

The Dynamics of Chinese Expansion in the South China Sea

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China is trying to increase its sphere of influence in the South China Sea. Expanded trade with countries in the region through special trade agreements helps China secure sources of commodities and supplies. China has established financial institutions, such as the Asian Infrastructure Investment Bank, and opened the way for greater use of the yuan in settlement of trade. Claims on certain islands in the South China Sea have other countries on high alert and work counter to trade offensive. Diplomatic solutions are called for to keep the area stable. Suggestions of conflict resolution are part of a possible settlement.

INTRODUCTION

In recent years, a rising China has been actively seeking a closer relationship with Southeast Asian nations. One approach was developing trade agreements with the countries in the region, especially the members of the Association of Southeast Asian Nations (ASEAN). Originally, the main purpose was to secure access to long-term supplies of the commodities needed to fuel China's continued growth and also to expand markets for Chinese exports.

Today, the ambitions are going way beyond securing commodity sources and opening markets. Beijing is using commercial agreements to enhance China's influence in the region and its ability to shape the next global order (Bremmer, 2015, June 29). China led the creation of the Beijing-based Asian Infrastructure Investment Bank which enhances China's development role across Asia and is a direct challenge to the World Bank. Besides trade agreements and investment bank, China aggressively promotes the greater use of the Yuan in settlement of trade in the region (Bremmer, 2015, June 29).

But it is China's claim of ownership of a number of islands in the East and South China Seas that has several countries on high alert. Japan, the Philippines, and Vietnam are the areas of the highest tensions. These claims by China have led to conflicts over the disputed islands and a state of alert about what is seen as Chinese maritime expansion.

The actions and reactions of those affected by China's assertiveness become part of the discussion. While China's actions in the South China Sea have provoked many of its neighbors to build up their armed defenses, the Philippines has opted, e.g., to bring the case before the International Court of Justice. Tensions in the region are high enough that the pursuit of diplomatic channels would benefit all. Suggestions toward conflict resolution will round out the discussion.

METHODOLOGY

A significant portion of this research is based on conversations with more than 350 key influencers in Shanghai, Beijing, Hong Kong, Singapore, and Washington, D.C. over a period of 22 years beginning in 1988 and most recently in the summer of 2015. In the summer of 2015 one author attended presentations by the Economist Intelligence Unit and conducted related interviews in Hong Kong. The focus was China markets. Interviews in the summer of 2010 were conducted with experts from the Royal Institute of International Affairs and the School of Oriental and African Studies both in London, the Council on Foreign Relations in New York and Imprimatur, a private investment firm in London. A significant effort has also been made to examine traditional data and documents from a variety of sources when and where they were available. One author did recent research in China on-site in Hong Kong, Guangzhou, Shanghai, and Beijing for one month in the summer of 2012. Professionals in China wish to have their comments kept confidential. Therefore, we chose to respect their request of confidentiality in all cases. We have referenced and documented data where they are public.

The methodology for this study where it involves interviews can be described as a focus on the policy views of key stakeholders and influencers. In general, the interviews were conducted with senior analysts, corporate officers, and professionals. In addition to experts from the above listed institutions, other institutions included analysts from such organizations as the Economist Group in Hong Kong, Shanghai, and London, and Old Bear Sterns Investment firm, Goldman Sachs, Chase Investment Bank, U.S. Chamber of Commerce, and Boston Consulting Group in at least two locations, Microsoft, and a host of other public and private professionals. The interview format did not include a formal survey.

TRADE AND FINANCE: CHINA'S "PEACEFUL RISE"?

Trade Agreements

Since the mid 1990's, China had been actively seeking to improve its relationship with Southeast Asia through cooperative approaches such as developing trade agreements with the countries in the region, especially the members of the Association of Southeast Asian Nations (ASEAN). In the period of 1993 to 2001, China's trade with ASEAN had increased rapidly, as much as 75 percent per year. The events of the financial crisis of 1997-1998 prompted China to strive for a stable environment in the region to allow for continued economic growth. China's assistance to the neighboring countries during the financial crisis helped to improve regional perception of China's motives (Geib & Pfaff, 2012).

