Economic Statecraft with Chinese Characteristics:
The Use of Commercial Actors in China's Grand Strategy

by

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ABSTRACT

This study is about Chinese economic statecraft: what it is, how it works and why it is more or less effective. The study builds a theory of economic statecraft that provides an explanation of how states use firms to pursue their strategic goals. This theoretical construct begins with an understanding of economic statecraft that has its roots in the concept of security externalities. These externalities are the security consequences that result from the commercial activity of firms or other entities that conduct international economic transactions. When states seek to deliberately generate such strategic effects by manipulating the activities of commercial actors, they are engaging in economic statecraft. Such manipulation rests on the state being able to direct and control the commercial actors. Five factors account for when the state will be able to control commercial actors. These factors reflect the business-government conditions under which economic statecraft will be likely to succeed.

Given the centrality of state-business relations in this account of economic statecraft, China provides a useful empirical context in which to explore this theory. Chinese economic statecraft provides useful variation across a number of cases to illustrate the dynamics of the theory. Specifically, the study examines three important areas of China's grand strategy that feature economic statecraft prominently: Mainland relations toward Taiwan, China's efforts to secure access to strategic raw materials, and China's sovereign wealth funds. The study compares cases of both successful and unsuccessful economic statecraft across each of these empirical contexts.

This study finds that economic statecraft is not an easy lever of national power for states to wield but when they master it, economic statecraft can have powerful strategic effects. These effects are reflected in a typology of security externalities. Control of commercial actors is a critical element enabling states to be able to generate such effects. Alignment of goals between the state and the commercial actors, unity of the state, a limited number of commercial actors, bureaucratic resources, and direct reporting relationships all facilitate effective economic statecraft.

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William J. Norris
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Chapter One

International Relations and the Study of Economic Statecraft

1. Introduction

This dissertation is about economic statecraft: what is it, how it works and why it is more or less effective. Economic statecraft can be understood as state manipulation of international economic activities for strategic purposes. To do this effectively, states must be able to control the behavior of commercial actors that conduct the vast majority of international economic activity. I explore economic statecraft in the context of contemporary Chinese grand strategy, providing a framework that explains both how states use firms to pursue their strategic goals as well as when economic statecraft is likely to succeed.[1]

In this introduction, I briefly discuss the theoretical and empirical significance of the dissertation followed by a more detailed statement of the question. I also define a few of the key terms used and review the literature on economic statecraft to situate my work in the context of existing scholarship. My own analytic framework for thinking about economic statecraft is presented in the next chapter.

[1] This dissertation is an effort to build a middle-range theory of economic statecraft. Merton is often credited with coining the term "middle range theory": Robert K. Merton, "The Role-Set: Problems in Sociological Theory," The British Journal of Sociology 8, no. 2 (1957): 106-120. For more on middle-range theories see: Alexander L. George and Andrew Bennett, *Case Studies and Theory Development in the Social Sciences* (Cambridge, Mass.: MIT Press, 2005); Derek Layder, *New Strategies in Social Research : An Introduction and Guide* (Cambridge, UK; Cambridge, MA, USA: Polity Press; Blackwell Publishers, 1993); Raymond Boudon, "What Middle Range Theories are," Contemporary Sociology 20, no. 4 (1991): 519-522.; Craig C. Pinder and Larry F. Moore, *Middle Range Theory and the Study of Organizations* (Boston: M. Nijhoff Pub., 1980) For a recent discussion of micro-level and macro-level theorizing in the monetary realm of economic power see: David M. Andrews, *International Monetary Power* (Ithaca, N.Y.: Cornell University Press, 2006).

1.1 Importance

This work is significant for three reasons. First, in the realm of theory, it contributes to the literature on economics and security—filling in gaps in the understanding of the relationship between economics, security, the state, and international commercial actors. Second, from an empirical perspective, it provides a set of tools for understanding the important role that economics plays in the real-world application of a nation's grand strategy—how states *actually* practice the exercise of their international economic power. Finally, in the context of contemporary Chinese strategic studies, it offers insight into the economic dimension of China's international relations.

Despite a long standing recognition among scholars of the importance of the relationship between economics and national security, the academic study of the economic aspects of grand strategy is under-developed.[2] In particular, relatively little work has focused on the micro-foundations of *how* states might mobilize their economic interaction to further their security goals. One reason may be found in a division within international relations between the subfields of security studies and international political economy (IPE).[3] Intellectual stove-

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[2] See for example: Jacob Viner, "Power Versus Plenty as Objectives of Foreign Policy in the Seventeenth and Eighteenth Centuries," World Politics 1, no. 1 (1948), 1-29.; Yuan-li Wu, *Economic Warfare* (New York: Prentice-Hall, 1952); Charles Hitch, "National Security Policy as a Field for Economics Research," World Politics 12, no. 3 (April, 1960), 434-452.; Klaus Eugen Knorr, *The War Potential of Nations* (Princeton: Princeton University Press, 1956); Michael Mastanduno, "Economics and Security in Statecraft and Scholarship," International Organization 52, no. 4 (1998), 825-854.; Richard Rosecrance and Peter Thompson, "Trade, Foreign Investment and Security," Annual Review of Political Science 6, no. 1 (2003), 377-398. Edward D. Mansfield and Brian M. Pollins, "The Study of Interdependence and Conflict: Recent Advances, Open Questions, and Directions for Future Research," The Journal of Conflict Resolution 45, no. 6 (2001): 834-859.; Miles Kahler and Scott L. Kastner, "Strategic Uses of Economic Interdependence: Engagement Policies on the Korean Peninsula and Across the Taiwan Strait," Journal of Peace Research 43, no. 5 (2006): 523-541. All of whom stress the significance of the intersection of economics and security.

[3] Kirshner notes that the minimal likelihood of security threats among advanced western economies during the Cold War may partly account for the relatively isolated history of development of the distinct subfields of security studies and international political economy: Jonathan Kirshner, "Political Economy in Security Studies After the Cold War," Review of International Political Economy 5, no. 1 (Jan 1998), 64-91. Michael Mastanduno, on the other hand, attributes the artificial division of the two fields to the institutionalization that occurred as a result of the two fields' academic development path during the Cold War. He makes a convincing case for the need to re-integrate the two fields of IPE and security studies. See: Michael Mastanduno, "Economics and Security in Statecraft and

piping has resulted in incomplete theoretical treatments of both the economic elements of grand strategy as well as the strategic aspects of economic interaction.[4] Many works in security studies that concern themselves with questions of grand strategy are almost exclusively focused on its military aspects with little development of the economic dimension of grand strategy.[5] As a field, security studies has spent considerable effort developing and honing its understanding of the exercise of military power: its limits, advantages, mechanisms, strategies, factors determining its success and failure, etc. We have not developed our theoretical understanding of the exercise of economic power in the same way. Just as military tools may be used to achieve strategic national objectives, economic tools may also be used.[6] Understanding how this is done

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Scholarship," International Organization 52, no. 4 (1998), 825-854. For more on this topic, see James A. Caporaso, "False Divisions: Security Studies and Global Political Economy," Mershon International Studies Review vol. 39, 1995, pp. 117-122.

[4] Russell Ong explicitly calls for greater synthesis across the subfields of economics and security studies with specific reference to the Chinese security context: Russell Ong, *China's Security Interests in the Post-Cold War Era* (Richmond, Surrey: Curzon, 2002).

[5] Much of the leading international relations scholarship on grand strategy focuses on the military dimension of grand strategy. See for instance: Carl von Clausewitz, Michael Eliot Howard, and Peter Paret, *On War* (Princeton, N.J.: Princeton University Press, 1984); Williamson Murray, MacGregor Knox, and Alvin H. Bernstein, *The Making of Strategy : Rulers, States, and War* (Cambridge, England ; New York: Cambridge University Press, 1994); Bernard Brodie, *War and Politics* (New York: Macmillan, 1973); Colin S. Gray, *Modern Strategy* (New York: Oxford University Press, 1999); Basil Henry Liddell Hart, *Strategy* (New York: Praeger, 1954); William Hardy McNeill, *The Pursuit of Power : Technology, Armed Force, and Society since A.D. 1000* (Chicago: University of Chicago Press, 1982); Peter Paret, Gordon Alexander Craig, and Felix Gilbert, *Makers of Modern Strategy : From Machiavelli to the Nuclear Age* (Princeton, N.J.: Princeton University Press, 1986); Barry Posen, *The Sources of Military Doctrine : France, Britain, and Germany between the World Wars* (Ithaca: Cornell University Press, 1984). While military aspects play a key role in a country's grand strategy, grand strategy also importantly includes an economic element. See especially, discussions of the full spectrum of tools available to states in the introduction of Paul M. Kennedy, *The Rise and Fall of the Great Powers : Economic Change and Military Conflict from 1500 to 2000*, 1st ed. (New York, NY: Random House, 1987) and footnote 2 on page 8 of Barry R. Posen and Andrew L. Ross, "Competing Visions for U.S. Grand Strategy," International Security 21, no. 3 (1996): 5-53.

[6] In fact in certain situations, economic power (as opposed to military power) may be a preferable set of tools for achieving national strategic objectives, given international distributions of military power. For instance, see: Robert Gilpin, *War and Change in World Politics* (Cambridge ; New York: Cambridge University Press, 1981). The classical realist E.H. Carr made a seminal contribution to our understanding of economic power when he stated that "the military and economic weapons are merely different instruments of power." (from Carr, *The Twenty Years' Crisis, 1919-1939; an Introduction to the Study of International Relations*, pp. 117-120). This critical insight provides the basis for my premise that economic power may be studied in much the same way that the field of security studies examines the nature and application of military power. Jacob Viner elaborated on the relationship between wealth and power (see Jacob Viner, "Power Versus Plenty as Objectives of Foreign Policy in the Seventeenth and Eighteenth Centuries" World Politics 1,1 pp.1-29). Viner argued that wealth and power are not mutually exclusive goals for states to pursue. Rather, Viner believed that power is complementary to wealth and vise versa. While I do not directly disagree with Viner, I offer a slightly different approach more in line with Carr's

constitutes an important element of understanding grand strategy. At the same time that economics has largely fallen through the cracks of security studies, the field of economics has generally ignored the strategic security consequences that arise in the course of international economic activities.[7] These two gaps result in an under-developed understanding of economic statecraft: the economic component of grand strategy.[8] Specifically, the field suffers from a relative lack of research on the economic mechanisms states use to pursue their grand strategy under conditions of modern globalization.[9] As a result, contemporary analyses of grand strategy as well as strategic assessments of economic policy remain incomplete.

Developing a better understanding of how states employ economics in their grand strategy is important not only as a theoretical exercise designed to fill gaps in the field, but also serves as a useful tool for understanding the important role that economics plays in the practical applications of a nation's grand strategy. Practitioners as well as scholars seek a deeper understanding of the nature, forms, limitations and possibilities of exercising economic power. It should be stated at the outset that economic power is often a difficult lever of international power to wield, but when it does occur it can be very important. Economic statecraft featured prominently in the American post-World War II containment strategy (Marshall Plan, Bretton Woods, GATT, the rebuilding and economic revitalization of Japan and Germany, etc.).[10] For a

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perspective. I would argue that the pursuit of wealth is really little more than the national pursuit of power by other means.

[7] John C. Scharfen, *The Dismal Battlefield : Mobilizing for Economic Conflict* (Annapolis, Md.: Naval Institute Press, 1995); Author conversations with Martin Feldstein, President Emeritus of National Bureau of Economic Research.

[8] Baldwin also notes that the field's understanding is under-developed. I share his view that Clausewitz's central insight that war is the continuation of politics by other means, can also be applied to the study of economic statecraft as simply another means for states to pursue their national interests. See: David A. Baldwin, *Economic Statecraft* (Princeton, N.J.: Princeton University Press, 1985) pp. 64-65.

[9] A more complete theory of economic statecraft would connect the micro-level behavior of global commercial actors with the larger, macro-level strategic consequences of that economic interaction.

[10] Michael Mastanduno, "Trade as a Strategic Weapon: American and Alliance Export Control Policy in the Early Postwar Period," International Organization 42, no. 1: 121.; China's current grand strategy also features a prominent role for economics.

variety of reasons, states often prefer to use economic rather than military tools of statecraft. Indeed, at different times throughout history, various countries ranging from Britain (efforts to support its continental allies in the late 1700s)[11] to Japan (in the 1980s)[12] have displayed a preference for using economic levers of power to pursue their strategic objectives. Reasons for pursuing national strategic objectives via economic rather than (or in conjunction with) military levers of power vary widely.[13] For example, exercising military power may be an *unattractive* option because of alliance obligations (Suez Crisis of 1956), a lack of force projection capabilities (numerous cases of UN sanctions), fear of escalation, etc.[14] In other cases, economic levers of power may be a particularly *attractive* option because of: asymmetric dependence (pre-World War II Japanese reliance on US oil), the lulling effects of perceived benefits of economic ties (nineteenth century railroad investment in the Far East), or relative ease of implementation (2006 freezing of DPRK assets at Banco Delta in Macao).[15] Over time and across geographic spaces, economics has been employed as a tool of national power—understanding exactly how states employ economics in practice to achieve their grand strategic objectives is a useful contribution to policy makers' understanding of how states behave in the international system.[16]

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[11] Sherwig, John M., *Guineas and Gunpowder: British Foreign Aid in the Wars with France, 1793-1815* (Cambridge: Harvard University Press, 1969).

