictions identified in this paper, China’s currency manipulation must be fully acknowledged as it effects the foundation of all bi-lateral Chinese and U.S. transactions as. In order to understand the foundation of

currency manipulation, a brief overview of monetary policy was addressed in chapter two in order to build on the readers understanding of historical monetary theory and today's critical issues.

In 1969, in recognition of the fragility of the Bretton Woods System, the Special Drawing Rights (SDR) system was created as a supplementary international reserve system. Today, the SDR system is used to value currencies internationally due to recognition that reliance on the U.S. to manage a currency valuation system backing the dollar with gold would be inadequate to facilitate international trade and transactions.²¹ The IMF website best explains the SDR as, "Neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. Holders of SDRs can obtain these currencies in exchange for their SDRs in two ways: first, through the arrangement of voluntary exchanges between members; and second, by the IMF designating members with strong external positions to purchase SDRs from members with weak external positions. In addition to its role as a supplementary reserve asset, the SDR serves as the unit of account of the IMF and some other international organizations."²² Today's SDR valuation and exchange rates are based on a basket of currencies: the U.S. Dollar, Japanese Yen, Euro, and Pound Sterling.²³ The IMF has decided to include the Chinese Yuan into this basket of currencies beginning October 1, 2016.²⁴

An IMF review of the weighting formula for currencies was adopted by the Executive Council in 2015 and currency valuation is now based on the following:

1. The value of the issuers' exports
2. The amount of national reserves held (in that nations currency)

3. Foreign exchange turnover

4. International bank liabilities and international debt securities (foreign debt)

It is important to note weights one, two, and four are continual data points assessed referenced with regard to the U.S. and China throughout the thesis. The respective proportionality of value determination of currency as a percent are the U.S. Dollar (41.73), Euro (30.93), Japanese Yen (10.92), and Pound Sterling (8.33).²⁵ Based on these weights, SDR allocations are determined every five years by the IMF and countries manage the supply and demand of their currency through the buying and selling of SDR allocations.

SDRs are essentially legal rights to create money. The SDR system is the regulatory system in place to attempt to ensure that countries do not create more money than they have assets and economic productivity to support. If this were to happen, the extreme devaluation of a nations currency would render it useless to holders of that currency; creating defaults and leading to economic turmoil internationally. In simplistic terms, the IMF is the bank which consumers (IMF members) maintain a checking account with. Checks are supplied to that consumer and act as debt instruments to make payments on goods and services. The bank supplies loans (SDRs) which create money outside of their normal income streams to the consumer (country) based on their checking account holdings (national reserves), debt to income ratio (International bank liabilities and international debt securities), and their income (The value of the issuers' exports).

Currency manipulation, also known as foreign exchange intervention, is “a monetary policy tool in which a central bank takes an active participatory role in influencing the monetary funds transfer rate of the national currency. Central banks,

especially those in developing countries, intervene in the foreign exchange market in order to build reserves, stabilize the exchange rate and to correct misalignments. The success of foreign exchange intervention depends on how the central bank sterilizes the impact of its interventions, as well as general macroeconomic policies set by the government.”²⁶ Currency Manipulation takes place in sterilized or non-sterilized transactions. Sterilized transactions do not significantly affect the monetary base or supply of a certain currency where non-sterilized transactions create noticeable changes to the supply of other currencies.²⁷ A simple example of sterilized currency manipulation is when a country A buys country B’s bonds in country B’s currency, creating an increase in the supply of country B’s currency on the market. In order to offset the change to the monetary base, country A purchases some of their own treasury bonds simultaneously with country A’s currency in order to create the same increase in supply of their domestic currency. For example, if China buys U.S. Treasury bonds, they increase the amount of U.S. Dollars in circulation as China receives the bond and the U.S. creates money to inject into the open market. This increase in supply of dollars (in the most simplistic terms) lowers demand and the value of the dollar. In order to maintain a similar exchange rate and sterilize their manipulation, China must then buy Chinese bonds in Yuan near the same value as the dollars they effectively created with the purchase of U.S. Treasury Bonds. If China only buys/sells U.S. Treasury bonds and does not buy/sell their own to offset changing the supply of the monetary base, these actions are considered non-sterilized.

China, a communist nation, maintains economic control as one of its top priorities and utilizes currency manipulation as a tool to facilitate this control. China joined the

IMF in 1945, but given that the Yuan is not part of the basket of currencies, it has had greater ability to manipulate its currency to create a competitive price advantage for Chinese exports. Whereas the IMF legitimately creates a tool via SDRs to increase and decrease the supply of money in the international market for the U.S. Treasury, China's currency manipulation has been an aggressive and non-sterilized plan of action for the previous two decades. As outlined previously, China manipulates the Yuan dollar exchange rate through the purchase and sale of U.S. Treasury Bonds and the conversion of Yuan to dollars from export proceeds out of its national reserves on the open market. The effects on the monetary supply of these actions are compounded by the significant trade imbalance between the U.S. and China as well as China's reliance on exports for revenue and desire to maintain price competitive goods.

China has consistently based its currency valuation primarily on the U.S. dollar as the U.S. is its greatest economic competitor and holds the majority of weight in the IMF currency basket. From 1994 to July 2005, China maintained a fixed exchange rate of 8.28 Yuan to the dollar.²⁸ This exchange rate was void of free market influence and maintained by China through the buying and selling of U.S. securities to adjust the supply of Yuan in circulation. In 2005, China responded to political pressure by adjusting the exchange rate from 8.28 to 8.11 Yuan per dollar, and allowing the Yuan to become more "adjustable, based on market supply and demand with reference to exchange rate movements of currencies in a basket" within a band of .5 percent relative to the dollar.²⁹ The basket of currencies China uses to value the Yuan is not the same as the IMF basket of currencies, and the specific currencies comprising this Chinese hybrid valuation system is internal to Chinese policies and not disclosed to date. Following the

announcement of loosening the peg to the U.S. dollar, the Yuan exchange rate adjusted from 8.11 to 6.82 Yuan per dollar by 2008; an appreciation of 18.7 percent. In 2008, the global financial crisis emerged and China intervened through currency manipulation holding the exchange rate at 6.83 Yuan per dollar constant through 2010. Finally, in 2010, the PBC again relented to market influence on the Yuan and today's exchange rate now lies at 6.48 Yuan per dollar.³⁰

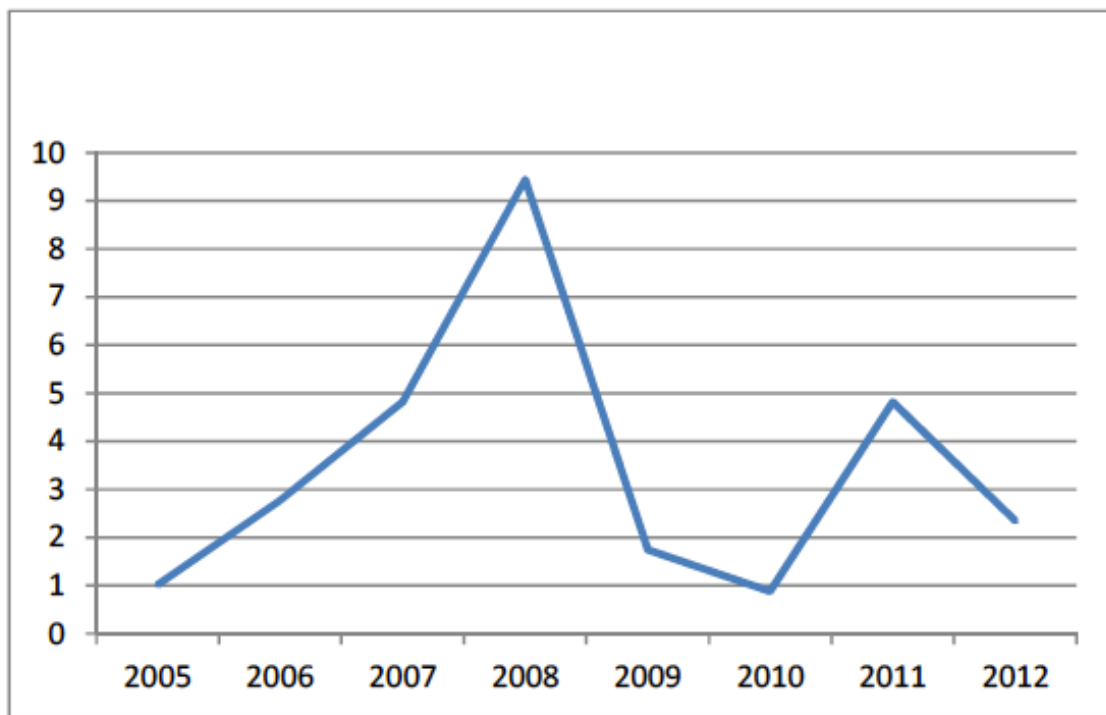


Figure 4. Annual Percent Change in the Yuan/Dollar Exchange Rate:
2005 to 2012 (percent)

Source: Wayne M. Morrison and Marc Labonte, *China's Currency Policy: An Analysis of the Economic Issues* (Washington, DC: Congressional Research Service, July 22, 2013), accessed April 2, 2016, <https://www.fas.org/sgp/crs/row/RS21625.pdf>.