In 2002, China adopted the ASEAN code of conduct on disputes in the South China Sea. This event turned China's emphasis to ASEAN, rather than to the Asia Pacific Economic Cooperation (APEC) framework which includes the United States. In 2002, China's attention centered on building an ASEAN-China Free Trade Area (ACFTA) which marked a fundamental shift in relations between China and ASEAN (Geib & Pfaff, 2012). Since then, China has become the chief trading partner for most countries in the region. As China becomes richer, it will become a market for the rest of Asia, just as the region will become a bigger market for China. In a way, Beijing is forging commercial agreements that enhance China's ability to influence the future global order (Bremmer, 2015, June 29).

The establishment of the FTA between China and ASEAN created one of the world's largest trade areas. As of 2010, it encompassed 1.9 billion people, had a combined GDP of U.S. \$6.6 billion and the total trade amounted to \$4.3 trillion (Geib & Pfaff, 2012). China is now proposing the Regional Comprehensive Economic Partnership, a more mercantilist deal for Asian countries. The Partnership would ask little of these countries in terms of commitment to real market-based reforms or to environmental and labor standards – in contrast to WTO rules. But it offers them greater access to China. This might advance China's regional interests, but would do little for an open, rule-based regional order (Zakaria, 2013).

But due to China's historic hegemony in Southeast Asia, there is always the fear in the region that China is trying to dominate the smaller countries. As much as the ASEAN countries are attracted to the opportunities offered by trade with China, they are looking for balance to other trading partners, namely

Japan, the European Union, and the United States. Although China stresses that the main reason for the FTA is to ensure access to markets and raw materials, and to attract foreign investment, the suspicion remains that the main motivation for China's assertiveness is strategic. China's so called "peaceful rise" is seen as a comprehensive long-term strategy to accelerate China's growing economic development, but also to elevate China's power and stature (Geib & Pfaff, 2012).

The implementation of the ASEAN-China Free Trade Area is an example of China's new policy: emphasis on expanding regional trade in the Pacific (Interviews). However, it is not only trade that the new leadership in Beijing is willing to expand, but also to change the rules of the game. Chinese leaders dislike the existing system of alliances. China is frustrated by what it sees as its lack of influence in international organizations. The country is ready to chart its own course in the global economy. In March 2015, President Xi Jinping called for a regional order that would be more favorable to Asia and the world. China would play a vital part and shoulder greater responsibilities for regional and world peace and development (Schuman, 2015).

When it comes to the Pacific, China seems to be building a separate system of its own. ACFTA appears as an initial step in the process. Trade with all the Southeast Asian nations and The Regional Comprehensive Economic Partnership go a step further to tie the ASEAN countries to China. Beyond this, President Xi Jinping announced at a regional summit in November 2014 a road map for the creation of a Free Trade Area of the Asia-Pacific (FTAAP). More than 20 countries have indicated interest in becoming members of FTAAP (Bremmer, 2014/2015).

Creating an Investment Bank

In step with the expansion of trade and the call for a new regional order are the financial institutions created by China. First there was the establishment of the Shanghai-based New Development Bank. All the BRICS countries (Brazil, Russia, India, China, South Africa) are members. The institution looks like a fledgling alternative to the World Bank (*The Economist*, 2014, August 23; *The Economist*, 2014, November 8).

In October of 2014, China launched an Asian Infrastructure Investment Bank (AIIB), based in Beijing, and another possible rival to the World Bank. The new institution will not require borrowing nations to uphold the environmental and labor standards that are conditions of help from Western institutions (Bremmer, 2014/2015; *The Economist*, 2014, November 8). Fifty-seven countries signed up to join the AIIB as founding members – many of them America's closest allies, including the U.K., Germany, and Australia (Schuman, 2015; Curran, 2015). The IMF and the World Bank have both indicated that they will cooperate with the AIIB. Beijing will probably hold a stake of up to 50 percent in the new institution (Bremmer, 2015, April 6).