[12] Heginbotham, Eric and Richard J. Samuels "Mercantile Realism and Japanese Foreign Policy," International Security vol. 22, no. 4 (Spring, 1998) pp. 171-203; also see: Pyle, Kenneth B. *The Japanese Question* (Washington, D.C.: AEI Press, 1996) and Bienen, Henry, ed., *Power, Economic Relations, and Security: An Overview with U.S.-Japan Cases* (Boulder: Westview Press, 1992).

[13] See Klaus Eugen Knorr, *The Power of Nations : The Political Economy of International Relations* (New York: Basic Books, 1975) pp. 18-19.

[14] For additional work on the declining utility of military statecraft, see: Quincy Wright, *A Study of War*, 2 , ed. (Chicago: University of Chicago Press, 1965), especially his "Commentary on War since 1942." Also see: Knorr, *The Power of Nations,* p. 45 and his Chapter V, "Uses of Military Power," and Klaus Eugen Knorr and Frank N. Trager, *Economic Issues and National Security* (Lawrence: Published for the National Security Education Program by the Regents Press of Kansas, 1977) p. 116.

[15] For more on the attractiveness of economic power, see: Robert Gilpin, *War and Change in World Politics* (Cambridge ; New York: Cambridge University Press, 1981) p. 218.

[16] "A good dissertation asks an important question. The answer should be relevant to real problems facing the real world." Stephen Van Evera, *Guide to Methods for Students of Political Science* (Ithaca: Cornell University Press, 1997) p. 97. In this dissertation I seek to contribute both to the theoretical and the applied understanding of economic statecraft.

The case of modern day China is of particular significance; both for the theoretical analysis of economics and its role in modern grand strategy, as well as for the empirical analysis of a significant emerging power in the international system. China—a rising power in the international system—has explicitly sought to develop and incorporate economics into its grand strategy. Understanding how this is done and what conditions facilitate the effective use of economic interaction to achieve foreign policy objectives is the third important reason for developing a theory that links microeconomic, firm-level behavior with the grand strategy of states. China's rise has attracted considerable scholarly attention,[17] but while some of this work has recognized the increasingly sophisticated nature of China's foreign policy,[18] the scholarship on Chinese foreign policy has not yet produced an adequate framework for understanding the economic dimension of China's foreign policy. Although there are a handful of China scholars that have sought to examine the role of economics in China's foreign policy, most of this work is still underdeveloped.[19]

Although this gap in the literature is understandable given that China's sophisticated use of economics in its foreign policy is still a fairly recent phenomenon, it nevertheless ought to be addressed. China's economy has recently become the second largest in the world and continues to grow rapidly. Moreover, China seems intent to use its economic clout to help achieve its

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[17] For a sample, see: Avery Goldstein, *Rising to the Challenge : China's Grand Strategy and International Security* (Stanford, Calif.: Stanford University Press, 2005); Robert S. Ross and Feng Zhu, *China's Ascent : Power, Security, and the Future of International Politics* (Ithaca: Cornell University Press, 2008); Alastair Iain Johnston & Robert S. Ross, *Engaging China: Management of an Emerging Power* (New York: Routledge, 1999); Kokubun Ryosei & Wang Jisi, *The Rise of China and a Changing East Asian Order* (New York: Japan Center for International Exchange, 2005); Alastair I. Johnston and Robert S. Ross, *New Directions in the Study of China's Foreign Policy* (Stanford, Calif.: Stanford University Press, 2006); the 2003 Ba'ao Forum; David L. Shambaugh, *Power Shift : China and Asia's New Dynamics* (Berkeley: University of California Press, 2005) etc.

[18] E. S. Medeiros and M. T. Fravel, "China's New Diplomacy," Foreign Affairs 82, no. 6 (2003), 22-35.

[19] These works are reviewed in more detail in the literature review that follows.

strategic objectives.[20] Indeed, as China pursues a "peaceful rise" grand strategy, economic power seems to provide a more and more attractive alternative lever of power than military force. In addition, current indications seem to suggest that this economically-oriented "peaceful rise" strategy is producing favorable results and greatly strengthening China's ties to other countries in the region and beyond. To what extent is China's rapidly rising economic clout going to be able to be translated into actual strategic results for China? As a field that examines important real-world international phenomena, we have an interest in understanding the manner in which economic interaction is used to pursue states' strategic objectives.

1.2 The Question

How does economics affect national security? More precisely, what is the manner in which economic interaction may carry ramifications for security? To answer that question, in Chapter Two I offer a typology of the economics-security interface. This typology does two things. First, it maps out the range of possible ways economics can affect security—the full domain of the phenomenon under investigation. Second, the typology specifies the causal chains that connect the micro-economic behavior of firms with macro-level strategic security effects. The typology discussion not only outlines the various channels through which economic interaction generates security consequences but also what states can do about these consequences.

I also ask why economic statecraft is more or less effective. What are the circumstances under which economic statecraft is more or less likely to achieve the strategic goals of the state? As is demonstrated in the literature review below, scholars have not adequately addressed the

[20] In the case of China, economics is a critical component of Beijing's "New Security Concept" and economics seems likely to continue to play an important role in China's pursuit of its strategic objectives. See: C. Fred Bergsten and others, *China: The Balance Sheet* (New York: Public Affairs, 2006).

role of commercial actors in economic statecraft. In particular, state coordination and control of the commercial actors that carry out the vast majority of economic commerce has received comparatively little attention.[21] How does a state manipulate commercial actors to behave in ways that support political goals? Despite their centrality to the exercise of international economic power, these commercial actors have not been adequately incorporated into a general theory of economic statecraft.

1.3 Definitions

So how should one think about these commercial actors? Who are they? *Commercial actors* are those entities that actually carry out international economic transactions (e.g. buying and selling commodities, making investments, selling products, building factories, purchasing assets, employing workers, etc.). They are often (but not always) multinational corporations.[22] States, strictly speaking, do not actually conduct the vast majority of today's international economic interaction—firms do. This is an empirical reality that has not been appropriately accommodated in the study of economic statecraft. Understanding how states use economics to pursue their strategic objectives requires that we focus on the role of commercial actors—the entities that actually conduct "economics."

So what is meant by the term "economics?" *International economic interaction* is the generic term used to describe the full range of economic activity that can take place across state

[21] Of course, control of commercial actors is not the only requirement for successful economic statecraft. I argue that there are four key determinants of the effectiveness of economic power: the relative importance of the issue area under contention, the magnitude of the economic interaction, the elasticity of the economic interaction, and the state's ability to control and mobilize that economic interaction. Each of these—in particular, this last factor—will be explained in more detail in Chapter Two.

[22] In some instances, states themselves may directly engage in economic transactions (foreign aid, procurement, etc.) but for the most part, states write the rules of the game and define the conditions under which firms operate. Being a referee or designing the playing field is not the same thing as being a player in the match—although both have an influence over the outcome of the game.

borders. This economic interaction may take the form of trade, investment or in some instances even monetary interaction. Although trade tends to receive the most attention in the international relations literature on economics and security (as discussed below), it seems reasonable to believe that not all economic interaction is trade. Moreover, other forms of economic interaction may have very different security implications than trade.[23] *Trade* encapsulates the exchange of goods and services across borders and is often measured in terms of exports and imports. The term *financial* is used to denote economic interaction relating to investment activities and capital flows. Investments typically come in two forms: foreign direct investment or portfolio investment.[24] The term *monetary* is used to distinguish the class of economic interactions that involve central bank relations, macro-economic coordination and foreign exchange policy including such areas as exchange rates, currency unions, interest rates, money supplies, the gold standard, foreign currency reserves and the like.

Grand strategy is the notion that connects these various forms of economic interaction to a state's pursuit of its national interests. Specifically, Avery Goldstein defines grand strategy as: "the distinctive combination of military, political, and *economic* means by which a state seeks to

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[23] Trade is only one facet of the complicated economic connections among states and I believe there is much insight to be gained by not limiting the scope of consideration to trade alone. Indeed there is considerable reason to believe that investment interactions have very different security implications than trade. Likewise, it seems plausible that the security implications of monetary interactions are also very different from either investment or trade. Although this is an intriguing insight to pursue further, it is largely outside the scope of this study and will need to wait until a future project to more precisely explore how the security externalities of the various types of economic interaction differ.

[24] Crudely speaking, foreign direct investment is distinguished from portfolio investment by its relative liquidity. FDI generally involves joint ventures or wholly-owned foreign enterprises operating in the host country. These ventures tend to involve assets that are relatively fixed. In contrast, portfolio investment is generally a much more liquid, usually non-controlling, non-operating, equity-based passive ownership investment that can take the form of stock, debt, or other derivatives that can be fairly easily traded on public exchanges. For an elaboration of the distinction between portfolio investment and FDI see Richard Rosecrance and Peter Thompson, "Trade, Foreign Investment and Security," Annual Review of Political Science 6, no. 1 (2003), especially pp. 383-389. For more on FDI in China see Ying-qi Wei and V. N. Balasubramanyam, *Foreign Direct Investment : Six Country Case Studies* (Cheltenham, UK: Edward Elgar, 2004); and Yasheng Huang, *Selling China : Foreign Direct Investment during the Reform Era* (New York: Cambridge University Press, 2003).

ensure its national interests."[25] My approach to grand strategy (and economic statecraft in particular) is closely tied to the intellectual tradition of neoclassical realist international relations scholars that make several assumptions regarding the centrality of international anarchy, the essentially competitive nature of international politics, the importance of power and the pursuit of national interests, etc.[26] States have a grand strategy that is based on their understanding of their national interests and states seek to pursue these interests according to the ordering of their preferences given the constraints states face. Countries are relatively rational actors that seek to pursue their national interests in the international system according to their capabilities.[27] Their grand strategy can be thought of as a "means-ends chain" as Barry Posen first described:

> "A grand strategy is a political–military, means–ends chain, a state's theory about how it can best 'cause' security for itself. Ideally, it includes an explanation of why the theory is expected to work. A grand strategy must identify likely threats to the state's security and it must devise political, economic, military, and other remedies for those threats. Priorities must be established among both threats and remedies because given an anarchical international environment, the number of possible threats is great, and given the inescapable limits of a national economy, resources are scarce. ... Of course, grand strategies are almost never stated in such rigorous form, but the analyst may be guided by this conceptualization in his attempt to ferret out the grand strategy of the state . . ."[28]

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[25] [My italics added] Goldstein, *Rising to the Challenge,* p. 17. For an excellent, brief discussion on the nature of grand strategy see Goldstein pp. 17-20.

[26] For a recent synopsis of classical realism in contemporary international relations scholarship see: Steven E. Lobell, Norrin M. Ripsman, and Jeffrey W. Taliaferro, *Neoclassical Realism, the State, and Foreign Policy,* (New York: Cambridge University Press, 2008).

[27] States will try to pursue their preferences in the international environment. See Goldstein's footnote 6 on p. 17: "...leading states have usually sought to shape, and not just survive in, their international environment, typically in ways that will further enhance their wealth, power, and status." Goldstein, *Rising to the Challenge*. Of course such efforts are constrained by varying levels of permissiveness in the international environment and the limitations of a state's capabilities. A state with greater capabilities will be able to pursue secondary and even tertiary interests, while some states with limited international power will have difficulty even pursuing minimal core national interests. In the same way, a cooperative international environment in which other states are supportive of your national goals makes pursuit of those goals easier.

[28] Posen, *The Sources of Military Doctrine* p. 13. Conceptualizing grand strategy as a means-ends chain allows scholars to study both the tools used to pursue national interests and the content of those national interests themselves. This project is focused on studying one particular type of tool that states use to pursue their national interests, namely economic statecraft. As discussed in the literature review below, most of the work that has been done on the topic of understanding the tools of grand strategy has tended to focus on the military realm. Although this is an important element of national power, it is not the only (nor is it necessarily the most effective) means of achieving national objectives. The field's theoretical treatment of economic tools of grand strategy seems to be under-developed given its practical relevance.