Many analysts believe that China's motivation to hold down the value of the Yuan is reflected in its amassing of significant foreign exchange reserves and the largest holding of U.S. Treasury Securities of any nation. Foreign exchange reserves are U.S. dollar assets held in reserve by the PBOC to back its liabilities. Reflective of the discussion about U.S. held debt, China is currently the world's largest holder of foreign exchange reserves. In 2001, China had \$212 billion and as of 2012 they held \$3.3 trillion.³¹

Some experts contend that large increases in China's foreign reserves reflect significant currency intervention in an effort to marginalize the value of the Yuan³² According to economist Joseph Gagnon, a country's current account balance increases between 60 and 100 cents for each dollar spent on currency intervention.³³ If Gagnon is correct with his assessment, Figure 5 indicates a significant effort on behalf of China to manipulate the Yuan from 2004-2008 and is further corroborated by the historical overview of the pegging of the Yuan to the dollar during the same period.

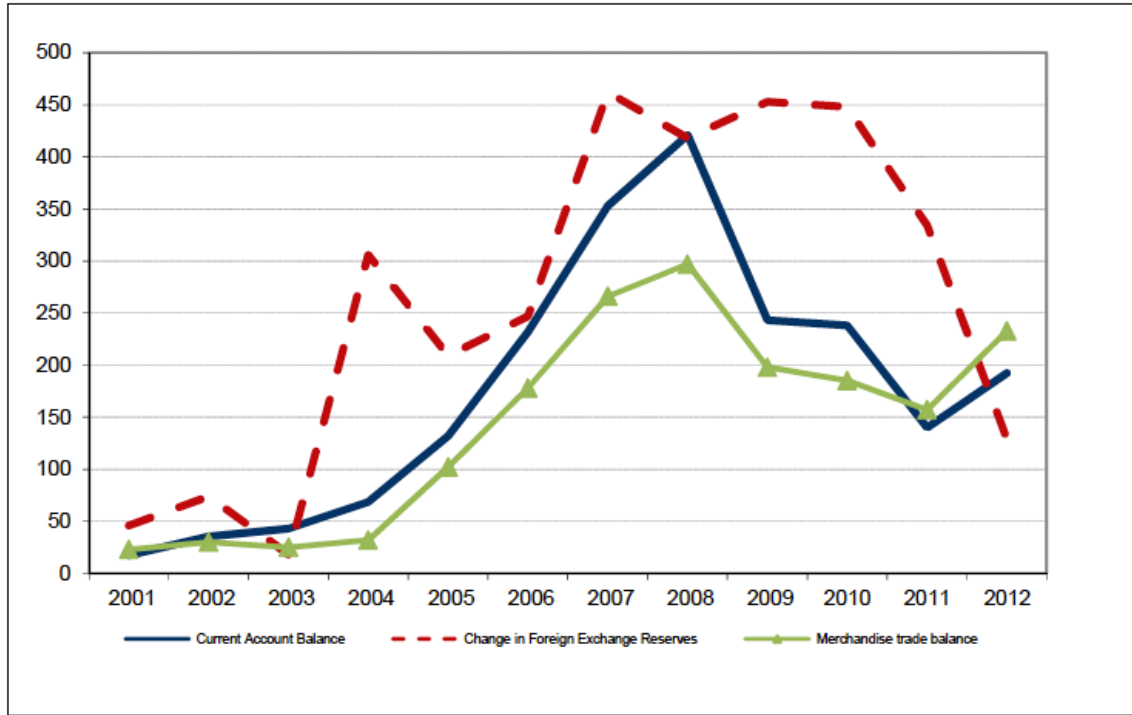


Figure 5. China's Current Account Balance, Merchandise Trade Balance, and Annual Change in Foreign Exchange Reserves: 2001-2012 (billions)

Source: Wayne M. Morrison and Marc Labonte, *China's Currency Policy: An Analysis of the Economic Issues* (Washington, DC: Congressional Research Service, July 22, 2013), accessed April 2, 2016, <https://www.fas.org/sgp/crs/row/RS21625.pdf>.

Understanding China's currency manipulation is not complete without acknowledging the assessed impacts this manipulation has on both the U.S. and Chinese economies. China wants to maintain competitive advantages in export prices, but how does currency manipulation affect the U.S. Labor market and manufacturing industry? What is the effect on Chinese civilians having an undervalued currency with respect to purchasing power? Essentially, what is the so what?

Traditionally, emerging economic powers have utilized currency manipulation to maintain a competitive advantage to foster growth. This is not a new phenomenon created

by the Chinese, but the style in which they execute this manipulation in a non-sterilized and aggressive manner has significant implications on the U.S. economy. As popularity of Chinese goods and the cost of doing business in China grows, less revenue is invested in corporate business and manufacturing of goods in the continental U.S. If an average consumer can go and purchase 1 items of good X at a local convenience store for \$1, but can purchase 1.5 items for the same \$1 at a competing grocery mart, natural inclination is to shop at the location where more is purchased for the same price. The cost incentives due to currency manipulation for doing business, purchasing, and manufacturing goods overseas in China is driving the growing trade deficit the between the U.S. and China today. One study estimates that a total of 2.7 million American jobs (primarily in manufacturing) were lost between 2001 and 2011 due to business shifting to China due to lower costs influenced by an undervalued Chinese Yuan.³⁴ Fred Bergsten from the Peterson Institute of International Economics argues that in 2010 if the Yuan was allowed to appreciate based on market influence and not manipulated, the U.S. government deficit would be lowered by up to \$150 billion.³⁵

Regardless of differing opinions, the following U.S. economic factors would be directly affected due to the appreciation of a Yuan in response to free market principles:.

1. Effects on the U.S. Export / Trade Balance
2. Effects on the U.S. Consumer
3. Effects on U.S. Borrowing

By maintaining an undervalued Yuan, China maintains demand for its exports to the U.S. The Chinese consumer inversely pays a much higher price for U.S. made goods. If the Yuan were to appreciate, U.S. exports to China would become less costly and the

demand for American goods would grow within China. Conversely, Chinese goods imported to the U.S. would become more costly and demand for these goods would shrink. This would effectively reverse the trend of a growing U.S. negative trade balance with China. U.S. based manufacturing firms would grow in size over the long term as would jobs and revenue generated from their operations. Corporations which once found it beneficial to outsource production of component systems to China would find the cost advantage no longer relevant, and return their operations, along with capital investment, jobs, and facilities back to U.S. shores.

U.S. Consumers would also be affected by the Yuan's appreciation. Goods manufactured in China are inherently cheaper to produce, and therefore provided to the average American consumer at a cheaper price. If and when the Yuan appreciates, the purchasing power of the American consumer's dollar with respect to Chinese goods is decreased. The full price change effect may not fall directly on the consumer but will inevitably be absorbed along the path by Chinese laborers, manufacturers, and corporations within the chain of production of those goods.³⁶ Regardless of the distribution of these cost changes, when an American citizen is faced with increased cost of goods and lowered purchasing power, they will decide to decrease their demand for that good, or sacrifice spending their money in other economic conduits to compensate for the increased cost of such Chinese goods. These consumer behavior changes would not be felt immediately, but the trickle down effect of free market forces would ultimately be measureable and significant.

Lastly, an appreciation of the Yuan would make it more expensive to borrow money by indirectly increasing interest rates in the U.S. Recall that China is the largest

holder of U.S. Treasury Securities in the world with an estimated \$1.4 trillion.³⁷ Through the government budgeting process, funding for capital investments and infrastructure are appropriated and this revenue eventually flows into the U.S. corporate and private economy.³⁸ China's indirect capital investment into the U.S. economy decreases interest rates by increasing the supply of money; incentivizing U.S. corporations and businesses to borrow more money for capital investment. Private consumers also benefit from lower interest rates as it is easier to purchase a car, home, or take out loans to purchase other durable goods within the economy. Should the Yuan appreciate, China's investment revenue would decrease as the need or desire to manipulate currency would be lessened. The slowing of the Chinese investment could drive interest rates upwards decreasing corporate and consumer spending, and making it more costly to fund economic development projects and growth.

In summary, China's monetary policies and currency manipulation directly affect every facet of the economic interaction with the U.S. The foundation of commerce is the purchase and sale of goods with a value instrument. Every economic consideration between the U.S. and China are effected by this issue and should be evaluated based on the effects of an undervalued Chinese Yuan and the implications of its appreciation.