All the organizations sponsored by China share the characteristics that China has a big and often dominant role and that the United States is not a member. It seems that China is not just challenging the existing world order, but building a new one in the Pacific with China in the leading role parallel to Western institutions (*The Economist*, 2014, September 20). China has used its development banks to begin to chip away at American dominance in global trade (Bremmer, 2015, June 29).

Payments in Yuan

The AIIB is only part of a larger Chinese agenda to remake the economic order. Beijing has called for an end to U.S. dollar dominance, promoting its own currency, the yuan, as a replacement (Schuman, 2015). Is that a realistic goal? As recently as five years ago, China conducted trade almost entirely in dollars. Today, nearly 25 percent of Chinese trade is now settled in yuan (Bremmer, 2014/2015). China accounts for more than 15 percent of the world's money supply. Before 2009, almost all of that money was sealed within the Chinese borders. Since then, the government has allowed Chinese importers and exporters to settle their trade in yuan, and Chinese companies to make foreign direct investment with the currency (*The Economist*, 2013, February 9). Settlement of trade in yuan also helps Chinese trade partners, especially the ASEAN countries, in their dealings with China. It smooths the integration within ACFTA, but also enhances China's role in the South China Sea.

The yuan has a long way to go before it becomes a rival for the dollar. Other countries peg their exchange rate to the dollar or issue bonds in it and hold it as currency reserve (*The Economist*, 2013, February 9). For the yuan to take on that role, it would have to become fully convertible. However, the yuan is now being used more widely. Some central banks – from France to Nigeria – have started to hold some of their foreign exchange reserves in the Chinese currency (*The Economist*, 2014, November 22). In March of 2015, China and Canada launched the first yuan trading hub in the Americas. Such hubs exist in London, Singapore, and other locations (Schuman, 2015). Still, in the same month, settlements made in yuan were only 2 percent of global payments (Schuman, 2015). The yuan is not fully convertible, foreign access to Chinese assets is restricted, and capital flows in and out of China are controlled. Unless major changes are made, the yuan is a long way from being a reserve currency.

Less of a Peaceful Rise

It appears that China is trying to integrate the countries in Southeast Asia and the South China Sea through trade and trade-related institutions and, in this way, restore its historic sphere of influence in the region. Even though the countries in the area welcome trade with China, the fear of China trying to dominate the region is always present. Due to China's historic dominance in Southeast Asia, there is a heightened sensitivity in many countries to the possibility of "economic colonization" by China (Geib & Pfaff, 2012). In light of recent events in the South China Sea and China's assertiveness in regard to ownership of certain islands in the East and South China Seas that fear seems to be justified and belie the claim of "peaceful rise." Much of the region resents what it sees as Chinese maritime expansion. In the following pages we will present some of the maritime disputes in the East and South China Seas and explore the reactions of the countries affected by the disputes.

RECENT DYNAMICS OF THE MARITIME DISPUTES

Interviews and research particularly in Hong Kong in the summer of 2015 reveal important new developments regarding China's claim on certain islands in the South China Sea. The core of the maritime disputes stems from China's increasingly strong assertion that it should control over 90 percent of the South China Sea. This runs directly counter to the claims of the Philippines and other Southeast Asian nations including Vietnam, Brunei, Taiwan, and Malaysia (Interviews; Hayton, 2014). China has challenged fishing boats of these countries in areas they claim as their territorial waters (Interviews). In 2014, China went so far as to set up an oil drilling rig within the territorial waters of Vietnam causing major anti-Chinese riots in Vietnam (Interviews). Following those events, the oil rig was eventually removed.

Actions by the Philippines

The Philippines seeks to resolve the dispute with China at the permanent court of arbitration at the International Court of Justice at The Hague, Netherlands. The basis in international law of the Philippines' claim is the 1982 United Nations Convention on the Law of the Sea. Under the convention, habitable islands can qualify to have 200 nautical mile exclusive zones. If above water, rocks and shoals can qualify for territorial zones within 12 nautical miles (Interviews; Hayton). In 2015, to qualify for territorial zones, China has gone so far as to turn tiny coral reefs into artificial islands and created at least one airfield (Interviews; *The Economist*, 2015, April 30).