In China's case, the Communist Party defines China's national interests and implements China's grand strategy. This imparts a few important characteristics to China's grand strategy.[29] For example, Chinese strategic policy is subject to factionalism. However, such factionalism has a limit given the hierarchy of domestic politics and the relative power of the central leadership. The result is that China acts (for the most part) like any other unitary, rational actor in pursuing its national goals in the international system. Many assumptions about China and its grand strategy are topics of intense debate in the China field today.[30] I do not pretend to adequately engage in these debates here, but good scholarship should lay bear its important analytical assumptions as explicitly as possible.[31]

The dissertation also draws on a few other simple concepts in economics that deserve to be briefly defined here. The economic concept of *elasticity* will be used to refer to how badly something is needed *and* how easily this need can be met by some substitute.[32] Frequently, in

[29] Goldstein offers a terrific synopsis of these characteristics in *Rising to the Challenge.* Preservation of the Communist Party's continued grip on power is a primary concern. One of the key legitimating factors that enables this is continued economic growth. Such growth helps ensure domestic stability. In addition, China's international economic interaction helps pave the way for its rise to great power status. Economics features prominently in China's grand strategy. See, for instance, 王缉思 [Wang Jisi] "中国的国际战略研究：范式的反思与构建" [trans: "Studying China's International Strategy: Model Reconsideration and Construction,"] 国际政治研究 2007 年 第 4 期 总第 106 期 1-8 页. For a good introduction to a variety of perspectives on China's grand strategy, see that entire dedicated issue of 国际政治研究 [English name: International Politics Quarterly] 2007, issue 4, no. 106.
[30] For example, there has been some debate over whether or not China even has a grand strategy. (e.g. Michael D. Swaine, "Does China have a Grand Strategy?" Current History 99, no. 638 (2000): 274.; Pillsbury, *China Debates the Future Security Environment*). However, when these arguments are unpacked, most of this debate is, at its core, an epistemic debate about whether or not *any* state has a grand strategy and how coherently *any* state can pursue its national interests. Such positions often argue that states are not unitary actors and are too prone to domestic schisms that effectively prevent a coherent rational pursuit of national interest (or in the extreme, even prevent a meaningful consensus of what national interests are). Although frequently framed as Chinese exceptionalism, similar debates can apply to discussions of Russian, Indian, Japanese, European and even American debates over grand strategy. While this is an interesting academic debate, these questions of whether states have a grand strategy will not be engaged in this work. My analysis of China's economic power assumes that China, like other nations, has a grand strategy.
[31] These assumptions are not very far removed from mainstream security studies or from the current conventional wisdom regarding state of the art scholarship on international relations and China. I merely wished to make these assumptions explicit at the outset.
[32] Klaus Knorr's discussions of economic power also include elements of these two qualities. See: Klaus Eugen Knorr and Frank N. Trager, *Economic Issues and National Security* (Lawrence: Published for the National Security Education Program by the Regents Press of Kansas, 1977) especially pp. 102-105.

discussions of economic power, the term *dependence* is used. In this dissertation, *dependence* refers to the fraction of the total supply (or the fraction of the total demand) for a given good, service, etc. coming from a single source. The definition of an *externality* also originates in economics. The concept of externalities captures the notion that a given transaction may also produce effects that are not fully internalized among the parties that are directly conducting the transaction. The dissertation uses the term *security externalities* to denote those security effects that are not fully internalized among the parties directly conducting any given economic interaction.[33] Whether or not states or firms are conscious of these security externalities does not—strictly speaking—matter. Whether these security effects are intended or not also does not matter in terms of the security consequences of the economic interaction.[34] Neither intentionality nor awareness matters.

An example may help to illustrate. Air pollution is often an environmental externality resulting from a factory employing its workers to produce steel. A common consequence of high levels of air pollution is asthma. Whether or not local citizens are aware of the presence of (or cause of) air pollution does not—strictly speaking—matter in terms of the incidence of asthma in the general population. Nor does it matter that the factory owners are aware that their economic activity of employing workers to produce steel is producing an environmental externality. The likelihood of developing asthma would be the same whether or not owners or citizens were

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[33] Of course not all security externalities are a consequence of economic activity. There may be security externalities that stem from environmental activities, social changes, demographic trends, or any other number of factors. This dissertation, however, will be limited to those security externalities resulting from economic activity. When the term "security externalities" is used, it is used to denote the security consequences arising as a by-product of economic interaction.

[34] Intentionality is merely likely to impact the degree to which *manipulation of the externality* occurs—such manipulation is defined as economic statecraft and is conceptually distinct from the notion of security externalities (see my definition of "Economic Statecraft" below). What really matters from the point of view of the strategic outcomes are the security externalities themselves—whether or not they were deliberately generated or simply the unintended by-product of normal commercial behavior does not really affect the security consequences *per se*. Whether or not intended, the casual logic of security externalities holds; that is, commercial actors can and do generate security consequences as a result of economic interaction. When states seek to deliberately manipulate that economic interaction they are engaging in economic statecraft.

conscious of the environmental externality. In the same way, whether the factory intended to cause asthma is unrelated to the fact that asthma was caused. An externality was produced because there were effects generated that were exogenous to the transacting parties. This exogeneity is what makes these effects externalities, irrespective of the intentions or awareness of the transacting parties. Just as environmental externalities may result from economic activity, security externalities may be thought of as the security consequences stemming from economic activity. Some examples of types of security externalities arising from economic interaction include: sensitive technology transfer, loss of strategic industries, concentrated supply or demand dependence (in areas of trade, investment and monetary relations), the forging of common interests resulting from currency unions, joint ventures, macroeconomic coordination or even simple trade complementarity.[35] The final definition builds on this concept of security externality.

I define *economic statecraft* as the state manipulation of economic interaction to capitalize on or to reduce the associated security externalities. In this way, economic statecraft is conceptually distinct from the security externalities that result from the activities of commercial actors. States are, to varying degrees, aware of these security externalities. Some externalities may be beneficial while others may be detrimental. Since the externalities are generated by commercial actors that are subject to incentive structures at least partly determined by states, states can seek to influence the behavior of commercial actors in an effort to promote the state's strategic objectives. When states seek to manage security externalities they are engaging in what is known as economic statecraft. This is where intentionality plays a role. Security externalities

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[35] In an effort to systematically analyze the various ways economic interaction may generate security externalities, in the next chapter, the dissertation provides a typology organizing security externalities according to their effects. Security externalities are categorized according to those whose effects are primarily economic and those whose effects are primarily military. For more detail on the various types of security externalities, see the section in the next chapter entitled: "Typology of Security Externalities."

may simply result from the autonomous activities of commercial actors pursuing profits (without any direction by the state). However, economic statecraft is the intentional attempt of the state to deliberately incentivize commercial actors to act in a manner that generates security externalities that are conducive to the state's strategic interests.[36] Economic statecraft often occurs as part of a state's grand strategy.[37] Such manipulation of commercial actors—and the economic interaction they conduct—occurs through a range of state policies including sanctions, taxation, embargoes, trade agreements, asset freezing, engagement policies, currency manipulation, subsidies, tariffs, trade agreements, etc. Economic statecraft encompasses the scope of state actions taken to manipulate economic interaction and the security externalities associated with that economic interaction. In this manner, states may use commercial actors to achieve foreign policy objectives by creating incentives for commercial actors to behave in a way that carries with it security externalities that are conducive to a state's strategic interests.

As this definition of *economic statecraft* differs from the one most common in the literature, it provides a convenient starting point for a larger examination of the limitations and gaps found in the existing literature on economic statecraft.

[36] Note that economic statecraft (the attempt on the part of the state to manipulate economic interaction to capitalize on the security externalities that result) is analytically distinct from the security externalities themselves. Security externalities may be (inadvertently) generated by commercial actors engaging in various types of economic interaction simply for their narrow commercial rationales. With economic statecraft, there is an element of intentionality present. When engaging in economic statecraft, the state seeks to direct and manipulate the economic activity so as to deliberately generate the associated security externalities.

[37] Broadly speaking, states have four objectives when they employ economic statecraft to achieve their strategic objectives: 1.) Limit the good done to rivals/enemies, 2.) Maximize the bad done to rivals/enemies (including transformation) 3.) Limit the bad done to themselves/allies 4.) Maximize the good done to themselves/allies.

1.4 Literature Review

The existing literature on the causes, nature and exercise of international economic power suffers from a lack of precision regarding how states *actually* use economics to pursue their strategic objectives. In particular, the literature has not adequately incorporated the role of commercial actors in its understanding of states' strategic use of economics to pursue national foreign policy objectives. This gap is mainly attributable to the field's tendency for state-centric analysis that often fails to pay adequate attention to the role of commercial actors. Addressing this shortcoming requires that we examine the role of these actors in economic statecraft. Doing so will provide a much richer understanding of exactly *how* a state uses economics to pursue its strategic foreign policy goals.

David Baldwin's *Economic Statecraft* is one of our field's best efforts to understand the wide range of economic tools states could call upon to achieve their national interests. His work attempts to systematically catalogue and evaluate the various types of economic statecraft that states can use to achieve their strategic objectives. By calling attention to the political rather than economic effects of using economic tools, he seeks to challenge the view that economic statecraft is not a very effective tool of international relations. The early chapters wrestle with the conceptual elements of how to analyze economic statecraft, while the later chapters discuss particular cases of economic statecraft. The work is often cited as the seminal modern text on economic statecraft and provides a useful reference for students seeking to understand the economic tools of international power.

In particular, three aspects of this work form the basis for my own project. First, his work builds on Lasswell's four-part classification scheme of national power in seeking to develop and expound the economic set of tools available to states to pursue their national objectives.[38] This is a useful starting point. Second, Baldwin makes a compelling case that "foreign policy is generally viewed as purposive behavior, i.e., activity oriented toward some end, goal, objective, or aim."[39] Finally, Baldwin seeks to illuminate both "positive" and "negative" consequences from economic statecraft—he points out that scholarship on economic statecraft often fails to adequately appreciate the strategically beneficial aspects of economic interaction. His insight that economic interaction can have both constructive and destructive effects on the target also informs my own typology.

One area of Baldwin's work that can be improved is his definition of "economic statecraft" itself. In particular, Baldwin's concept is poorly specified and ill-suited to developing a deeper understanding of how states actually exercise their economic power. Baldwin focuses his scholarship on the phenomenon of "economic statecraft" which he defines as "influence attempts relying primarily on resources that have a reasonable semblance of a market price in terms of money."[40] Essentially, Baldwin's definition begins by saying that *statecraft* defines the range of tools, policies, etc. that a state has at its disposal to pursue its interests in the international system.[41] This definition is straightforward. He goes on to define *economic* as those transactions, goods, etc. which can be measured and priced in terms of money.[42] This logic leads Baldwin to conclude that *economic statecraft* defines the activities, policies, etc. of a state that rely on resources that have a price tag. The purpose in constructing such a definition seems to be to emphasize that the term "economic" merely defines the means employed (rather than the

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[38] Harold D. Lasswell, *Politics: Who Gets What, When, and How.* (New York: Meridian Books, 1958). Lasswell's postscript suggests that states can exercise their power across four dimensions: information, diplomacy, economics and force. My work, like Baldwin's, is concerned with the economic tools of statecraft.
[39] David A. Baldwin, *Economic Statecraft* (Princeton, N.J.: Princeton University Press, 1985) p. 16.
[40] *Ibid.* p. 30. Baldwin actually introduces this definition on page 13-14 of Chapter 2, but develops it more fully in his Chapter 3 "What is Economic Statecraft?". The framework I present in Chapter Two provides a much more detailed discussion of how these types of "influence attempts" actually work. By elucidating specific causal mechanisms and the micro-economic foundations of economic statecraft, I provide a more powerful explanatory framework for exploring how states use economics in their grand strategy.
[41] See *ibid.* pp. 8-9 in which he borrows from Harold and Margaret Sprout and K.J. Holsti.
[42] *Ibid.* pp. 31-32.

end-state goals that are sought—which may be purely political). Although this perspective is not incorrect and in the practice of international relations, states do seem to frequently seek to achieve non-economic ends by way of using economic means, this does not seem to be a particularly innovative nor analytically helpful insight. It would be more interesting if we could say something about exactly how it is that states use such tools. What is different about state use of economic tools as opposed to other means of international influence? What are their limits? Are there any patterns that we can explore regarding conditions that are likely to result in "success?" If so what are those conditions? In what manner, exactly, do state applications of economic instruments produce the strategic consequences that states seek? These are the questions that drive my project. Baldwin's definition of *economic statecraft* is too vague to provide useful analytical leverage on such questions. In the section on "Definitions" above, I offered a more specific, analytically precise definition of *economic statecraft* that moves away from Baldwin's "intentionally broad" definition in favor of an understanding of *economic statecraft* that frames the strategic outcomes as security externalities that result as a consequence of the economic activities of commercial actors. Defining *economic statecraft* in this way allows us to be more precise about the conditions under which and the manner in which states seek to use economic interaction to promote their strategic goals.