China's Non-Compliance with WTO Regulations

China became a member of the WTO on December 11, 2001. In the beginning of their membership, China was open to policy change and compliance with WTO mandates, but this effort on their behalf has consistently degraded and remains passive at best today. Since joining the WTO, China has been the direct respondent to 34 official WTO disputes and 129 disputes as a third party member.³⁹ China's compliance with

WTO mandates has become such a significant issue that the U.S. Trade Representative publishes an annual report to congress on China's WTO compliance. The scope of these violations is far to large for this paper, so the author has chosen to focus on three of the most significant issues the U.S. is contesting with China in the WTO:

1. Export Regulation
2. Foreign Bank Access
3. Translation of Trade Laws

Export Regulation

China engages in voluntary export restraint processes to provide additional competitive advantages to its domestic economy and production. A voluntary export restraint (VER) is "a trade restriction on the quantity of a good that an exporting country is allowed to export to another country. This limit is self-imposed by the exporting country. Typically, VERs are a result of requests made by the importing country to provide a measure of protection for its domestic businesses that produce substitute goods. VERs are often created because the exporting countries would prefer to impose their own restrictions than risk sustaining worse terms from tariffs and/or quotas."⁴⁰ China utilizes export restraints through imposing inflated duties or taxes on critical components of end processes, or restricting their exportation quantities to increase the price internationally for purchase of such goods. Specific examples of such products include the raw material coke, which is a critical component of steel manufacturing, as well as rare earth metals (REM), which China owns a preponderance of in the world. The goal of VERs and duties associated with these actions is to ultimately maintain a cost advantage for domestic manufacturing processes. Allowing domestic corporations the ability to produce goods at

a lower cost also incentivizes international corporations to headquarter their operations in the Chinese economy and avoid the cost increases of exporting raw materials overseas.

China's membership in the WTO obligates them to cease export restraints as articulated in Article XI of the GATT 1994.⁴¹ This provision does not ban duties or taxes on those exports, but Article VIII only permits duties and taxes which are reasonable in providing the material or service, and excludes duties and taxes which are created to protect and or incentivize the purchase of domestic goods.⁴²

There are 17 REMs, and they are distributed unevenly throughout the world. According to reports, China produces 97.4 percent of the worlds REM, and its borders contain 50 percent of the world's REM reserves.⁴³ This monopoly on the supply of REMs creates a critical advantage to Chinese manufacturers if China continues its blatant export restrictions while inflating the price of these metals to the international community.

Countries	World Percent	Reserves (in tons)
China	50%	55,000,000
Commonwealth of Independent States	17%	19,000,000
United States	11.8%	13,000,000
India	2.8%	3,100,000
Australia	1.45%	1,600,000
Brazil	.44%	48,000
Malaysia	.27%	30,000
Other	20%	22,000,000
TOTAL	100%	110,000,000

Table 2. Estimated World REM Reserves as of January, 2011

Source: Christopher Blakely et al., *Rare Earth Metals and China* (Gerald. R. Ford School of Public Policy, September 2012), accessed April 6, 2016, <http://sites.fordschool>.

umich.edu/china-policy/files/2012/09/Rare-Earth-Metals-China.pdf.

Rare earth metals (REM) export restraints are a critical issue China has been challenged on in the WTO. In March 2012, the U.S., EU, and Japan filed a WTO dispute against China (DS 431) for their manipulation of export restraints of specific rare earth metals tungsten and molybdenum.⁴⁴ In March 2014, the WTO panel found China guilty of voluntary export restraint measures on these metals, and ordered their removal by 2015.⁴⁵ Tungsten and Molybdenum are critical metals used in the production of hybrid car batteries, steel, electronics, automobiles, petroleum and chemicals.⁴⁶

A more specific example of the economic impacts of China's export restraints can be evaluated through the material coke. Coke is a high carbon fuel derived from coal utilized in the production of steel. From 2000 to 2013, China accounted for 75 percent of global steel making capacity.⁴⁷ As of 2014, China's steel production capacity was more than the EU, Japan, the United States, and Russia combined.⁴⁸ In 2009, the U.S. and EU filed a WTO case against China for export restraints and duties on coke among other key raw materials (DS 394).⁴⁹ In 2008 China produced 336 million metric tons (MT) of coke, but only exported 12 million MT while adding on a 40 percent duty to the export of coke.⁵⁰ As a result, the world price for coke was \$740 per MT of coke while China's was \$472 per MT.⁵¹ This price discrepancy created by the export restraint and inflated duty of coke created a significant price advantage for Chinese made steel, and resultantly, demand for Chinese made steel and components drastically increased.

China maintains a significant advantage over the world economy due to its monopoly on materials such as REMs and coke. These are merely two examples of materials that China attempts to manipulate the price on via export controls and duties.

China's accession into the WTO obligates them to cease their practices of these actions, but they continue to deviate from the WTO mandates in order to gain and maintain a competitive price advantage in the international marketplace. China's persistence in such activities and disregard for WTO mandates continues to be protested by the U.S. and other members through the formal dispute process. China's submission to these challenges and change of behavior remains minimal at best.

Foreign Bank Access

The Peoples Bank of China (PBOC) is entirely run and directed by the CPC. China's control over its banking operations clearly mirrors its communist agenda and directive government. This control poses a challenge to China as it attempts to comply with WTO requirements of openness to foreign bank access. The trickle down effect of China's strict control of the PBOC is that without that control, the CPC lacks the ability to favor SOEs over private businesses; manipulate and regulate exchange rates; and ultimately balance the demands of an economy overly reliant on exports as a source of revenue. Currently the CCP is countering this unbalance through federal infusion of funds from its quickly shrinking federal reserves. China's actions regarding banking regulation thus far established precedence upon which the U.S. strongly opposed China's creation of the Asian Infrastructure and Investment Bank (AIIB), which will be discussed in a later section.

China agreed upon assessment into the WTO that it would allow foreign banks to begin conducting foreign currency business without governmental restrictions or denied access to specific markets.⁵² Under the five-year plan, China agreed foreign banks would be allowed to conduct domestic currency business with Chinese enterprises within two

years, and Chinese enterprises as well as individuals within five years.⁵³ This initial intent was acceptable in the eyes of the WTO, but its execution has been far less than promised. In 2006, the State Council issued the Regulations for the Administration of Foreign-funded banks.⁵⁴ These regulations effecting foreign-funded banks negated China's initial promise of a five-year implementation plan. It imposed the following restrictions for international bank incorporation:

1. Only foreign-funded banks that had a representative office in China for two years prior to the regulations acceptance would be allowed to apply for incorporation
2. Equity holdings of Chinese state owned banks held by foreign banks is capped at 20 percent
3. Foreign-funded banks were required to have assets exceeding \$10 billion to incorporate in China
4. Foreign-funded banks would only be eligible to offer domestic currency services to Chinese individuals if that bank could demonstrate a three-year operational history with two consecutive years of profit
5. Foreign-funded banks would be prohibited from taking Yuan deposits of \$164,000 from any Chinese individual
6. Foreign-funded banks were prohibited from issuing Yuan credit or debit cards to Chinese enterprises or individuals⁵⁵

In response to these extreme regulations, the U.S. and other nations engaged China on the impracticality of such rules and effectual blocking of foreign bank operations. China committed to allowing incorporated banks to issue Yuan credit and

debit cards to Chinese enterprises and individuals, but with stipulation that the data processing centers for these cards would be moved onshore to the China mainland.⁵⁶ In 2011, with continued pressure, China also agreed to allow incorporated foreign banks to underwrite corporate bonds if they met “relevant prudential requirements.”⁵⁷ A large number of banks applied for incorporation, but after China’s interbank bond market oversight body reviewed all applications, only one foreign bank was approved to underwrite.⁵⁸

Favoritism for SOE business development (specifically business development loans); exchange rate manipulation and controlling the supply of Yuan; and overall control of investment and direction of the economy are all motivators for China to not allow foreign-funded banks to establish a footprint within the country. China continues to make promises that seem to appease the WTO members when engaged on banking issues, but contradict every promise with new regulations and requirements undermining the WTO intent.

Transparency Through Translation

As of 2014, China continues to obfuscate the WTO’s oversight by not providing translations of its trade laws in one or more of the WTO languages required (English, French, or Spanish). This lack of transparency is the essence of Chinese attempts to emplace obstacles at every turn for WTO mandate enforcement. According to the 2014 USTR Report to Congress, China agreed when accepted into the WTO to provide translation of all of its trade laws, regulations, and other measures affecting trade in goods, services or the control of foreign exchange into a common language.⁵⁹ China agreed to provide translations of all new laws and regulations prior to their enforcement

or no more than 90 days past their enactment.⁶⁰ After 14 years membership, China still is not honoring its obligation for translation and further complicating common understanding of all WTO members.