The Philippines has taken several other actions that have angered the Chinese. First and foremost in 2015 the government of the Philippines announced that it would base fighter planes at Subic Bay for the first time in decades to counter Chinese power (Interviews). Subic Bay is only a short distance from Scarborough Shoal which the Chinese seized from the Philippines in 2012 (Interviews).

Japan's Reactions

Since China began to challenge aggressively Japan's control of the Senkaku Islands in the East China Sea in 2012 (China lays claim to the uninhabited islands), Sino-Japanese reactions have been strained,

even though China is Japan's largest trading partner. The clash with China in this territorial dispute may have triggered an overhaul in Japan's national security strategy.

In the summer of 2015, Prime Minister Shinzo Abe initiated legislation which seeks to transform Japan's post World War II pacifist tradition. Since the end of World War II, Japan's constitution under article 9 requires that Japan renounce war or threat of war as a means of settling disputes (Japan's constitution). Among other issues this has meant that Japan is prevented from supporting its allies in many efforts (Interviews).

One can assume that the steps taken by the Japanese government were provoked by Chinese actions in the East China Sea. China began challenging Japan's control of the Senkaku Islands as early as 2012. In the summer of 2015 Japan released photos of Chinese offshore platforms to protest what it calls China's unilateral development of natural gas fields in the East China Sea. The Japanese believe that Chinese construction of platforms has occurred in Japanese territorial waters. In the Japanese view, China is involved in artificial island construction and could deploy radar systems on the platforms and use them as an operating base for helicopters or drones conducting air patrols (Japanese Defense White Paper approved by the Japanese cabinet, July 21, 2015).

The skirmishes over the islands had led Prime Minister Abe to aim foreign policy goals on the other Asian countries threatened by this dispute. For that purpose, Mr. Abe visited all ten members of ASEAN and hosted the ASEAN leaders in December 2013 in an attempt to build a friendship network with the nations around China (Einhorn & Philips; *The Economist*, 2014, January 4).

Prime Minister Abe has taken advantage of every opportunity to strengthen relationships with Southeast Asian nations, including financial aid for big infrastructure projects (Einhorn et. al.). At the Shangri-La Conference in Singapore in May 2014, in his keynote address, Mr. Abe argued that Japan and the nations of Southeast Asia should play a stronger regional security role.

U.S. Involvement

Traditionally, the U.S. position has been based on the need for stable relationships and open commercial sea lanes in the East and South China Sea (Bremmer, 2015, June 8). With China's assertive behavior, the U.S. has to reevaluate its position in the region, especially considering that many Asian countries want a stronger U.S. presence in the Pacific as a reassuring counterweight to China. Due to the Chinese stance of redrawing China's borders, even countries that once rejected American influence are now open to it.

In the summer of 2015 the U.S. responded dramatically by stepping up its monitoring of developments. This has included an increased number of observation flights over disputed areas (Interviews). All media reported the much publicized flight of Admiral Scott Swift of the Pacific Fleet. Swift is the new commander of the Pacific Fleet as of May 2015. He has taken extensive observation flights over disputed areas of the South China Sea. Moreover, Swift has made it known that he might deploy more assets to the South China Sea. Also, he has made it widely known that he is interested in expanding annual combat exercises with allies in the area (Interviews). The admiral also employs what many observers suggest is necessary for regional conflict resolution – continuous high level diplomacy (Interviews). Swift does not take sides but emphasizes freedom of navigation and multilateralism at every opportunity (Interviews).

Just as Japan is doing more to support U.S. power in East Asia, the U.S. is seeking to draw closer to countries such as Australia, Vietnam, the Philippines, as well as Japan. Initiatives such as the U.S. Transpacific Partnership (TPP) represent the U.S. "pivot" toward Asia (Interviews). Gerald Curtis, a leading authority on Japan and far Eastern politics at Columbia University provides important insights. He argues that "China should face stiff resistance to attempts to extend its power into the waters and islands of the South and East China Seas" (Address to Chamber of Commerce, Shanghai). He also states it is important to integrate China into the world system by giving it a voice in multilateral institutions (Curtis, 2015).