By focusing the analytical lens on the consequences of various patterns of economic interaction, my work is also able to move beyond another limitation of Baldwin's formulation: namely, that specific policy tools are categorized simply as "positive" or "negative." On pages 41 and 42, he provides a table of policy tools that states may use to pursue their national objectives. These tools are categorized as either "negative" (having a harmful effect on the target) or "positive" (having a beneficial effect on the target) and as having to do with either "trade" or "capital" (by which he means financial flows). His definition of economic statecraft as essentially the economic means to realize foreign policy objectives may be partly responsible for this narrow, binomial categorization. The outcome of economic statecraft (i.e. the end it is designed to achieve) is largely exogenous for Baldwin. He is primarily concerned with identifying the economic set of tools that states can use to pursue a range of foreign policy goals.[43] By framing economic statecraft as an issue of security externalities, my approach shifts the focus to the security *effects* of economic interaction and thus is better able to illuminate and distinguish the specific types of security concerns arising out of various patterns of economic interaction. Rather than merely categorizing the various policy tools that states can use to engage in economic statecraft (which, as Baldwin admits, may be an almost infinite list of policy tools), I organize the space on a different basis.[44] I put forward a comprehensive typology that distinguishes the specific security effects that state policies may seek to bring about. By framing the conceptual space in this way, I am better able to distinguish and specify the causal pathways that link the economic behavior of commercial actors to the ultimate security consequences for states. This conceptual approach also places a state's policy tools in their proper context: namely as levers that states can pull to influence the commercial actors that actually conduct international economic interaction. In some circumstances, these levers are very powerful. In other conditions they may be less effective at influencing the behavior of commercial actors. Such an approach provides a much clearer view of the inner workings of economic statecraft—exactly how states use economics to pursue their foreign policy objectives. This higher resolution on the actual conduct of economic statecraft permits a richer categorization of the conceptual domain of economic statecraft than a positive/negative framework.

[43] On pp. 40-41 he provides a long list of the "wide variety of foreign policy goals."*ibid.*
[44] "These tables are intended to illustrate the wide variety of economic techniques and do not purport to be exhaustive." *ibid.* p. 40. One can imagine a dizzying array of policy options available for the state to influence economic conduct: laws, conditionalities, regulations, tariffs, taxes, licensing, quotas, bilateral and multilateral regimes, fiscal measures, subsidies, etc.

Of course Baldwin's is not the only seminal work on this important topic. There is a long history of scholarly efforts to examine how states could use their economic relations to pursue security goals. In fact, unlike much of the more recent scholarship on the topic, many of the earliest works were empirically-driven analyses that gave considerable attention to understanding the role of commercial actors in states' foreign policy. Eugene Staley premised his 1935 work, *War and the Private Investor,* on the notion that the economic behavior of private sector actors cannot be fully understood without also considering the political and military contexts that frequently influenced ultimate economic outcomes.[45] His work drove home the importance of considering the commercial actors when examining how states wield their international economic power. In particular, Staley's framing of his cases reflected the heart of the business-government challenge inherent in economic statecraft: namely whether the commercial actor or the state is ultimately driving the strategic outcome. One of the best known classics, is Albert Hirschman's study of Germany's trade relations with its weaker Eastern European neighbors.[46] Hirschman depicted the German state policies designed to establish, deepen and exploit asymmetric structural economic dependence on the part of Eastern European states on Germany before World War II. By the time that Hirschman wrote his well-known book, Herbert Feis had already discussed how pre-World War I powers used investment and finance to facilitate their own security policies.[47] Each of these works helped to frame how states could use various types of economic interaction to pursue their strategic goals.

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[45] Eugene Staley, *War and the Private Investor; a Study in the Relations of International Politics and International Private Investment* (Garden City, N.Y.: Doubleday, Doran & Co., inc., 1935). This work was an early attempt to systematically examine cases in which commercial actors behaved in ways that were conducive to states' strategic objectives. Staley was also keen to note that his research often found governments doing the bidding of their commercial actors as well.

[46] Albert O. Hirschman, *National Power and the Structure of Foreign Trade* (Berkeley and Los Angeles: University of California press, 1945).

[47] See: Herbert Feis, *Europe the World's Banker, 1870-1914* (New Haven; London: Yale university press; H. Milford, Oxford university press, 1931). Feis would later also document the American and British efforts to support

Although some of these early works in the field of economics and security examined ways states may seek to further their strategic goals through private sector or quasi-private sector actors,[48] most of this literature was largely framed in mercantilistic terms that do not account for the complex relations between the state and the firm in a more modern, liberalized economic context. Although the broad, general concepts pertaining to the role of the state in managing its economic affairs may still provide insightful conceptual leverage, much of the specific empirical relevance of these early works are naturally rather limited in a contemporary Twenty-First Century context.

Later works did seek to explore how states could use economic power to achieve their interests in a more modern, globalized and interdependent environment. Authors in this spirit include Klaus Knorr, Robert Gilpin, Robert O. Keohane, and Joseph S. Nye whose work on the nature and exercise of modern transnational economic power was both insightful and path breaking.[49] Knorr's work carried E. H. Carr's initial insight—that economic power and military power are merely two sides of the same coin—into a more modern multinational context. Knorr sought to provide a theoretical framework for understanding how modern states harness, aggregate and utilize the economic tool in international relations. Knorr applied economic concepts and principles to parse out the nature, mechanics and consequences of economic

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China's currency against Japanese attempts to undermine the currency as part of Japan's strategy to fracture China into more easily conquered autonomous regions. Herbert Feis, *The Road to Pearl Harbor; the Coming of the War between the United States and Japan* (Princeton: Princeton University Press, 1950).

[48]See especially Staley's *War and the Private Investor* and Hirschman p. 170.

[49]See Klaus Eugen Knorr, *Power and Wealth; the Political Economy of International Power* (New York: Basic Books, 1973), Knorr, *The Power of Nations : The Political Economy of International Relations,* Klaus Eugen Knorr and Frank N. Trager, *Economic Issues and National Security*, Vol. 7 (Lawrence: Published for the National Security Education Program by the Regents Press of Kansas, 1977). Also see Robert Gilpin, *U.S. Power and the Multinational Corporation : The Political Economy of Foreign Direct Investment* (New York: Basic Books, 1975); Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton, NJ: Princeton University Press, 1984); and Robert O. Keohane and Joseph S. Nye, *Power and Interdependence: World Politics in Transition* (Boston: Little, Brown, 1977).

power.[50] In many respects, this dissertation is an extension of Knorr's efforts to analyze the economic dimensions of the strategic international power dynamics between states in the international system.[51] Although Knorr provided an intriguing foundation for the study of economic power, his enumeration of the various uses of economic leverage lacked a unifying logic as well as a mutually exclusive and collectively exhaustive categorization. In the next chapter, I present a typology of the various security effects that may stem from a variety of economic interactions. By building a framework based on understanding the relationship between economics and security to be one of "security externalities," I bring a unifying conceptual organization to many of the "uses" of economic power that Knorr first itemized.

While Knorr's work is an important contribution, he focused on the macro-level strategic aspects of economic power: "Our focus on government policy excludes from major consideration those kinds of international relations that occur between private groups and individuals across national boundaries."[52] As a result, he was not able to fully explore the tactical dimensions of the actual exercise of economic power. One area in particular that seems to be lacking in Knorr's work is the role of commercial actors.[53] Even though "many of these interactions are fostered by governments (e.g., international trade conducted by private business), and their regulation often raises issues of foreign policy" Knorr was not able to go into any significant level of detail regarding the operational role of commercial actors in the exercise of economic

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[50] See especially Chapter 4 "International Economic Leverage and Its Uses," of Knorr and Trager, *Economic Issues and National Security,* and Chapter I "International Power and Influence" of Knorr, *The Power of Nations.*
[51] Indeed, many of the examples of various types of economic power that Knorr discusses (like those on pp. 82-84 *ibid.* and those on pp. 99-102 of Knorr and Trager, *Economic Issues and National Security,*) may be mapped onto the typology I present in Chapter 2.
[52] Knorr, *The Power of Nations,* p. 28.
[53] In *The Power of Nations*, Knorr discusses multinational corporations chiefly in the context of a brief refutation of neo-Marxism. See: Chapter IX "Imperialism and Neocolonialism," in *ibid.* pp. 239-309.

statecraft.[54] By developing a commercial actor-based approach to economic power, I extend some of Knorr's principles and examine how they actually play out in modern practice.[55]

Other important authors that contributed to the development of this economic power literature, while providing important theoretical insights, likewise tended to loose sight of the commercial actors. Susan Strange made a significant contribution with her depiction of the structural dimension of economic power.[56] Although mainly concerned with national macroeconomic goals, Richard Cooper was among the first to elucidate the constraining nature of modern interdependence on states' use of economic tools to achieve their objectives in the international system.[57] Keohane and Nye explicitly sought to examine the various ways in which states were made vulnerable to economic pressures from other states in this interdependent world.[58] Their notions of asymmetry and dependence exploitation inform many of the concepts and ideas put forward in this dissertation. Although these works blazed important new paths in the study of international economic power, they often sacrificed specificity in their efforts to build a general theoretical foundation for the exercise of economic power. In so doing, they drifted further and further away from an analytical framework that integrated commercial actors into a larger strategic understanding of economic statecraft.

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[54] *Ibid.* p. 28.

[55] Also, as is generally the case with seminal works in any field, this early literature has theoretical gaps around the precise mechanisms involved. Part of this dissertation's contribution is to specify and disaggregate some of the effects and causal logic that Knorr highlights in his work.

[56] Susan Strange, *States and Markets* (London: Pinter Publishers, 1988). Although the systemic architectural designs of the international regime do clearly confer a significant source of power to the hegemon, like other works in the hegemonic theory literature, Strange's focus on the third level of analysis prevents her from directly engaging the role of commercial actors. Cheryl Christensen also discusses the importance of structural power in the context of economics and security in her Chapter 5 "Structural Power and National Security," in Knorr and Trager, *Economic Issues and National Security,* pp. 127-159.

[57] See Richard N. Cooper and Council on Foreign Relations, *The Economics of Interdependence; Economic Policy in the Atlantic Community*, 1st ed. (New York: Published for the Council on Foreign Relations by McGraw-Hill, 1968) especially Chapter 6 "National Economic Policy in an Interdependent World."

[58] Robert O. Keohane and Joseph S. Nye, *Power and Interdependence : World Politics in Transition* (Boston: Little, Brown, 1977).

One portion of the literature that has sought to lend precision to the discussion of the tools of economic statecraft is the literature on sanctions. Unfortunately, much of this prolific body of literature focuses rather narrowly on the effectiveness of sanctions.[59] The quantitative nature of much of this work makes it difficult to gain insight into the actual causal mechanisms behind states' use of economics in pursuit of their objectives. The quantitative approach used by a good deal of the sanctions literature precludes a deep exploration of the causal logics underpinning the contending schools of thought. In addition, as is often the case in social science research, much of this work tends to focus rather narrowly on a phenomenon that is relatively easily measured, namely sanctions imposed by states or other intergovernmental bodies. By not paying sufficient attention to other (albeit perhaps less easily measured) causal mechanisms, this narrow approach focused on sanctions may be missing a wide range of security consequences associated with various other more subtle mechanisms of economic statecraft like a strategic policy of foreign aid that is designed to alter the national interests of the recipient state. Finally, almost all of these works have been limited to *trade* sanctions—thus missing the empirical richness of the full panoply of economic interaction and the security externalities related to non-trade based economic interaction like financial and monetary relations.[60]

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[59]On the effectiveness of sanctions refer to Gary Clyde Hufbauer, Jeffrey J. Schott and Kimberly Ann Elliott, *Economic Sanctions in Support of Foreign Policy Goals*, Vol. 6 (Washington, DC; Cambridge: Institute for International Economics; Distributed by MIT Press, 1983); and their updated: Gary Clyde Hufbauer, *et al.*, *Economic Sanctions Reconsidered*, 3rd , Expand ed. (Washington, DC: Peterson Institute for International Economics, 2007) as well as: Lisa L. Martin, *Coercive Cooperation : Explaining Multilateral Economic Sanctions* (Princeton, N.J.: Princeton University Press, 1992); David Cortright and George A. Lopez, *Economic Sanctions : Panacea Or Peacebuilding in a Post-Cold War World?* (Boulder: Westview Press, 1995); Richard N. Haass, "Sanctioning Madness," *Foreign Affairs* 76, no. 6 (11//Nov/Dec97, 1997), 74-85; Richard Haass and Council on Foreign Relations, *Economic Sanctions and American Diplomacy* (New York: Council on Foreign Relations, 1998); Daniel W. Drezner, *The Sanctions Paradox : Economic Statecraft and International Relations* (Cambridge England ; New York: Cambridge University Press, 1999); Richard Haass and Meghan L. O'Sullivan, *Honey and Vinegar : Incentives, Sanctions, and Foreign Policy* (Washington, D.C.: Brookings Institution Press, 2000); David Cortright *et al.*, *Sanctions and the Search for Security : Challenges to UN Action* (Boulder: L. Rienner Publishers, 2002); and for work on smart sanctions see: David Cortright and George A. Lopez, *Smart Sanctions : Targeting Economic Statecraft* (Lanham, Md.: Rowman & Littlefield Publishers, 2002).
[60]See for example David A. Baldwin, *Economic Statecraft* (Princeton, N.J.: Princeton University Press, 1985); Hufbauer, *Economic Sanctions Reconsidered,*K. Barbieri and G. Schneider, "Globalization and Peace: Assessing

Although Baldwin set out to cast a wide net encompassing all the various positive and negative mechanisms states could pursue across all types of economic interaction—trade as well as financial relations—in the end, most of his book focused on sanctions. However, Jonathan Kirshner's *Currency and Coercion* helped address the lack of systemic scholarship on the use of monetary tools of economic statecraft.[61] Each of these works made important contributions to the study of economic statecraft, but in seeking to develop the theoretical context for the exercise of contemporary economic power, these works tended to focus almost exclusively on the state and drifted away from the commercial actor-driven approach that characterized the earlier generation of scholarship (e.g. Staley).