Since China's acceptance into the WTO, the U.S. has directly filed 17 cases against the Chinese government. These cases are not including others, which the U.S. has been a secondary party to with respect to China. The U.S. continues to pressure China via WTO case disputes and the annual U.S.-China Strategic and Economic Dialogue Meetings (SED) to comply with WTO mandates and act as a responsible and fair partner within the international market. China continuously promises to take actions to further align themselves with WTO policies, but regularly under-delivers on those promises. China's acceptance as a WTO member obligates them to abide by the regulations of the organization, but thus far, China's disingenuous efforts to honor their responsibility exacerbates a historical tension point affecting not only the U.S., but the rest of the WTO members as well.

Asian Infrastructure and Investment Bank (AIIB)

The AIIB has been the most dominant economic tension point between the U.S. and China in the last year. Chinese President Xi Jinping and Premier Li Keqiang proposed the bank at the Asian Pacific Economic Cooperation (APEC) summit in October 2013. The U.S. has been staunchly against allied nations and other East Asian countries supporting the bank given China's leadership in its establishment and questionable banking practices highlighted in the WTO section of this paper.

The AIIB is "a multilateral development bank (MDB) conceived for the 21st century. Through a participatory process, its founding members are developing its core

philosophy, principles, policies, value system, and operating platform. The Bank's foundation is built on the lessons of experience of existing MDBs and the private sector. Its modus operandi will be lean, clean and green: lean, with a small efficient management team and highly skilled staff; clean, an ethical organization with zero tolerance for corruption; and green, an institution built on respect for the environment. The AIIB will put in place strong policies on governance, accountability, financial, procurement and environmental and social frameworks.”⁶¹

The focus of the AIIB is “on the development of infrastructure and other productive sectors in Asia, including energy and power, transportation and telecommunications, rural infrastructure and agriculture development, water supply and sanitation, environmental protection, urban development and logistics, etc. The operational strategy and priority areas of engagement may be revised or further refined by its governing boards in the future as circumstances may warrant.”⁶² Essentially, the AIIB will focus a majority of its efforts on infrastructure development in Asia facilitating international financial cooperation to do so.

Today, the AIIB consists of 57 founding members including U.S. allies Australia, Korea, The Philippines, Thailand, the United Kingdom, France, Germany, and Italy.⁶³ Its financial structure authorization is \$100 billion and China holds an investment stake of \$29.78 billion (30.34 percent).⁶⁴ With such a significant share holding through capital investment, China has pledged to not exercise veto power in the current agreement, and that it would rather not hinder the infrastructure advancements the AIIB will bring to Asia.⁶⁵ The bank will be headquartered in Beijing, China and is presided over by the AIIB President Mr. Jin Liqun of China. He was appointed in January 16, 2016 and will

hold his position for a five-year term.⁶⁶ Five vice presidents were confirmed on February 5, 2016:

1. Sir Danny Alexander (UK): Vice President Corporate Secretary
2. Dr. Kyttack Hong (Korea): Vice President, Chief Risk Officer
3. Dr. D.J. Pandian (India): Vice President, Chief Investment Officer
4. Dr. Joachim von Amsberg (XX): Vice President, Policy and Strategy
5. Dr. Luky Eko Wuryanto (Indonesia): Vice President, Chief Administration Officer⁶⁷

Beneath the President and Vice Presidents, each country has members who sit on the Boards of Governors and Directors and represent the differing interests of every member country.⁶⁸

The U.S. has strongly advocated against its allies from joining the AIIB, but that foreboding has fallen on deaf ears as the UK, France, Germany, and Italy became major shareholders. The U.S. National Security Council responded by stating, “Our position on the AIIB remains clear and consistent . . . We believe any new multilateral institution should incorporate the high standards of the World Bank and the regional development banks. Based on many discussions, we have concerns about whether the AIIB will meet these high standards, particularly related to governance, and environmental and social safeguards”⁶⁹ In essence, the U.S. expects the same behavior exhibited by China in its practices with national banking, currency manipulation, and dealing with the IMF and WTO to continue despite grandiose promises of cooperation, partnership, and compliance in the oversight of the AIIB. China’s track record of not adhering to its WTO banking

obligations gives the U.S. credible reason to be concerned about its conduct founding, institutionalizing, supervising, and largely funding a new powerhouse bank in Asia.

China has great motivation in establishing the AIIB. As per bylaws, seventy percent of the bank's investment must come from Asia and this investment from Asian countries will directly feed into China's plans of global distribution channels in its Silk Road Economic Belt linking to Europe; as well as the 21st Century Maritime Silk Road further connecting China with SEA, the Middle East, and Europe.⁷⁰ China also is also tired of the disproportionate voting rights represented in the IMF. China represents twelve percent of the world's economy, yet maintains only a 3.81 percent voting share in IMF proceedings.⁷¹ Today, the U.S. and 15 developed nations hold 52 percent of the voting power in the IMF.⁷² China demands that its economic size and power be respected on the international market, and they are utilizing the AIIB to ensure that position is recognized.

The reader must recall that the IMF and WTO were both products of the Bretton Woods System and founded around U.S. leadership and currency value regulation. Many contend the AIIB is a counter to the U.S. dominated Bretton Woods System. China contends that the IMF and World Bank are no longer able to provide the capital necessary for a rapidly developing Asia, and that the AIIB was created purely for that purpose. Regardless of the underlying reasons, the naked reality is that the AIIB is yet another shrouded contest of economic dominance between the U.S. and China. Positional power and influence are the key factors in the contest between the two countries, and the AIIB along with its support from many U.S. allies is a decisive strategic and economic victory for China.

The Trans-Pacific Partnership (TPP)

The Asia-Pacific Economic Cooperation (APEC) is a conglomerate of 21 member countries surrounding the Pacific Rim and was founded in 1989. APEC's mission is to “to leverage the growing interdependence of the Asia-Pacific; create greater prosperity for the people of the region by promoting balanced, inclusive, sustainable, innovative and secure growth and by accelerating regional economic integration. APEC ensures that goods, services, investment and people move easily across borders. Members facilitate this trade through faster customs procedures at borders; more favorable business climates behind the border; and aligning regulations and standards across the region”⁷³ Through APEC's pursuits of expanding trade within the Pacific region, Free Trade Agreements (FTA) have been signed between individual countries and groups of countries in alignment with that mission. Today, two large emerging FTAs again have the U.S. and China at odds. The U.S. is leading the efforts of the Trans-Pacific Partnership (TPP) while China is the leading advocate for the Regional Comprehensive Economic Partnership (RCEP). Both of these comprehensive FTAs dwarf previously existing individual Asian FTAs due to the effect of partnering twelve to sixteen nations in each massive FTA.

The TPP and RCEP are competing with one another for economic dominance in Asia. Both of these FTAs contain many of the same countries as potential members, but China has shown no interest in the TPP and the U.S. has shown no interest in becoming a member of the RCEP. The TPP is touted as a “comprehensive and high-standard” FTA time and again in official U.S. correspondence.⁷⁴ This “high standard” infers the Chinese lack of adherence to WTO mandates and international economic laws will be less

tolerated in the TPP. The tension created by these considerably similar, yet competitive FTAs again highlights the economic power struggle between the U.S. and China in Asia.

The TPP includes 12 APEC member countries: Australia, Brunei, Canada, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam. The FTA was signed by all member nations on February 4, 2016 and each nation has two years to ratify the FTA via their governmental processes. Donilon stated, “Moreover, we’re determined to move ahead with the high-standard Trans-Pacific Partnership. The TPP is widely viewed as the most significant negotiation currently underway in the international trading system. The TPP will deepen regional economic integration not only by lowering tariffs, but by addressing 21st century trade and investment issues. This includes good regulatory practices, ensuring that state-owned enterprises compete on a level playing field, market-based trade in digital goods and innovation, and addressing challenges faced by small businesses.”⁷⁵ The TPP is the most direct approach the U.S. is taking in its LOE in advancing Asia’s economic infrastructure. Ironically, the U.S. already has an FTA with 6 of the 11 prospective TPP members and all prospective members are official members of the WTO.⁷⁶ Figure 6 illustrates the expanse of the TPP and its economic significance for the U.S.