Most specifically, U.S. policy needs to encourage Chinese participation in international bodies. Curtis argues that it is also essential to balance Chinese power as China rises. The long-term goal is a

balance of power in East Asia. Finally, and specifically, U.S. policy needs to encourage Japan to contribute more to the U.S.-Japan military alliance and to encourage Japan's military to integrate further with U.S. forces. Curtis believes that this would make it more difficult for Japan to act independently (Curtis, 2015).

CONFLICT RESOLUTION

There are no easy alternatives to continuing strife in the South China Sea. No side wishes to provoke a conflict, but none is willing to reduce tensions by moderating its territorial claims (Hayton, 2014). But as the interviews have shown, many professional experts have expressed the opinion that, given certain circumstances, a conflict resolution may be possible. Hayton offers at the end of his book a scenario by which everyone would benefit. If the line in the South China Sea were to be redrawn, the Sea could become a collectively managed region for the benefit of all. Most professional observers believe that in the broader sense conflict resolution regarding the maritime disputes must be based on focused diplomacy and all that it implies. This means marshaling dramatic consensus-building and coalition management (Interviews).

Given this diplomacy and consensus-building, a number of issues have emerged that need to be addressed, such as focus on international law, multilateralism, cross-cultural communication, and others. The discussion below centers on these topics.

Training and Education

The one certain assumption required for effective conflict resolution, is understanding the conflict and the nations involved. This requires that all leadership efforts are based on a profound and in-depth knowledge of the historical, legal, commercial, political, and international relations context of the maritime disputes. This further requires a continuous major investment in focused education of responsible authorities.

Focus on International Law and Process

As we described in previous paragraphs, the Philippines leadership has submitted its dispute with China to the International Court of Justice at The Hague. This initiative represents an important strategic alternative. In this context, it is important to note the participation requirements. All contending parties need to agree to judicial arbitration. In the case of the Philippines, China refuses to participate in the judicial process.

Focus on Cross-Cultural Communication and Negotiation

Whether the conflict resolution initiatives are taken within the context of multilateral institutions or bi-lateral formats, cross-cultural negotiation skills are needed. Some of the following points should be given consideration.

- Exceptional empirical analysis and understanding of the cultural and political circumstances of all participating parties. This enables an understanding of mental images and attitudes.
- Careful separation of the commercial issues from the political and the military. The inevitable overlap and spillover must be continually evaluated and priorities reconsidered.
- In the process of conflict resolution, key influencers such as the U.S., China, and Japan have to be continually assessed. Other key influencers beyond the U.S., China, and Japan have to be identified.
- Within the relevant training and education, ethno-centric assumptions and attitudes have to be avoided.
- An essential function would be the determination of agenda items which can be removed or set aside for another time given cross-cultural cross currents and the interdependence of politics and commercial considerations.

CONCLUSION

In the end it all comes down to resources. The policies of trade expansion with all the financial underpinnings and the disputes about ownership of certain islands are basically two sides of the same coin. The trade agreements are aimed at securing supplies of oil, gas, metals and minerals, but also to find new markets for excess production. The island conflict is about access to vital supply sources, to the oil and gas reserves believed to lie underneath those rocks and shoals.

All countries in the region are concerned about their energy security. Demand is increasing while supply is diminishing. New offshore development in the region is delayed by the territorial disputes. Having control over those rocks and islands would give China more access to the resources in the South China Sea such as oil and minerals, but, at the same time, also control of the waters and shipping in the region. It is the Chinese leadership's approach to its energy problem: physically control the resources in order to be able to rely on them (Hayton, 2014).

China will continue to use trade and investment overseas to advance its national goals, just as it will continue its quest for physical access to resources in the South China Sea. But its neighbors in the region have the same goals. Military conflict would damage the chances for every country. Only a prescription for collective management could benefit all.

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