One notable exception is Robert Gilpin's *US Power and the Multinational Corporation.* Gilpin argued that multinational corporations thrive because the international system's hegemon creates and maintains an international environment in which private sector actors can benefit and succeed.[62] At the abstract level, Gilpin's work seeks to directly account for the role of commercial actors in international strategic relations. However, Gilpin was mainly motivated by an effort to explain the long-term rise and decline of hegemons in the international system. The

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New Directions in the Study of Trade and Conflict," Journal of Peace Research 36, no. 4 (1999) 387-404. Frequently, the most readily available data is trade data. Partly as a result, foreign direct investment and cross-border capital flows as well as monetary interaction have received far less attention in the literature. Important exceptions are Janet Kelly's Chapter 9 "International Monetary Systems and National Security," in Knorr and Trager, *Economic Issues and National Security,*; Jonathan Kirshner, *Currency and Coercion : The Political Economy of International Monetary Power* (Princeton, N.J.: Princeton University Press, 1995); Erik Gartzke and others, "Investing in the Peace: Economic Interdependence and International Conflict," International Organization 55, no. 2 (2001), 391-438; Rosecrance and Thompson, "Trade, Foreign Investment and Security," Annual Review of Political Science 6, no. 1 (2003) 377-398; Benn Steil and Robert E. Litan, *Financial Statecraft : The Role of Financial Markets in American Foreign Policy* (New Haven: Yale University Press, 2006) and Andrews, *International Monetary Power* (Ithaca: Cornell University Press, 2006).

[61] See Jonathan Kirshner, *Currency and Coercion*. In 2006, David Andrews edited a very good volume that builds on earlier work relating to the use of monetary power: Andrews, *International Monetary Power.*

[62] "...[T]his book argues that the international political order created by dominant powers primarily in their security interests has provided the favorable environment for economic interdependence and corporate expansionism." Gilpin, *U.S. Power and the Multinational Corporation,* p. 19.

field is still lacking a middle-range theory that bridges the levels of abstract theory and the more concrete applications of exactly *how* commercial actors do the strategic bidding of the hegemon.

Although Gilpin's work is largely compatible with the theory put forward in this dissertation, there are inevitably, some areas of friction: First, Gilpin's book emphasized the unique role of the hegemon in the international system and the benefits accruing to the *hegemon*'s multinational corporations (MNCs). This perspective stands in contrast to my work that argues that *any* state is more or less theoretically capable of using commercial actors to further its national strategic interests. Moreover, there does not seem to be any *a priori* reason to assume that the MNCs of non-hegemonic states would not also accrue benefits in a modern, liberalized global regime (e.g. WTO). Second, Gilpin's normative position highlighting the danger of national over-reliance on investment returns also seems not to have been borne out by the facts in the American case as it has developed since the time of his writing. Elsewhere, I have addressed some of Gilpin's normative concerns in my discussion of the security externality called "Hollowing Out."[63]

Finally, Gilpin's work left many questions unanswered—is it only the hegemon's corporations who can benefit or can all commercial actors? If all commercial actors benefit, then can other non-hegemonic states also pursue their strategic goals through the use of commercial actors? How? What are the processes through which such strategic alignment of interests between the commercial actors and the national strategic interests actually take place? To what degree can states shape and influence the behavior of their multinational firms? In what way does the behavior of MNCs affect national security? Gilpin's work was an important step forward in considering the inter-relationship of modern multinational corporations and US

[63] See: William Norris, "A Theoretical Framework for Analyzing the Relationship Between Economics and Security" Paper presented at the 2009 Annual Meeting of the New England Political Science Association, Portland, Maine.

national interests. His book frames a discussion of how the behavior of MNCs served that interest. As with Knorr, my work will attempt to build on elements of Gilpin's theoretical foundation and examine the resulting theory in the empirical context of contemporary Chinese interests.

Many of the other works in the literature on globalization that did seek to explore the role of commercial actors have tended to overstate the autonomy of multinational corporations and the erosion of the nation state as the dominant actor in international relations.[64] This dissertation's empirical research will demonstrate that even if the direct, classical mercantilist power of the state to dictate policy to its private sector actors has diminished under a more liberalized system, sufficient power remains for the state to influence and generate incentives for the private sector to behave in ways that are conducive to state interests. Although many of the exaggerated claims of a "vanishing state"[65] have since been largely corrected,[66] the field has yet to develop a middle range theory that would connect the micro-level behavior of commercial actors who possess some degree of autonomous agency to the macro-level strategic outcome of how modern sovereign states actually mobilize their economic interaction to further national

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[64] Examples of works making the case for a significantly diminished national state in the era of globalization abound. See for instance: *The Retreat of the State: The Diffusion of Power in the World Economy* by Susan Strange (Cambridge University Press, 1996); *Global Order and Global Disorder: Globalization and the Nation-State* by Keith Suter (Praeger, 2003); Martin Wolf, "Will the Nation State Survive Globalization?" Foreign Affairs January-February 2001; *Twilight of Soveriengty: How the Information Revolution is Transforming Our World* by Walter B. Wriston (Scribner Book Company, 1992). In response to a frequent assumption in this literature on globalization that the state has become irrelevant in the face of multinational corporations, my work argues that the mechanisms of state influence may have changed over time, but states remain powerful international actors. For a somewhat similar theoretical perspective see: Sean Kay, "Globalization, Power, and Security," Security Dialogue 35, no. 1 (2004): 9-25. Contemporary conditions of complex, interdependent global economic interaction require that we understand the ways in which states continue to exert their influence.

[65] Richard N. Rosecrance, *The Rise of the Trading State : Commerce and Conquest in the Modern World* (New York: Basic Books, 1986).

[66] See for example: Suzanne Berger and Ronald Philip Dore, *National Diversity and Global Capitalism* (Ithaca, N.Y.: Cornell University Press, 1996); Maria Gritsch, "The Nation-State and Economic Globalization: Soft Geo-Politics and Increased State Autonomy?" Review of International Political Economy 12, no. 1 (2005): 1-25; and Peter Evans, "The Eclipse of the State? Reflections on Stateness in an Era of Globalization," World Politics 50, no. 1, Fiftieth Anniversary Special Issue (1997): 62-87. Norrin Ripsman and T.V. Paul's *Globalization and the National Security State* (New York: Oxford University Press, 2010) also addresses some of these claims that the nation state and national security have been fundamentally altered as a result of globalization.

security goals. It is not enough to simply "bring the state back in" to our analyses—as scholars, we should also illuminate *how* states interact with their commercial actors in a strategic context.

So if the English language literature does not get economic statecraft right, perhaps Chinese language sources do a better job. After all, if China is a productive case setting in which to study the phenomenon, it seems reasonable that Chinese scholars of international relations may offer a more sophisticated theoretical treatment of how states exercise their international economic power. Alas, a survey of Chinese language scholarship on economic statecraft indicates that this literature is prone to many of the same shortcomings already discussed in the context of the English language literature. Perhaps this is not so surprising.

A good deal of the leading Chinese scholarship on international relations reflects a strong influence from Western international relations theory.[67] In fact, most Chinese language work in international relations is derivative of Western international relations: many of the leading scholars were trained in American doctoral programs, many of the theoretical assumptions stem from Western international relations theory, and basic lines of reasoning often parallel those found in Western scholarship. It should not be surprising, then, to discover that Chinese language work that has been done at the intersection of economics and security maps fairly neatly onto the English language scholarship—and suffers from many of the same shortcomings.

So, how does Chinese scholarship treat the subject? Broadly speaking, Chinese scholars think about the relationship between economics and security in three ways. First, is the view that argues stable foreign economic relations are instrumental for China's longer-term development.

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[67] Indeed in recent years, there has been an effort to consciously articulate a distinctly "Chinese" school of international relations that is explicitly non-Western. See for instance: 王缉思 [Wang Jisi], "国际关系理论与中国外交研究"[trans: "International Relations Theory and the Study of Chinese Diplomacy"] in 袁明 (ed.) *跨世纪的挑战：中国国际关系学科的发展* （修订版） [*An Assignment for the New Century: International Relations Studies in China (Revised Edition)*] （北京： 北京大学出版社 2007) pp. 322-340. These attempts have largely failed to produce a uniquely Chinese theoretical paradigm. See: Gustaaf Geeraerts and Men Jing, "International Relations Theory in China," Global Society, Volume 15, Number 3, (July 2001) pp. 251-276.

Since the opening up and reform period began, the Chinese economy has used an export-oriented growth model that relied on greater and greater integration into the global economy. Such relations help fuel China's rise to great power status as this model has delivered near double-digit annual growth for the last thirty years. This line of reasoning is a fairly constant theme underpinning much of mainstream contemporary Chinese grand strategy and Chinese language scholarship on economic statecraft. To the extent that this line of thinking directly addresses strategic security concerns, it is usually through the notion that beneficial international engagement helps to fuel China's growing military might.[68] Such works often emphasize the need for China to maintain an international environment that is conducive to further economic growth.[69] Authors in this vein often advocate for further opening up and liberalization of the Chinese economy since this represents the most efficient path to achieving even greater economic results.[70] Many of these works grow out of Deng Xiaoping's initial strategic logic of focusing on economic liberalization as a way to increase China's power and frequently continue to invoke Deng's strategic thought.[71]

The second way that economics factors into China's grand strategy is as a legitimizing factor for the regime. According to this line of reasoning, ongoing economic development

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[68] Such works frequently highlight the intrinsic connections between economic growth and increasing military capabilities. See for instance: 林雄辉 [Lin Xionghui], *经济全球化与部队思想政治教育研究* [trans: *Research on Economic Globalization and Army Political Thought Education*]（北京： 军事科学出版社 2004).

[69] See for example: 叶自成 [Ye Zicheng]'s "对中国和平发展与国际环境之关系的几点思考" <u>国际政治研究</u> 2006 年 第 1 期 20-30 页 [trans: "The International Environment's Relationship to China's Peaceful Development: Some Thoughts" <u>International Politics Research</u> 2006, Issue 1, pp. 20-30.]

[70] For example in 门洪华 [Men Honghua] and 胡鞍钢 [Hu Angang]'s "入世五年：中国应进一步对外开放" <u>开放导报</u> 2007 年 2 月 第 1 期 总第 130 期 68-73 页 [trans: "Five Years after Entering the WTO: China Ought to Further Open to the Outside" <u>The Opening Herald</u> February, 2007, Issue 1, Number 130 pp. 68-73.] the authors argue that China's entry into the WTO has been a successful extension of China's thirty year reform and opening up effort. This strategy has produced considerable results for China, prompting the authors to call for further opening up.

[71] For instance, see: 元成章 [Yuan Chengzhang], "论邓小平国际战略思想内涵十要素" [trans: "A Discussion of Deng Xiaoping's International Strategic Ideological Disposition: Ten Essential Elements"] in 金灿荣 (ed.) *中国学者看世界：大国战略卷* [*World Politics—Views from China, Volume 3: Strategies of the Great Powers*] （北京： 新世界出版社 2007) pp. 71-84.

(internationally, but especially domestically) serves to help secure and legitimize the governing regime.[72] The most important national interest is to maintain the CCP's control over China.[73] This is closely tied to stability (稳定 *wending*). This stability is both domestically oriented—to directly limit sources of threat to the regime—and internationally oriented—to provide an international environment that is conducive to China's continued economic growth.[74] Continued economic growth provides an ongoing reaffirmation of the CCP's ruling mandate by underscoring the CCP's ability to deliver economic growth to the society. To the extent that these sources of economic interaction can be diversified, such diversification offers China less concentrated reliance and thus less vulnerability to potential disruption (which would undermine the economic foundations upon which so much of China's national interests rest).