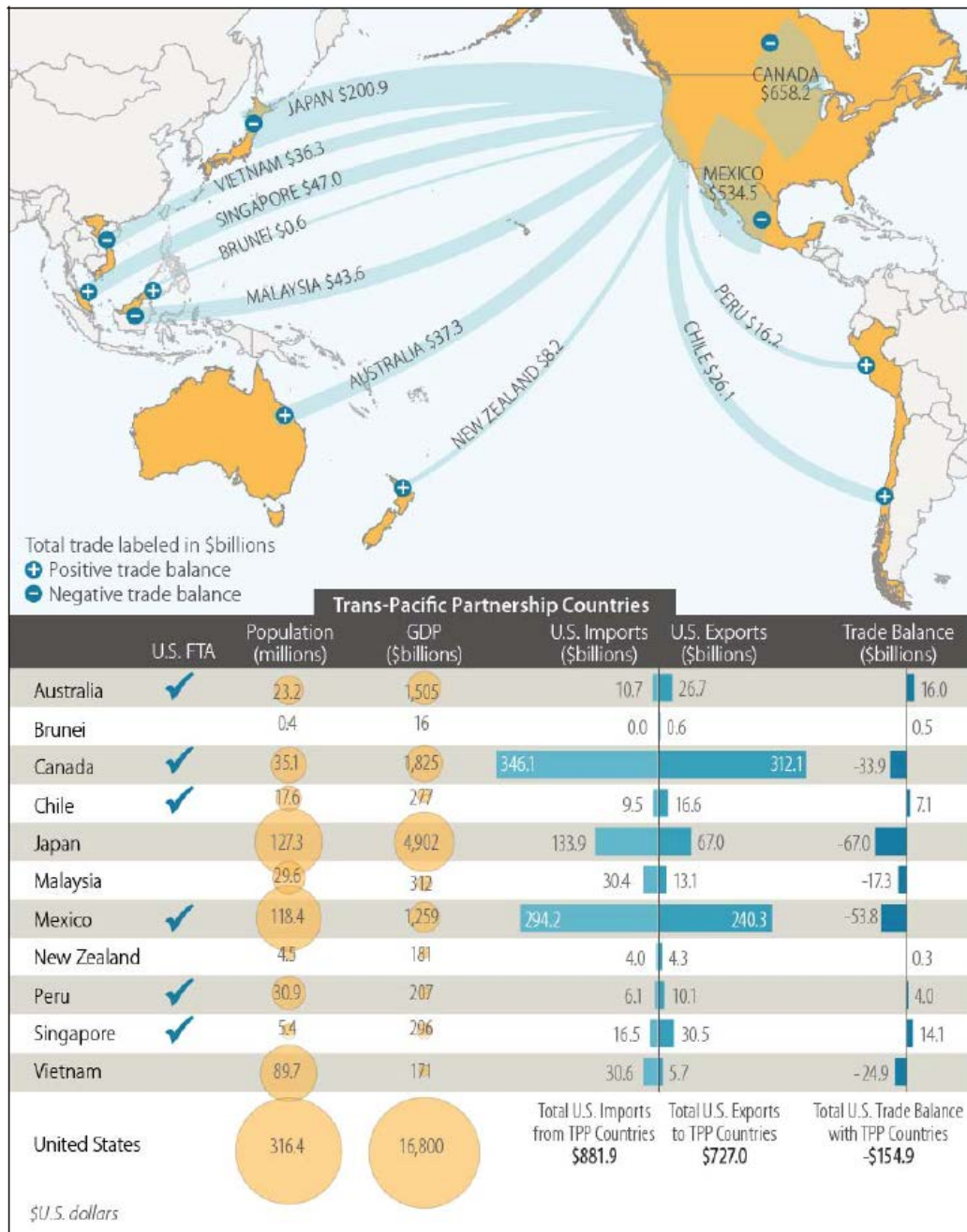


Figure 6. Trans Pacific Partnership Countries

Source: Ian F. Fergusson, Mark A. McMinimy, and Brock R. Williams, *The Trans-Pacific Partnership (TPP) Negotiations and Issues for Congress* (Washington, DC: Congressional Research Service, March 20, 2015), accessed April 24, 2016, <http://photos.state.gov/libraries/vietnam/8621/pdf-forms/tpp-crsreport032015.pdf>.

U.S. goods trade with TPP countries is reflected in table 3. It is estimated that the 11 TPP countries account for 37 percent of U.S. trade, and the conglomeration of all 12 countries in the TPP represent 37 percent of the world's GDP.⁷⁷

Country	Exports	Imports	Balance	Total Trade
Canada	312,125	346,063	-33,938	658,188
Mexico	240,326	294,157	-53,831	534,483
Japan	66,964	133,939	-66,975	200,903
Singapore	30,532	16,463	14,069	46,995
Malaysia	13,136	30,448	-17,312	43,584
Australia	26,668	10,670	15,998	37,338
Vietnam	5,725	30,584	-24,859	36,309
Chile	16,630	9,491	7,139	26,121
Peru	10,070	6,079	3,991	16,149
New Zealand	4,261	3,980	281	8,241
Brunei	550	32	518	582
Total	726,987	881,906	-154,919	1,608,893

Table 3. U.S. Goods Trade with TPP Countries, 2014

Source: Ian F. Fergusson, Mark A. McMinimy, and Brock R. Williams, *The Trans-Pacific Partnership (TPP) Negotiations and Issues for Congress* (Washington, DC: Congressional Research Service, March 20, 2015), accessed April 24, 2016, <http://photos.state.gov/libraries/vietnam/8621/pdf-forms/tpp-crsreport032015.pdf>.

While the economic numbers and profitability of the TPP are obvious motivators, international leaders believe the true heart of the matter is economic projection of power by the U.S.; and the success or failure of the TPP is a test to its legitimacy and relevancy in Asia. As quoted by Singapore Prime Minister Lee Hsien Loong “whatever the merits or demerits of individual line items of trade covered in the TPP, the agreement has a

wider strategic significance. Getting the TPP done will deepen links on both sides of the Pacific. Failing to get the TPP done will hurt the credibility and standing of the U.S. not just in Asia, but worldwide.”⁷⁸ Supporting this presumption, a former U.S. Ambassador to China was quoted in 2015 stating, “Domestically we tend to view trade through a political prism by way of winners and losers. . . . In Asia, it’s seen as directly tied to our leadership and commitment to the region. A failed TPP would create an influence vacuum that others, primarily China, would fill”⁷⁹ Success in implementing the TPP will determine and sustain U.S. economic influence in SEA as well as the entire Pacific.

China’s Regional Comprehensive Economic Partnership (RCEP) potential members include all members of ASEAN (Brunei, Burma, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand, Vietnam) and six nations with existing FTAs with ASEAN (China, India, Australia, Japan, New Zealand and South Korea). Like the TPP, the RCEP intent is to increase trade amongst the members and decrease the barriers that exist such as tariffs and export quotas. Unlike the TPP, the RCEP concept is based on similar existing ASEAN FTAs and does not liberalize trade as extensively; provides less protection for intellectual property rights; investment, and environmental conditions; and does not preclude the protection of SOEs.⁸⁰ Recent Japanese and South Korean interest in membership with the TPP has China wavering on its full commitment to the RCEP, and these endorsements now have China advocating for a Free Trade Area of Asia Pacific (FTAAP), or in simple terms, a regional, all encompassing FTA of Asia.⁸¹ As evidence of this shift, China issued a communiqué in 2015 calling for a “collective strategic study” to the “eventual realization” of the FTAAP to be delivered by 2016.⁸² This announcement was within the same timeframe that the U.S. Congress voted to give

President Obama Trade Promotion Authority in June 2015; authorizing unilateral action as President to agree negotiated terms for the TPP and bypass Congressional authorization until ratification.⁸³

Ultimately, the TPP and RCEP are in a race for precedence as the first FTA of such magnitude in Asia. The economic gains are not what is at stake, but more so the ability to influence and project economic power not only within Asia but the entire Pacific region. Ironically, the TPP and RCEP have a commonality of seven members who are part of supporting both FTAs, while China and the U.S. continue to court other nations in order to compel them to support one FTA over the other. The two largest economies in the world are engaged in an intensely strategic contest not for economic gain, but the right to influence future economic affairs, policy, and support on the Asian continent for the foreseeable future.

Protection of U.S. South East Asian Allies Economic Interests

The United States maintains Collective Defense Agreements (CDA) the following countries in SEA:

1. South Korea
2. Thailand
3. Philippines

These countries are the Actors as addressed in paragraph three of this thesis that the United States must consider when shaping foreign policy with China. They maintain markedly different functions within the region, but their economic strength is directly correlated with the stability the U.S. seeks to achieve as specified in its end state for EA

Republic of South Korea

The United States and the Republic of South Korea entered the Republic of Korea (ROK) Treaty on October 1, 1953. The treaty states, “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 that each Party would act to meet the common danger in accordance with its constitutional processes.”⁸⁴ The ROK is a significant strategic partner in the U.S. effort to shape the OE of EA given its growing economic influence, ongoing efforts to contain North Korea, and the projection platform of more than 28,000 U.S. Soldiers currently stationed within its borders.