Beyond securing the regime's stability, China seeks to shape its international strategic environment in a way that maximizes China's national interests.[75] In particular, China seeks to ensure that the US is prevented from checking China's efforts to modernize and enhance its power. A common approach has been to use multilateral institutions to further China's national

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[72] "One profound consequence of China's reform and opening up is that the Communist ideology has lost its appeal and economic growth has become the primary legitimizer and stabilizer of the Chinese political system." Bo Kong, *China's International Petroleum Policy* (Santa Barbara, Calif.: Praeger Security International, 2010) p. 141. Wang Zhengyi traced how economic growth became fused with national security and ongoing regime stability in his 2004 piece: "Conceptualizing Economic Security and Governance: China Confronts Globalization," The Pacific Review Vol. 17 No. 4 pp. 523-545.

[73] "As ever, China's current grand strategy first attends to potential threats to vital interests (territorial and political integrity)." Goldstein, *Rising to the Challenge* p. 23.

[74] For more on this internal/external dichotomy in China's economic security and grand strategy, see: 王正毅 [Wang Zhengyi], "理解中国转型：国家战略目标，制度调整与国际力量" [trans: "Understanding China's Transformation: International Strategic Objectives, System Adjustment and International Power"] in 查道炯 (ed.) *中国学者看世界：非传统安全卷* [*World Politics—Views from China, Volume 6: Non-traditional Security*] （北京： 新世界出版社 2007) pp. 41-56.

[75] China's specific goals and objectives will be articulated at the outset of each macro-case that follows. For more on China's broad national interests see: 王逸舟 [Wang Yizhou] ed., *中国学者看世界：国家利益卷* [*World Politics—Views from China, Volume 2: National Interests*] （北京： 新世界出版社 2007), especially Part 3 "中国国家利益分析" [China's National Interests Examined] pp.197-328.

interests in a relatively nonthreatening manner.[76] In addition, increasingly dense economic interaction promises to reinforce the atmosphere of international partnership and cooperation that provides China with a peaceful international security environment allowing for the continued global economic interaction that enables China's rising capabilities.[77] Growing economic clout plays a key role in enabling China's national power (usually discussed as a component of China's "Comprehensive National Power"). Economic ties facilitate China's "peaceful rise" both by way of the liberal notion that economic ties help make conflict less likely and by giving economic partners a direct stake in China's continuing success. This latter feature helps make China's rising power look less like a threat and more like an economically attractive growth opportunity. Mutually beneficial economic interaction is also used to reassure other states in the system that China's rising power need not be cause for alarm.[78] In many instances, increasing economic interaction both allays fears of a rising China while providing China with the beneficial economic interaction to further augment its influence and power capabilities. In more recent years, as the official term of art in China has shifted from a discussion of China's "peaceful rise" toward China's "peaceful development" and "harmonious society/world," economics continues to play a prominent role in furthering Chinese foreign policy.

This last aspect of the Chinese literature on the relationship between economics and China's grand strategy is the area most closely related to my project. While the literature—like

[76] "China's recently more active and positive approach in Asian regional economic, security, and political organizations seems to reflect the strong recent priority of the Chinese administration to ensure that China's rising power and influence not be seen by China's neighbors and the region's dominant outside power, the United States, as a danger." Robert G. Sutter, *Chinese Foreign Relations: Power and Policy since the Cold War* (Lanham, MD: Rowman & Littlefield Publishers, 2008) p.113.

[77] For an example of this sort of strategic logic, see 门洪华 [Men Honghua]'s "中国国家战略体系的建构" 教学与研究 2008 年第 5 期 13-20 页 [trans: "The Construction of China's National Strategy System" Teaching and Research 2008, Issue 5 pp. 13-20.] in which he argues for an integration between China's domestic, regional and global strategy focusing on continued "opening up" efforts that have underpinned China's modern strategic success.

[78] This line of reasoning has been a particular feature in China's recent relations with Southeast Asia. See: 梅平 [Mei Ping], *中国与亚太经济合作：现状与前景 [trans: China and Asia-Pacific Economic Cooperation: Current State of Affairs and Future Prospects]* (北京： 世界知识出版社 2008).

its English language counterpart—still lacks a theory that links the behavior of commercial actors to the grand strategy of the state, this literature has produced several useful concepts that my work will seek to build upon. In particular, three terms from the Chinese literature on economics and security relate closely to the work of this study. Perhaps the concept that is most germane to my area of research is *jingji waijiao* [经济外交 trans: economic diplomacy].[79] Chinese scholars use the term *jingji waijiao* in two ways.[80] One meaning is used to denote the diplomatic activity concerned with securing economic objectives (e.g. China's membership in the WTO and other international economic organizations). This can be thought of as using diplomatic means to realize economic results.[81] The other use of the term (and more interesting for purposes of this project) is the instrumental use of economic means to achieve national strategic objectives.[82] This use of the term (economics used to pursue foreign objectives) is very similar to the English language literature's discussion of how states go about exercising their international economic power. Although this is an important area that deserves better understanding, the Chinese literature on this topic is even less theoretically developed than its

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[79] One of the most comprehensive treatments of this idea can be found in 周永生 [Zhou Yongsheng] *经济外交 [Economic Diplomacy]*, （北京：中国青年出版社 2004) another good source on the topic is: 何中顺 [He Zhongshun], *新时期中国经济外交：理论与实践 [Research on China's Economic Diplomacy: Theory and Practice]*, （北京： 时事出版社 2007).

[80] Although both usages can be found in the literature, any given author will normally use it to mean *either* the use of diplomacy to further economic goals *or* the use of economics to further diplomatic goals.

[81] For an example of a type of work that uses the term in this way see: 清华大学国际问题研究所，清华大学经济外交研究中心 [trans: Tsinghua University's Institute of International Studies & Research Center of Economy and Diplomacy], *中国经济外交 2006 [China's Economic Diplomacy 2006]*, （北京： 中国人民大学出版社 2007).

[82] Put another way, this use of the term can be thought of as using economic means to achieve diplomatic results. See 周永生 [Zhou Yongsheng], "经济外交面临的机遇和挑战：经济外交概念研究" 世界经济与政治 2003 年第 7 期 39-44 页 [trans: "The Opportunities and Challenges Confronting Economic Diplomacy: A Conceptual Study of Economic Diplomacy" World Economics and International Politics 2007 Issue 7 pp. 39-44.] Perhaps the best recent example of this type of work is by 吴白乙 [Wu Baiyi] entitled: "中国经济外交：与外部接轨的持续转变" 外交评论 2008 年 6 月总第 103 期 11-19 页 [trans: "China's Economic Diplomacy: Continually Transforming External Integration" Foreign Affairs Review June, 2008 no. 103 pp. 11-19.] in which he argues that China has shifted the emphasis of its foreign policy toward economics and is seeking to maximize China's power through global economic integration. Interestingly, this piece explicitly makes note of state-firm cooperation to pursue China's strategic objectives.

English equivalent.[83] In addition to the methodological, evidentiary, argumentation, and research design challenges that bedevil a significant number of Chinese language publications, perhaps not surprisingly, this literature also suffers from many of the same gaps found in the English language treatment of economic statecraft. Virtually all of the Chinese literature on the subject examines the state as the unit of analysis—notably absent is an adequate, theoretically-informed accommodation of commercial actors.

In addition to *jingji waijiao,* two other concepts concerning economics and its relationship to security deserve to be highlighted here. The first is *jingji anquan* [经济安全 trans: economic security].[84] This term is frequently used in the context of discussions of globalization [全球化 *quanqiuhua*] and usually emphasizes China's raw material dependence vulnerabilities (资源依存度).[85] The literature employing this term seems to be especially sensitive to natural resource vulnerability—particularly China's dependence on imported sea-

[83] This partly due to much of the work being highly empirical in nature. See for example: 王树春 [Wang Shuchun], *经济外交与中俄关系 [Economic Diplomacy and the Sino-Russian Relationship],* (北京： 世界知识出版社 2007). Scholars of economic diplomacy are also frequently regional experts (e.g. 周永生 [Zhou Yongsheng] is primarily a Japan specialist). Another example is the recent interest in China's use of economics in its relations with Southeast Asian states; see for example: 张胜军 [Zhang Shengjun], "东亚经济一体化与中国的国家利益" [trans: "East Asian Economic Convergence and Chinese National Interests"] in 王逸舟 [Wang Yizhou] ed., *中国学者看世界：国家利益卷* [*World Politics—Views from China, Volume 2: National Interests*] (北京： 新世界出版社 2007), pp. 295-306; also see: 国防大学战略研究所 [National Defense University] 国际战略形势分析 2006-2007 *[International Strategic Analysis 2006-2007],* (北京： 时事出版社 2007) especially Chapter 2 : "东南亚战略形势" ["The Southeast Asia Strategic Situation"].

[84] For a comprehensive treatment of this concept see the CICIR book by that name *国家经济安全 [National Economic Security],* (北京： 时事出版社 2005). Also see: 查道炯 (ed.) *中国学者看世界：非传统安全卷* [World Politics—Views from China, Volume 6: Non-traditional Security] (北京： 新世界出版社 2007) especially Part Two on economic security pp. 39-84.

[85] See: 林雄辉 [Lin Xionghui], *经济全球化与部队思想政治教育研究 [trans: Research on Economic Globalization and Army Political Thought Education]* (北京： 军事科学出版社 2004). For an example of a scholar arguing that China's security is threatened by its reliance on an American-dominated globalization regime see: 张文木[Zhang Wenmu], "全球化视野中的中国国家安全问题" 世界经济与政治2002 年第3 期 4-9 页。[trans: "China's National Security Problem from the Perspective of Globalization" World Economics and Politics 2002, Issue 3 pp. 4-9].

borne petroleum (海上石油进口依存度).[86] Discussions of *jingji anquan* often include the related concepts of resource security (资源安全), energy security (能源安全), external dependence (对外依存度), sea power (海权), and diversification (多元化). We will revisit many of these ideas in the chapters on China's extractive resource strategy.

The second concept is *shuang ying* [双赢 trans: win-win] and is closely tied to China's economic and diplomatic engagement strategy and "win-win diplomacy." This concept emphasizes the economic benefits accruing to China's partners as a result of tapping into China's economic expansion. Rather than having China's neighbors view China's rise with apprehension, this strategy stresses how partnering with China can result in mutually beneficial outcomes. At its core, *shuang ying* is about transforming the interests of China's partners and represents a very effective use of China's economic statecraft. Discussions of *shuang ying* often include the related concepts of collective security (集体安全), comprehensive national power (总合国力), mutual benefit (互惠), "non-zero sum" ("非零和"), China's multilateralism (多边主义), and the New Security Concept (新安全观). Win-win ideas feature prominently in China's relations with Southeast Asia, Africa, and Central Asia, although the basic idea of using economic benefits to facilitate China's foreign policy has other applications as well. I will return to these ideas in Chapter Three's discussion of interest transformation.

So, to summarize, the Chinese language work on economic statecraft can be grouped into three broad types. These types are differentiated by their views of the role of economics *vis a vis*

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[86] See: 门洪华 [Men Honghua], "确保中国能源安全的战略意义" 太平洋学报 2005 年第 1 期 33-44 页。[trans: "The Strategic Significance of Ensuring China's Energy Security" Asia Pacific Journal 2005, Issue 1 pp. 33-44]. in which he argues for Chinese sea power projection capabilities to secure China's energy security. For more on sea power and its relationship to China's national and economic interests, see: 王立东 [Wang Lidong], *国家海上利益论* [trans: *A Theory of National Maritime Interests*], (北京： 国防大学出版社 2007) especially Chapter 6 entitled: "海上经济利益是国家海上利益的首要利益" [trans: Marine Economic Interests Are the Primary National Maritime Interests].

China's security.[87] First, continued economic progress serves to legitimize the regime. Second, economic success fuels China's military capabilities. Third, economic relations facilitate China's rise to great power status. In addition to these families of literature, there seem to be three key concepts from Chinese language scholarship on economics and security that bear directly on my research. The first is *jingji waijiao*—in particular, the interpretation of this concept that stresses the use of economic means to further foreign policy objectives. Second, *jingji anquan* encapsulates many of the concerns and ideas surrounding China's ability to secure its access to raw materials. Third, *shuang ying* reflects the strategy that is designed to alter the calculus of partner states so as to avoid negative reactions to China's growing power.

Like their Western counterparts, these efforts to explore the intersection of economics and security often fail to adequately incorporate the role of commercial actors in economic statecraft. For the most part, Chinese works at the intersection of economics and security tend to focus on the state as the unit of analysis and make the same basic error found in many Western works on economic statecraft. Commercial actors, not states, are responsible for conducting the majority of international economic interaction. A suitable theory of economic statecraft ought to accommodate this reality.

So if Chinese language scholarship is largely subject to the same shortcomings as the English language literature on economic statecraft, but China nonetheless still seems to provide a productive empirical setting for exploring the strategic use of economics, then perhaps the English language work that has been empirically focused on China's economic statecraft (as opposed to the more abstract works focusing on a universal, general theory of economic statecraft) will be a more productive area to survey. Indeed, there is a small but growing body of

[87] It should be noted that very few Chinese language works make such a stark distinction between these various roles, but for our purposes, I offer a somewhat artificially discrete categorization to provide the reader with a more organized sense of how Chinese scholars think about this topic.

literature focusing on China's use of economics in its foreign policy. That is the good news. The bad news is that while these works on China and its strategic use of economics do occasionally recognize the importance of state-firm interactions, they still lack a robust theoretical framework for conceptualizing or generalizing these dynamics. These works have tended to mirror the theoretical shortcomings of the more general literature on economic statecraft—namely an under-theorized role for commercial actors and their relationship to the strategic goals of the state.

These western works on China's economic statecraft can be categorized into two types. The first genre starts from the perspective of analyzing China's grand strategy. For example, Russell Ong has highlighted the important role economics plays in China's grand strategy. [88] Although Ong's work notes the importance of economics, he also calls for deeper analysis and theoretical understanding of the largely unexplored economic dimension of grand strategy. Indeed, economics plays an important part in China's grand strategy and the field currently lacks a useful theoretical paradigm for analyzing this important tool of statecraft. In another insightful treatment of China's grand strategy, Phillip Saunders highlights the main motivations behind China's recent international activism.[89] Saunders does a nice job laying out the strategic rationale for China's foreign policy actions. Economics features prominently in his analysis. But Saunders, like many authors on this topic, struggles to adequately accommodate what he identifies as complexity characterized by the multiple actors and interests that pervade China's attempts to use commercial activity as part of its grand strategy. In particular, the field seems to lack a theoretical framework for analyzing the actual practice of economic statecraft. Take for

[88] See Russell Ong, *China's Security Interests in the Post-Cold War Era* (Richmond, Surrey: Curzon, 2002) and Russell Ong, *China's Security Interests in the 21st Century* (New York, NY: Routledge, 2007).
[89] Phillip C. Saunders, "China's Global Activism: Strategy, Drivers, and Tools," Institute for National Strategic Studies Occasional Paper No. 4 (Washington, D.C.: National Defense University Press 2006).

example, Adam Segal's chapter entitled, "Chinese Economic Statecraft and the Political Economy of Asian Security," in William Keller and Thomas Rawski's edited volume on China's rising influence in which Segal argues that China is making increasing use of economic statecraft in its pursuit of foreign policy objectives.[90] Although Segal raises important questions, he fails to provide a comprehensive analytical framework for understanding China's strategic use of economics.[91] Segal's more recent work continues to grapple with the question of whether China's use of economics is effective or not.[92] I would argue that framing the issue in this manner misses the point. Asking whether China's economic power is resulting in increased influence will necessarily lead to the inconclusive findings that both Segal and Scott Kastner observe.[93] Although scholars like Segal and Kastner have done commendable work examining the issue of whether China's use of economics has been translated into strategic results, neither has engaged in the larger question: not *whether* China's economic power can be used strategically, but rather *under what circumstances* can it be used effectively.

In addition to focusing on questions of grand strategy, the other common approach of this literature is to focus on a particular regional/empirical context of China's foreign policy in which economics features prominently. For instance, the Taiwan context is an important empirical arena for understanding the interplay between economics and strategic considerations.[94] Scott Kastner has done good work in this area although his focus has largely been on the effects of

[90] William W. Keller and Thomas G. Rawski, *China's Rise and the Balance of Influence in Asia* (Pittsburgh, Pa.: University of Pittsburgh Press, 2007).
[91] Segal draws on Hirschman's analysis, but limits his considerations of the effects to "influence" and "coercion." My typology adds four other types of security externalities and identifies specific causal pathways for understanding how economic statecraft actually works in practice.
[92] For example, see his "China's Economic Statecraft: Markets, Trade, Power, and Influence," a paper he presented at the Assessing China's Rise: Power and Influence in the 21st Century Conference at MIT (February 9, 2009).
[93] Both Segal and Kastner conclude that China's growing economic clout sometimes can be leveraged for political objectives and sometimes such efforts are not successful. For Kastner's quantitative complement to Segal's paper see: "Buying influence? Assessing the political effects of China's international economic ties," a paper he presented at the Assessing China's Rise: Power and Influence in the 21st Century Conference at MIT (February 9, 2009).
[94] Other such regional approaches have focused on China's relations with ASEAN/Southeast Asia, Africa, Central Asia, Latin America, etc.

political conflict on economic ties.[95] Equally, if not more importantly, are the effects of economic ties on the security relationship between Beijing and Taiwan. Scot Tanner did attempt to examine the ability of Beijing to use its economic power to coerce Taiwan.[96] In what is probably the most comprehensive treatment of the use of economics to coerce Taiwan, Tanner concludes that political factors often complicate the use of economics in the cross-Strait relationship. While I do not disagree with Tanner's analysis, his findings seem idiosyncratic and his work lacks a comprehensive framework for thinking about the conditions under which economic statecraft is likely to succeed. In the next chapter, I offer a more theoretically-grounded treatment of the conditions and business-state relationships that facilitate economic statecraft. Tung Chen-yuan is another scholar who has looked at the issue of economics in a cross-Strait context.[97] However, his cost-benefit framework must ultimately rely on inferred utility functions that are, in reality, dynamic and inherently difficult to specify with a reliable degree of accuracy. Moreover, Tung's focus on sanctions limits the scope of his analysis. I argue that sanctions are just one of many mechanisms that states can use in pursuing their strategic objectives. As discussed in the next chapter, economics can affect strategic security issues in a number of ways—any one or combination of which may be manipulated to achieve strategic ends. Exactly how this occurs is the subject of the next chapter.

In summary, the dissertation is situated in a long tradition of scholarly work that has sought to understand how states use economic power. Inspired by the early Twentieth Century classical realists who emphasized the importance of both national strategic goals *and* the role of

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[95] Scott L. Kastner, *Political Conflict and Economic Interdependence Across the Taiwan Strait and Beyond* (Palo Alto: Stanford University Press 2009). See also: Scott L. Kastner. "When Do Conflicting Political Relations Affect International Trade?" *Journal of Conflict Resolution* 51, no. 4 (August 2007): 664-688.
[96] Murray Scot Tanner, "Chinese Economic Coercion Against Taiwan: A Tricky Weapon to Use," RAND Monograph (Santa Monica: RAND 2007).
[97] See Chen-Yuan Tung, "Cross-Strait Economic Relations: China's Leverage and Taiwan's Vulnerability," Issues & Studies 39, no. 3 (Sept, 2003), 137-175.

commercial actors in pursuing those goals, this dissertation seeks to address a number of gaps in the literature. My own work seeks to extend and tactically operationalize some of the earlier work done on the nature of economic power and how states *actually mobilize* commercial actors to pursue national strategic interests in a contemporary context. Specifically, this work answers the following questions: In what manner do states seek to use economic interaction to further their larger strategic goals? What is the role of commercial actors in states' strategic efforts to wield economic power? Why do these efforts succeed or fail? What factors facilitate or hinder effective economic statecraft?

When attempting to answer such questions, the existing literature has tended to take too narrow of an approach. In particular, existing efforts to explore this topic have generally fallen victim to some combination of three limitations. First, existing literature has focused mainly on the most readily observable form of economic interaction: a statistical examination of trade—thus missing the empirical richness of the full panoply of economic interaction and the security externalities related to non-trade based economic interaction like financial and monetary relations. This dissertation offers a theory that is consciously designed to accommodate all forms of economic interaction.

Second, much of the work that has been done on the issue of using economic interaction to pursue larger strategic goals has been framed in the context of sanctions, missing the wide range of security consequences associated with various other mechanisms of economic statecraft. Framing the issue through this sanctions lens may omit more subtle mechanisms that seek not only compliance, but a deeper transformation of interests themselves. Starting from this standpoint, the dissertation presents a theoretical approach that is not narrowly limited to sanctions, but rather encompasses a broad range of economic activities like aid, investment flows, etc. and their concomitant security effects.

Finally, much of the literature dealing with the use of economics to pursue strategic goals tends to take a state-centric approach. By focusing predominantly on states as the unit of analysis, these perspectives give relatively little consideration to a rigorous treatment of the role of commercial actors—the agents *actually* responsible for conducting most of the economic activities of the modern state.[98] As demonstrated by the empirical work in this dissertation, the behavior of these commercial actors plays a crucial role in determining economic interaction, and ultimately, how states may use that economic interaction to pursue their strategic interests more or less effectively. The dissertation adopts a framework that facilitates a meaningful exploration of the business-government dynamics that are so important for understanding how states use economic interaction to further their strategic interests.

1.5 Conclusion

This chapter began by introducing the project as a study of economic statecraft, briefly highlighting its theoretical and empirical significance. Following this introduction, I specified the main research questions (How does economic statecraft work? and Why is it more or less effective?). I then defined several terms, including "economic statecraft" and the concept of "security externalities," before delving into the review of the economic statecraft literature.

The literature on economic statecraft has largely failed to provide enough attention to how states *actually* deploy their economic tools of grand strategy.[99] Given that the vast majority

[98] Karen M. Sutter, "Business Dynamism Across the Taiwan Strait," Asian Survey 42, no. 3 (May/Jun, 2002), 522.
[99] This gap in the literature exists for several reasons. First, as mentioned above, many economists do not concern themselves with questions of grand strategy. At the same time, many security studies scholars lack the economic training and familiarity to confidently engage in understanding the economic dimensions of national power. Academic scholarship in the United States has become increasingly specialized resulting in a siloed approach that insulates the study of economics from the study of grand strategy. Second, what work has been done on the relationship between economics and security studies has often focused rather narrowly on trade (which is only one of several types of economic interaction). In addition, much of this work has used statistical analytical approaches which are poorly suited to specifying causal mechanisms. Finally, the study of economic power, like most works in

of international economic activity is actually carried out not by states, but rather by commercial actors, an appropriate theory of economic statecraft ought to feature an explicit role for these commercial actors. The literature on economics and security continues to lack an integrated theory that links microeconomic, firm-level behavior with the grand strategy of states. As a result, the field continues to struggle with understanding the specific micro-foundations of economic statecraft as actually practiced in grand strategy. This study seeks to address that gap.

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international relations, has focused on states as the unit of analysis. This analytical perspective risks overlooking the importance of commercial actors and the role that commercial actors play in attempts to realize strategic national objectives using economic means. To address these gaps in the literature, in Chapter Two I offer an account of how aggregate economic agents' micro-level incentives and their resulting behavior generate national security effects at the level of state grand strategy.

Chapter Two

A Theory of Economic Statecraft

2. Introduction

As shown, most scholarship on economic statecraft fails to explain exactly how states exercise their economic power. This chapter helps fill that void by providing a typology that specifies the full range of ways by which economic interaction may be used to generate security consequences. In addition, it identifies the conditions under which economic statecraft is likely to succeed. The goal is to provide a more precise understanding of how states use economics to pursue their grand strategic objectives.

The chapter begins with a typology offering a theoretical framework that captures the various ways in which economics can affect security. Taken together, the typology answers the question "In what manner does economics affect security?". This conceptual framework for thinking about the relationship between the economic activities of commercial actors and the security of a nation state calls attention to the importance of business-government dynamics; specifically, the factors that enable a state to effectively control or direct the behavior of commercial actors such that their activities generate security externalities that are conducive to national strategic objectives. I operationalize a theoretical model that explains the factors that enable such control. This theory links microeconomic, firm-level behavior with the macro-level grand strategy of states. In this chapter, I also examine preconditions that enable attempts to engage in economic statecraft to be successful. The final portion of this chapter discusses the case selection, methodology and research design of the project.

2.1 A Typology of Security Externalities

As presented in Chapter One, framing the relationship between economic interaction and national security as one of "security externalities" highlights the importance of commercial actors and calls attention to the strategic ramifications of their activities. States often take an active interest in these security consequences. When states seek to encourage or discourage commercial actors to behave in ways that will generate the types of economic patterns that result in security externalities, states are engaging in what is known as *economic statecraft*. Economic statecraft is an important tool that states can use to pursue their strategic objectives. But how should we think about organizing these security externalities? I categorize security externalities on the basis of their effects on the target. The resulting typology captures the full range of security effects that may be generated as a consequence of economic activity.