The ROK has a population of 50 million with a GDP of 1.4 billion ranking as the 11th largest GDP in the world.⁸⁵ The country is ranked 7th in the world for dollar value of exports and 9th in the world for dollar value of imports as of 2014.⁸⁶ From 2000 to 2014, as Korea’s global trade tripled from \$333 billion to \$1.1 trillion, Korea-China trade rose eight-fold, from \$31.2 billion to \$235.4 billion. As a result, China’s share of Korean merchandise trade rose from nine to twenty-one percent, and China became both the top source of imports and the top export destination for Korean goods. Over the same period, the U.S. share of South Korean total trade fell from 20 to 11 percent, and shares by Japan and the European Union dropped sharply as well.⁸⁷

South Korea has signed a Free Trade Agreement (FTA) with both the United States and China. The Korea United States FTA (KORUS) was signed and adopted in June 2007 and was projected to add \$10 to \$12 billion dollars to the U.S. GDP while increasing annual merchandise exports to the ROK by \$10 billion.⁸⁸ While the Korea-China FTA regulates almost \$300 million in trade value, analysts assess it to be an overly

comprehensive FTA jaded by political aspirations rather than the desire for true economic expansion between both countries.⁸⁹

The ROK finds itself in a precarious economic situation as it attempts to balance its relationships and tensions with the U.S. while seeking an expanded economic partnership with China. According to a Congressional Research Service Report, five main interests drive the U.S. ROK relationship

1. The challenges posed by North Korea, particularly its weapons of mass destruction programs
2. The growing desire of South Korean leaders to use the country's middle power status to play a larger regional and, more recently, global role;
3. China's rising influence in Northeast Asia, which has become an increasingly integral consideration in many aspects of U.S.-South Korea strategic and economic policymaking
4. South Korea's transformation into one of the world's leading economies
5. South Korea's continued evolution as a democratic nation⁹⁰

President Park Geun-hye became the first female ROK President in 2013 and entered office with over half of the popular vote. She has been lauded for her policy of "Trust-politik" which was first introduced by an article she wrote entitled "A New Kind of Korea, Building Trust between Seoul and Pyongyang" in 2011. In essence, Geun-hye advocates for greater engagement with North Korea and a re-establishment of trust between the two nations for hopes of future unification and solidarity. Thus far, her efforts to further engagement with North Korea have had surprising secondary effects on South Korea's relationship with China.

China, previously a staunch advocate of North Korea, has begun to marginalize North Korea as they continue their recent provocations. Given North Korea's recent policies, China's President Xi Jinping has emphasized a growing partnership with Geun-hye. "China's growing alienation from North Korea in the aftermath of Kim Jong-Il's death and the ascension of Kim Jong-un has accelerated the accommodation process with Seoul; it also correlates closely with Xi Jinping's advance to the top position in Beijing. Though officials are loath to openly compare relations with the two Koreas, the asymmetries are inescapable. An open, globalized South is increasingly committed to deeper ties with Beijing while a defiant, nuclear-armed North resents its dependence on its erstwhile ally and fears the consequences of a more open economy."⁹¹ Thus far, the indicators of a warming of relations between Geun-hye and Jinping have been abundant. Geun-hye attended a summit in Beijing alongside Russian President Vladimir Putin to attend the "Commemoration of 70th Anniversary of the defeat of Victory of Chinese People's Resistance against Japanese Aggression and World Anti-Fascist War" in September 2015. This marked her sixth summit meeting with Jinping since her election to office.⁹² Reciprocally, Jinping's first official trip to the Korean Peninsula as the Chinese President was to Seoul to meet with President Geun-hye; a direct snub at the North Korean President Kim Jung-Un and a foreshadowing of the future direction of relations within the region.

Excellent summarized, author Jonathan Pollack states in his article, *The Strategic Meaning of China-ROK Relations: How Far Will the Rapprochement Go and with What Implications?* "For Seoul, the conferring of legitimacy and sovereignty by its Korean War adversary (and still Pyongyang's nominal treaty ally) provided ample

validation, though the political relationship remained circumscribed. The parallelism between Deng Xiaoping's developmental model and the state-centered path pursued under Park Chung-hee in earlier decades further enhanced the logic of Sino-ROK accommodation. In 1985, seven years before the normalization of relations, China's trade with South Korea had already surpassed total trade with the North; it is now approximately 40 times the level of trade between China and the DPRK. Though these judgments might have reflected an overly effusive mood of the moment, they convey the enhanced value of the ROK to Chinese interests. Beijing no longer sees the need to choose between the two Koreas, and prevailing sentiment within China increasingly views the South as an asset and the North as a liability determined to frustrate Beijing's policy goals. At the same time, China's increasing distance from North Korea is an objective indicator of its fundamental interests, which ineluctably enhances the importance of the ROK to Beijing. Though there is as yet no definitive alteration in China's dealings with the DPRK, without major changes in North Korean strategy, the gravitational pull in Chinese policy on the peninsula continues to move in Seoul's direction."⁹³

Finally, political and economic tensions are abundant and the ROK must balance in a tensely charged OE. For simplification in understanding for the reader, the author has chosen to list them with respect to the U.S. and China.

Tensions between South Korea and China:

1. China's passive / implicit support of North Korea
2. ROK's recent support of the TPP

3. ROKs treaty with the U.S. and the permanent presence of U.S. troops within its borders
4. KORUS FTA
5. U.S. / ROK partnership for Ballistic Missile Defense Capabilities (BMD) on the Korean Peninsula

Tensions between South Korea and the U.S.:

1. ROKs membership in the AIIB
2. ROKs continued pursuit of economic expansion with China
3. Cost sharing of forward positioned U.S. Soldiers in South Korea
4. ROK historical/territorial disputes with Japan

Thailand

The U.S. and Thailand entered their first defense agreement in 1954 when both countries, partnered with Australia, France, New Zealand, Philippines, Thailand, and the United Kingdom, signed the Manila Pact creating the Southeast Asia Treaty Organization (SEATO). With the departure of SEATO, Thailand and the U.S. signed an updated CDA known as the Thanat-Rusk Communiqué in 1962, reiterating the priority both nations place on their collective defense and partnership.⁹⁴ Over 50 U.S. government agencies base regional operations in Thailand and its geographic location is strategically dominant in South East Asia. The country is bordered by the Andaman Sea, Gulf of Thailand, and positioned to provide operational reach into almost any location within SEA including the Straits of Malacca. The Thai/U.S. partnership was founded on military cooperation/training, but political turmoil directly resultant from recent military coups

has thawed relationships between both countries and jeopardizes the U.S. relationship with its longest standing ally in SEA.

The Kingdom of Thailand has a population of 67 million and a current GDP of \$373.8 billion. It is ranked as the 29th largest economy in the world and second largest in SEA.⁹⁵ 11 percent of gross Thai material exports (\$25 million) are delivered to China with the U.S. closely behind at 10 percent (\$22.8 million). 17 percent of all Thai imports originate from China (\$38.7 million) while the U.S. holds a 6.4 percent share of the (\$14.6 million).⁹⁶ The U.S. was the largest export destination for Thai goods until 2010. The Thai Commerce Ministry reports that between 1991 and 2014, total trade between China and Thailand rose from \$1.48 billion to \$63.58 billion.⁹⁷ As of 2014, overall Thai-China trade was 66 percent larger than Thai-U.S. trade.⁹⁸ This surge is strongly attributed to the Sino-Thai FTA signed in 2003. The United States and Thailand do not currently have a negotiated FTA as discussions for this endeavor were halted in 2006 as a result of the military coup.

The Kingdom of Thailand has existed as constitutional monarchy with a parliamentary form of government with an executive branch, a bicameral National Assembly, and a judicial branch of three court systems.⁹⁹ This monarchy has historically been challenged by military coups as the most recent occurred on May 20, 2014 when the Thai military ousted Prime Minister Yingluck Shinawatra and dissolved Parliament. On 21 August 2014, the Thai army commander Prayuth Chan-Ocha was appointed as the Prime Minister and has maintained a martial law ruling.¹⁰⁰ This political tension remains a significant threat to both economic and political relations between the U.S. and Thailand. Since the coup, the U.S. discontinued \$3.5 million in Foreign Military

Financing (FMF), and \$85,000 in International Military Education and Training (IMET) funds ¹⁰¹ As mentioned previously, the military partnership is the cornerstone of Thai/U.S. relations and the recent withdraw of military financing and limited U.S. partnership in annual high visibility exercises such as “Cobra Gold” strike at the core of the relationship.

China is seizing the opportunity created by political discourse between the U.S. and Thailand through increased diplomatic engagement and investment in the Thai economic infrastructure. Through both the Sino-Thai FTA and China’s FTA with ASEAN, China has established significant influence within the Thai economy. This development has been further propagated by the fact that a third of all Thais have Chinese blood and the historical and ancestral ties facilitate Thai cooperation with China. China has been the second largest FDI provisionary for Thailand since 2008.¹⁰² In 2002, China invested \$21 million in Thailand. The United States invested \$188 million. As of 2012, China’s FDI totaled \$569 million representing a 2,709 percent increase in FDI over 10 years. The United States invested \$888 million representing a 474 percent increase in Thai FDI.¹⁰³

Significant infrastructure project agreements have been undertaken within the past two years between China and Thailand. A \$10 billion Sino-Thai Railway project connecting the northern portions of China with Thailand with roughly 900 kilometers of rail will give China greater access to both the Mekong Delta and the Gulf of Thailand while serving as the first leg of China’s “Silk-Road Initiative.”

Thailand continues to struggle with its political landscape. The military’s involvement in coups and degradation of a democratic process have overlapped to now

induce significant tension between the U.S. government and Thai political leaders; as well as the military relationship both countries have fostered over decades. The following tensions between Thailand, the U.S., and China must be acknowledged in understanding the OE of SEA.

Tensions between Thailand and China:

1. Thailand's military training and cooperation with the U.S.
2. Thailand's purchasing of U.S. military equipment

Tensions between Thailand and the U.S.:

1. Thailand's military coup and political instability/disruption of democracy
2. Thailand's reported human rights violations
3. Thailand is a member of the AIIB
4. U.S. "interventionist" policies (in response to the coup)

Republic of the Philippines

The Philippines and the U.S. relationship is defined by two CDAs. The Philippine Treaty, signed in 1951, and the South East Asia Treaty signed in 1954. Effectively, both treaties state the following: "by which the parties recognize that an armed attack in the Pacific Area (treaty area) on either (any) of the Parties would be dangerous to its own peace and safety and each party agrees that it will act to meet the common dangers in accordance with its constitutional processes."¹⁰⁴ Of all U.S. allies in SEA, the Philippines has been the most directly engaged in the ongoing contest of territorial disputes with China in the South China Sea.

The Republic of the Philippines has a population of 100.1 million and a GDP of \$299 billion. It is ranked as the 35th largest economy in the world and projected to

improve its ranking as the 29th largest by 2020.¹⁰⁵ China receives 13 percent of the Philippines exports (3rd largest export market) valued at \$8 billion. The United States ranks as the second largest export market for the Philippines receiving 14 percent of all exports valued at \$8.7 billion. Regarding imports, China is the Philippines main source providing 15 percent of total Philippine imports at a sum of \$10.1 billion. The U.S. supplies 9 percent of all Philippine imports valued at \$6 billion.¹⁰⁶

FDI is the highlight of the U.S. Philippine relationship. The U.S. provided \$785 million in investments in 2012 while China's FDI was negligible in the same year.¹⁰⁷ Cumulatively, the U.S. has invested an estimated \$7.7 billion in the Philippines since 2001, while China (primarily the Hong Kong FTZ) has invested \$2.2 billion.¹⁰⁸ As territorial disputes escalate in the South China Sea, the U.S. and Chinese FDI have been inversely related as U.S. FDI continues to grow and Chinese FDI declines or stagnates. This relationship projected to continue on this trajectory for the foreseeable future or until territorial disputes are negotiated.

Apart from FDI, the Philippines has been one of the largest recipients of U.S. developmental and military foreign aid assistance in SEA. Major U.S. programs include strengthening the rule of law, streamlining the process of obtaining business permits, improving government services, expanding health care, and increasing the Armed Forces of the Philippines (AFP) ability to govern and protect its maritime domain.¹⁰⁹ In 2014, the Republic of the Philippines established The Foreign Aid Transparency Hub (FAiTH), "an online portal of information on calamity assistance pledged or given by countries and international organizations." Since the websites inception, the U.S. has contributed \$89.3 million in FA funds while China has contributed \$1.3 million.¹¹⁰ The U.S. continues to

expand its FA investment, and in 2014, the Congressional Budget Justification for Foreign Operations, FY 2014 requested an increase in Foreign Military Financing (FMF) of \$50 million for the Philippines to support bolstering the Philippines external defense capabilities.¹¹¹ It is estimated that the U.S. provided a total of \$312 million in FMF for the Philippines between 2002 and 2013.

The Republic of the Philippines is a traditional republic with an executive, legislative, and judicial branch. President Aquino is in the final year of his term and has made efforts to purge the government of corruption and regain the faith of the Philippine people. Philippine presidents are able to serve one six-year term and are not allowed to seek election. There is concern that many of the changes Aquino has initiated are in jeopardy if a strong leader of like-minded aspirations does not replace him. Despite recent political improvement, one report states, “the country has a robust civil society and a lively press. However, the state often has been unable to stand above or control competing interests. Patterns of patronage and cronyism; entrenched socioeconomic elites; the influence of local clans and power holders; the lack of civilian control over the security forces; Muslim and communist insurgencies; and a weak judicial system have allowed corruption to thrive, undermined governmental effectiveness, and led to human rights abuses.”¹¹²

Multiple internal security threats are of consistent concern for U.S. policy makers within the Philippines. Islamic extremist groups the Abu Sayyaf Group, Moro National Liberation Front (MNLF), and the Moro Islamic Liberation Front (MILF) are actively conducting an insurgent campaign against the Philippine government. An estimated 150,000 people have been killed in the Philippines due to Muslim insurgency fighting

since 1960.¹¹³ Adding to the Muslim insurgencies, the Communist Party of the Philippines (CPP) conducts its own insurgency campaigns against the government and is considered the most valid threat to the Philippine government today.

Like Thailand, a significant cornerstone for U.S./Philippine relations is a military cooperation. On April 28, 2014, President Obama and President Aquino signed the Enhanced U.S.-Philippine Military Cooperation Agreement (EDCA). This ten year, renewable agreement, “will help the U.S.-Philippine alliance continue to promote the peace and stability that has underpinned Asia’s remarkable economic growth over the past six decades. The EDCA updates and strengthens U.S.-Philippine defense cooperation to meet 21st century challenges. The agreement will facilitate the enhanced rotational presence of U.S. forces; facilitate humanitarian assistance and disaster relief in the Philippines and the region; improve opportunities for bilateral training; and support the long-term modernization of the Armed Forces of the Philippines (AFP) as it works to establish a minimum credible defense.”¹¹⁴ The reinforcement of the U.S. military cooperation is not a surprise given the Philippines increased engagement with China over disputed territories in the South China Sea involving small outposts in the Spratley Islands, and the Scarborough Shoal, a set of islets within the Philippines sovereign territorial waters. The Philippines have since filed a case with the Law of the Sea tribunal governing the United Nations Convention on Law of the Seas (UNCLOS). Given the U.S. has not ratified the UNCLOS charter, the U.S. continues to take a somewhat neutral approach to the conflict while “reaffirming the strong support of the United States for the peaceful resolution of territorial, sovereignty, and jurisdictional disputes in the Asia-Pacific maritime domains.”¹¹⁵ The Sea Tribunals ruling has yet to be decided, and the

U.S. continues to increase its military cooperation with the Philippines via both FMF and increased presence in the region via military partnership in order to deter further aggressive Chinese territorial expansion.

Thailand is on the forefront of the territorial disputes with China, and their relationship with China continues to degrade as China becomes more assertive in its claims. The U.S. is directly leveraging the Philippines geographic position as a platform of U.S. naval force projection within disputed waters, while conducting freedom of navigation operations. Political instability and extremist groups within its borders continue to be a cause of concern for U.S. policy makers, but the Pilipino government's outreach to the U.S. for protection of its sovereignty makes the Philippines a strategic ally for the U.S.

Tensions between the Republic of the Philippines and China:

1. South China Sea territorial disputes
2. The Enhanced Defense Cooperation Agreement (EDCA) with the U.S.

Tensions between the Republic of the Philippines and the U.S.:

1. Armed extremist insurgencies existent within Philippine borders
2. Political instability
3. Human rights violations/ extra-judicial killings of Muslim insurgents by Philippine military

In summarizing the analysis, the author emphasized mutually dependent economies of the U.S. and China and the understanding that while the U.S. and Chinese economies are not reliant upon one another, they can have significant symbiotic and devastating negative effects if cooperation is not properly managed.

China continues to look for any way it can to gain and maintain an advantage in not only supporting its international revenue streams, but also to mitigate U.S. economic dominance around the globe. The most prevalent LOE China has pursued in maintaining pace with U.S. economic dominance has been in its currency manipulation and maintaining a price advantage for goods by undervaluing the Yuan. Founding the AIIB gives China greater ability to induce that currency manipulation, but more importantly to foster regional reliance, and direct economic expansion in alignment with its ideal and end state for Asia. It has also served as somewhat of a wedge driven between the U.S. and its allies facilitating a watershed moment of allegiances.

The U.S. continues to counter China's attempts at undermining its influence through the WTO dispute process and bringing suit against China for its practices in currency manipulation, foreign bank access, and transparency in economic policies and implementation. Given the limited effects of the WTO dispute process on shaping Chinese compliance, the U.S. is now creating the TPP which will not give China the room for maneuver it has had in responding to WTO disputes and will require a "high standards" adherence to benefit from the membership of a massive FTA. China recognizes the political and economic power of the TPP and is desperately attempting to counter its implementation.

In the midst of all of the economic positioning, the U.S. continues to build on its long-standing alliances in SEA. South Korea, Thailand, and the Philippines are critical regional allies the U.S. desires to maintain under its influence. Militarily, these alliances are strong, but politically and economically, Korean and Thai relationships with China

are beginning to flourish. In order to maintain influence the U.S. must maintain operational reach, and its allies are a critical piece of this strategy

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CHAPTER 5

CONCLUSION

Lessons Learned

The following were the salient lessons the author learned throughout his research:

1. The U.S. can not achieve in totality its strategic end state for South East Asia without bi-lateral cooperation with China
2. The Center of Gravity (COG) for both China and the United States in South East Asia is economic influence
3. The U.S. has failed to maintain an effective indirect approach to defeating China's COG, and China has been more successful in quietly undermining the U.S. COG
4. China is reaching a point of culmination in attempts to indirectly undermine the U.S. COG in Asia

Theory: The U.S. must exercise tactical patience in order to ensure dominant economic position and influence in SEA, or risk exorbitant costs of economic instability prematurely for the sake of idealism, limiting its ability to achieve the desired end state.

Implications of the Theory

Time is directly correlated to the U.S. ability to influence the economic operational variables in South East Asia. China currently holds economic momentum, but their effectiveness in indirectly countering U.S. attacks on its COG are reaching the point of culmination as that momentum begins to wane. The U.S. must cooperatively manage and leverage China's economic influence in the region until the U.S. is better positioned,

with time, to re-establish its economic influence and operational reach in South East Asia. Until U.S. economic influence and support for its COG is re-established, failure to cooperate with China will instigate a premature degradation in economic stability in SEA.

The U.S. does not yet possess the economic operational reach nor the ability to fill the gap a faltering Chinese economy would have on the Asia-Pacific Region. Pursuing agreements such as the TPP, and re-energizing commitments to allies in the region are an attempt to bolster operational reach, however the U.S. is behind the power curve. China has spent years embedding itself deeply into the economies of Asia-Pacific nations through its FTA with ASEAN as well as through its sheer magnitude and positional power. Not only has China infiltrated the network of economic ties in South East Asia, the U.S. now is truly grasping the scope of the effects China has on its own economy. Had the U.S. recognized this and countered the growing and subtle entrenchment of China's influence earlier, this may have been reversible, yet slowly and steadily, China strategically positioned itself to strongly influence future economic development throughout the Asia Pacific region. Idealistically, the U.S. opposes communism and everything it represents, but realistically, communist China has become a critical component of the world's economy. The U.S. has learned several hard lessons about the costs of being overly idealistic in its approach to fostering democracy in countries such as Iraq and Afghanistan, and ultimately the cost was greater than expected because of a failure to fully understand and frame the operational environment prior to executing an operational approach. China's economic health is now intrinsically tied to the health of many developing Asian nations and strong U.S. allies throughout South East Asia. The

author in no way supports or condones communist ideals, but rather has assessed that the costs of not working with China through mutually agreed arrangements will be more damaging to U.S. efforts in the long term than finding a way to pursue what Hon. Rudd referred to as “constructive realism.” The U.S. and China must focus on the areas with which they can agree to cooperate while acknowledging and addressing the points of contention that are not immediately solvable. They must manage these points of contention, but not devote maximum energies into “winning” these disputes while negotiating mutually agreed victories.

The COG for both countries is clearly garnering the economic and political support of Asian nations. The TPP and RCEP FTAs provide the most striking support of this argument. Seven countries in the region support both the TPP and RCEP and this is indicative of the rock and the hard place China and the U.S. are putting developing nations between as both nations battle to gain popular support for their individual economic vision and ideals for the region in the future. Developing countries Brunei, Malaysia, Singapore, and Vietnam, are fearful of missing the opportunities both the RCEP and TPP will provide, but are caught in limbo waiting to see whether China or the U.S. vision will dominate the narrative as both FTAs navigate legal processes.

As described in JP 5.0, there are indirect approaches and direct approaches to affecting an enemy’s COG. “An indirect approach attacks the enemy’s COG by applying combat power against a series of decisive points that lead to the defeat of the COG while avoiding enemy strength.”¹ The U.S. and China have been waging a war of indirect measures in an attempt to undermine each other’s economic influence. Indirect approaches require greater monitoring and constant attention to changes in the overall

enemy actions and strategy. The author believes that the focus of the U.S. for the past two decades on the Middle East conflicts undermined its ability to effectively maintain an indirect approach of managing the growth and power of China's economic influence. As the U.S. stringently focused on two wars, China quietly grew in economic size and strength through both overt and subversive means. China succeeded strategically in its attempts to overpower U.S. economic influence in the region as it latched onto ASEAN via an FTA and began to provide a preponderance of Asian countries imports at a lower cost and concurrently fostering dependency. The U.S. deficit, which only grew with protracted wars, was leveraged by China as they became the largest U.S. international debtor and amassed the \$1.7 trillion in U.S. debt it now holds today. The Department of Defense has had to order a review of the defense implications China's U.S. Treasury bond holdings could represent, as well as the realization that massive amounts of weapon systems computer chips currently in U.S. military equipment were outsourced and produced in China. The author believes the U.S. pivot to Asia was in recognition of China's strategic advances and an attempt to counter China's success in undermining U.S. economic influence in the region. The U.S. underestimated and failed to anticipate China's abilities to infiltrate the Asian Pacific and U.S. economies as effectively as they have done.

Lastly, China is reaching a point of culmination in its ability to indirectly affect and undermine U.S. economic influence in the region. Culmination is "that point in time and/or space at which the operation can no longer maintain momentum."² China has been able to maintain an indirect approach to the U.S. COG in Asia during times of massive demand for its exports. This demand supported China's over-investment in

manufacturing and production and grew its national reserves to give it the flexibility to absorb the inherent risks in an unbalanced economy. Today, demand has decreased and more and more Chinese factories are shutting down operations due to over-capacity and a lack of revenue. China is keeping its SOEs afloat by restructuring their debt with revenue from its reserves, and as a result those reserves are rapidly decreasing providing less ability to assume risk and ballast its economic imbalance. The U.S. has now re-oriented its focus on the Asia Pacific and is reinforcing its alliances, developing economic architecture through the TPP and other ventures, and postured military forces to counter Chinese aggression in the South China Sea. The author believes China's aggression in territorial expansion is an early indicator that China is preparing to transition to a direct approach of attacking U.S. influence in the region. Through diplomatic, economic, informational, and legal means of power, the U.S. is beginning to see early signs of success in compelling China to adjust its behavior. The U.S. must anticipate China's point of culmination and diplomatically engage China at the decisive point prior to China's culmination in order to see the greatest benefits of a peaceful resolution and development of an economic partnership benefiting all of Asia in the process.

In conclusion, China's communist influence and inherent requirements for control are degrading their ability to fully realize their economic potential. This is a very obvious and generalist statement, however, the implications of this are that China will never overcome the U.S. as the most dominant economic world power. China has enjoyed several decades of impressive growth and has positioned itself to be a critical economic player on the Asian continent. The U.S. and its free market economic principles based on a democratic government will outlast and out-perform China's economy in the long run

for this one principle. This paper was written to recognize the impacts on U.S. foreign policy and security interests based on its pivot to Asia and desired end state. The U.S. singularly does not require China to be successful for its own stability, but it does require China to be successful for the stability of Asia and the allies and economic infrastructure it wishes to protect and foster. The instability and costs associated with lack of U.S. cooperation with China by either an isolating of or degrading China's economic prospects would have to be absorbed the greater international community. The U.S. must fully understand the intricate web of interdependence Asian nation's economies have developed with China and appreciate the direct tangible costs associated with intangible idealism. There is a balance to be struck in compelling China to cooperate in its obligations as a world economic power, but as Deng Xiaoping once said, "To cross the river, it is important to feel the stones step by step."³ As Hon. Rudd so eloquently put it, "So, too, might we be able to breach the widening gap between China and the United States over time. It requires a realistic understanding of the values, perceptions, and interests of the other. It requires an equal amount of creative diplomatic imagination about what can be done constructively together. It also requires the political will to dream of a different future other than what history has shown us, often horrifically, from the past."⁴

Issues for Further Research

The author would recommend further research in understanding the socio-economic factor in China's pursuits of its economic operations. The Chinese people's perception of the CCPs ability to foster and grow the economy is a critical consideration the CCP examines in both the execution and communication of its intent to their people.

The CCP is extremely cognizant of maintaining the general support of the people, and one of its greatest fears is the loss of popular support. If tensions continue to rise and the is forced to U.S. escalate deterrence operations, there are indicators throughout the authors research that rather than target international support for effects, the U.S. would realize more devastating effects by targeting the Chinese people through an intense IO campaign. This would ultimately force a two front engagement by the CCP by both international and internal threats. The communist control of information is a significant obstacle, but the effects of such a campaign at this point, are severely underestimated.

¹ U.S. Joint Chiefs of Staff, Joint Publication 5.0, *Joint Operational Planning* (Washington, DC: U.S. Joint Chiefs of Staff, August 11, 2011).

² Ibid.

³ Rudd.

⁴ Ibid.

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