In this typology, there are six types of security externalities which fall into two broad categories: those acting through primarily economic channels and those externalities with direct military effects.[1] Thus economic interaction may produce a direct effect on a state's military capabilities or security externalities may be indirect, affecting the state's security through the channel of its economy.[2] Both channels ultimately carry strategic consequences. Each of these two broad categories of externalities (military and economic channels) can be further specified into a total of six types of security externalities (four acting through primarily economic channels

[1] Although any given economic interaction may entail security externalities that fall into more than one of these categories, the categories themselves are designed to be a helpful way of organizing the security effects of economic interaction. To be useful, this categorization strives to be as mutually exclusive and collectively exhaustive as possible.

[2] The strength of a nation's economy carries implications for its military power (since economic power historically has been the foundation of military power). In fact, assessments of relative power frequently rely on GDP or some other proxy of underlying economic power. See for example: Kenneth Neal Waltz, *Theory of International Politics* (Reading, Mass.: Addison-Wesley Pub. Co., 1979); William C. Wohlforth, "The Perception of Power: Russia in the Pre-1914 Balance," World Politics 39, no. 3 (1987): 353-381. or see Stephen Van Evera, "Why Europe Matters, Why the Third World Doesn't: American Grand Strategy After the Cold War," Journal of Strategic Studies 13, no. 2 (1990): 1—especially his rationale for the strategic importance (and unimportance) of specific geographies.

and two with primarily military effects). The logic of this categorization is discussed in greater detail below.

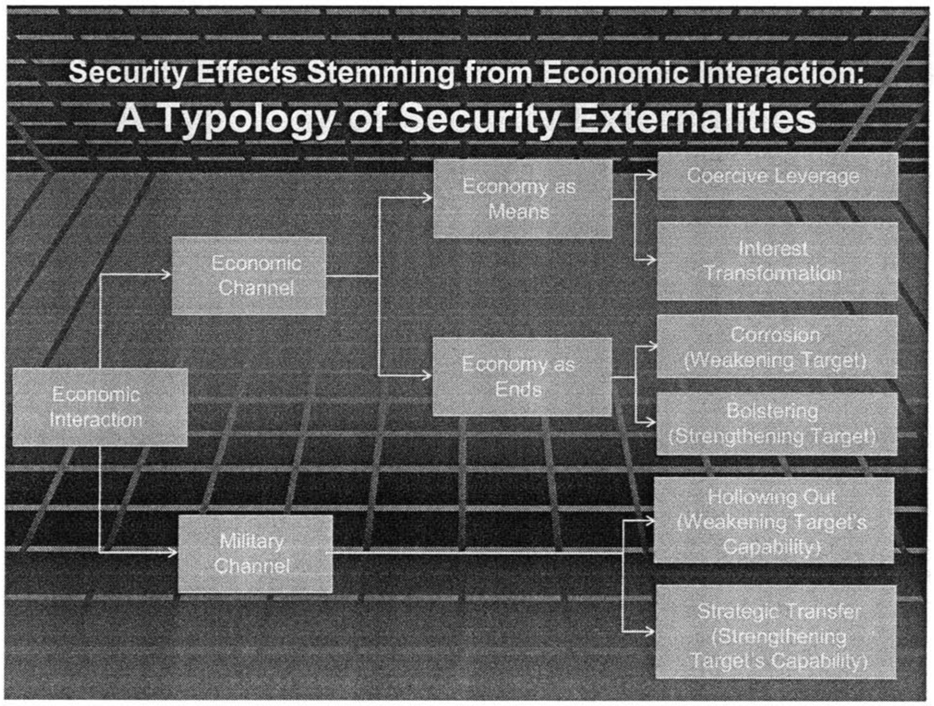

Figure 2.1: Typology of Security Externalities

The military channel comprises those security externalities that weaken the target state's military capabilities (this process is referred to as "Hollowing Out") and those that enhance the target state's relative military capabilities (this process is called "Strategic Transfer"). *Hollowing Out* is the security externality that results from economic interaction which erodes a target state's domestic military-industrial complex, resulting in a reduction of military capabilities that are available to a state. This process occurs when international economic interaction undermines the continuing commercial viability of firms, sectors, or industries that directly contribute to a state's military power capabilities. Without a vibrant domestic military-industrial complex, a state's options to defend itself become limited. The state must either forgo specific capabilities in which it lacks expertise or it must rely on external providers for the necessary equipment. The causal path of this type of security externality is one in which international economic interaction undermines the health of sectors of the target economy which are directly involved in the generation of military power.[3] Loss or damage to this portion of the state's economy carries direct consequences for the state's ability to generate military power and as a result carries significant implications for its security. These security effects fall into the category of security externalities called *Hollowing Out.*

Strategic Transfer is the category of security externalities that results from economic interaction which enhances a target state's war making capabilities through the acquisition of strategic goods, knowledge, resources or dual-use and/or dedicated military technologies.[4] Certain types of economic interaction in strategic goods and services can result in enhancing the target's military capabilities through the transference of strategically important technologies, materials, processes, goods, strategic resources, or expertise. This process occurs when economic interaction engenders a transmission of ideas, expertise, technology, or even raw

[3] Examples of Hollowing Out are often discussed in what is typically called "strategic trade theory." See: Marc L. Busch, *Trade Warriors : States, Firms, and Strategic Policy in High Technology* (Cambridge England ; New York: Cambridge University Press, 1999); Stephen G. Brooks, *Producing Security : Multinational Corporations, Globalization, and the Changing Calculus of Conflict* (Princeton, N.J.: Princeton University Press, 2005) for two intelligent works that stay well-focused on the security and strategic dimensions. One example of a strategy that seeks to exploit the Hollowing Out type of externalities is technology licensing like the kind applied by the U.S. against Taiwan as part of its effort to prevent Taiwan's nuclear weapons development. States may also nationalize assets, or engage in preclusive buying to prevent target states from accessing strategic goods. "Dumping" is yet another strategy that may be used to weaken a military-industrial sector, niches or even specific commercial actors. In a similar vein, subsidies can also be used to undermine a targeted military-industrial base. Subsidies can take a variety of forms in addition to a classic, straightforward payment including tax incentives, credit financing, and regulatory discrimination to name a few. In addition, arms embargoes can be particularly harmful to military-industrial efforts to secure raw materials, talent and/or markets for their goods and services. Famous examples of this include post-Tiananmen export control lists prohibiting the export of certain goods and technologies to the PRC to hamstring its military modernization as well as similar efforts to enforce export controls on certain "strategic goods" to the Soviet Union during the Cold War. Over a longer time horizon, foreign arms sales coming into a target state may have a displacing effect that squeezes out that target state's domestic producers.

[4] For interesting work on strategic goods as a potential source of conflict see: Anne Uchitel's chapter, "Interdependence and Instability," in Jack Synder and Robert Jervis (eds.), *Coping with Complexity in the International System* (Boulder: Westview Press 1993). Uchitel deserves credit for recognizing that the strategic nature of goods being traded is an important consideration when determining whether a given pattern of trade will be likely to result in conflict. My category of "Strategic Transfer" type of security externalities makes her distinction explicit.

materials and components that have military applications. These strategic goods and services can then be incorporated by the target state to enhance its military capabilities. Encryption technology exports, Loral satellite launches, and 12-inch semiconductor wafer production technologies are all fairly recent examples of the transfer of sensitive technologies. States themselves often define what does or does not constitute "strategic" although their definition generally involves some combination of the following perceptions: 1.) the relative scarcity of the good or service 2.) the ease with which the service or good can be converted into military capabilities and 3.) the ease with which the good or service can be substituted. Strategic goods or resources have been fairly broadly defined across time and space but at various times and regions have included saltpeter, fissile material, cod, bauxite, horses, oil, coal, silver, iron ore, rubber, water, wheat, and gold. When states acquire such goods and services they directly enhance that state's military capabilities. In this manner, economic interaction that involves strategic goods and services carries significant security externalities. These types of security externalities are classified into the category of security externalities called *Strategic Transfer*. Chapters Five and Six illustrate instances of Chinese economic statecraft concerning the *Strategic Transfer* of raw materials in more detail.

On the other main branch of the typology are those externalities that affect a state's security by way of primarily economic channels. For this family of externalities, the security ramifications are often the second-order consequences of the economic interaction. This distinguishes them from the types of externalities located on the military effects branch of the typology. In the cases of *Strategic Transfer* and *Hollowing Out*, the economic interaction directly contributes or detracts from military capabilities. For the four types of security externalities found on the economic branch, firms' activities affect the economy which, in turn, carries consequences for security. This economic branch is subdivided into two groups: 1.) the types of externalities that affect the overall health of the target economy as an ends in itself and 2.) those security externalities in which the economic interaction plays an instrumental rather than a teleological role. In this first group, there is one category of externalities that weaken the target's economy and there is another category of externalities that strengthen the target's economy. Strategies that employ these two security externalities (*Corrosion* and *Bolstering*) may be thought of as strategies that target the health of an economy as an end in itself.

Corrosion is the security externality resulting from a weakened domestic economy.[5] Just as a strong economy provides the bedrock for national strategic power, when economic interaction results in a weakening of the underlying economy, it carries strategic ramifications. This group of security externalities fall into the category called *Corrosion.* The causal pathway producing *Corrosion* is one in which economic interaction erodes the health of the target's economy.[6] As a result, the target is less able to defend itself and its strategic interests. There are several ways in which economic interaction might conceivably weaken an economy. As Adam Smith pointed out, international competitive dynamics may strangle infant industries before they have a chance to develop.[7] More recently, some have been concerned that outsourcing may limit positive spill-over effects from domestically-rooted technology and manufacturing.[8] The

[5] This distinction between "Coercive Leverage" and "Corrosion" may be thought of as similar to the distinction that Thomas Schelling makes between pure punishment (in which the pain is an end unto itself) and the coercive use of violence (in which the violence is instrumental). See: Thomas C. Schelling, *Arms and Influence* (New Haven: Yale University Press, 1966). Knorr makes a similar distinction to Schelling in his discussion of applications of economic power for coercive purposes as opposed to purely for purposes of punishment, see: Klaus Eugen Knorr, *The Power of Nations : The Political Economy of International Relations* (New York: Basic Books, 1975) p. 82 and p. 151.

[6] For a good perspective on "economic warfare"—much of which revolves around the strategic elements of "Corrosion," see: Yuan-li Wu, *Economic Warfare* (New York: Prentice-Hall, 1952).

[7] Adam Smith, Thomas Wilson, and Andrew S. Skinner, *The Market and the State : Essays in Honour of Adam Smith* (Oxford: Clarendon Press, 1976); Adam Smith and Charles Jesse Bullock, *An Inquiry into the Nature and Causes of the Wealth of Nations* (New York: P. F. Collier & sons, 1909).

[8] For more on the importance of spillover effects and other externalities for security see Richard J. Samuels, *"Rich Nation, Strong Army" : National Security and the Technological Transformation of Japan* (Ithaca: Cornell University Press, 1994); Klaus Eugen Knorr and Frank N. Trager, *Economic Issues and National Security* (Lawrence: Published for the National Security Education Program by the Regents Press of Kansas, 1977).

positive effects of spillover may also stem from management and organizational expertise as well as lost synergies among downstream and upstream partners and adjacent industries.[9] In addition, economies in various stages of development may find themselves "locked in" to particular segments of the value chain preventing further economic progress.[10]

A strategy employing *Corrosion* simply seeks to undermine the robustness of the target state's economic health; such efforts are likely to be focused on encouraging patterns of economic interaction that are likely to weaken the target economy.[11] This weakening of the target economy may be a direct shrinking of the current GDP or a more qualitative *Corrosion* which limits productive national growth capabilities and thus, future growth prospects. Tariffs, currency subversion (e.g. Germany dropping counterfeit Pound notes over England during World

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[9] See for instance, Michael Porter's Chapter 13, "Locations, Clusters, and Company Strategy," in Gordon L. Clark, Maryann P. Feldman, and Meric S. Gertler, *The Oxford Handbook of Economic Geography* (Oxford, England ; New York: Oxford University Press, 2000) pp. 253-274. There is a large literature on clusters, manufacturing knowledge dissemination, and other related concepts. See for example: Steven Pinch et al., "From 'Industrial Districts' to 'Knowledge Clusters': A Model of Knowledge Dissemination and Competitive Advantage in Industrial Agglomerations," Journal of Economic Geography 3, no. 4 (2003): 373-388.; Dominic Power and Mats Lundmark, "Working through Knowledge Pools: Labour Market Dynamics, the Transference of Knowledge and Ideas, and Industrial Clusters," Urban Studies 41, no. 5-6 (2004): 1025-1044.; Dieter Ernst and Linsu Kim, "Global Production Networks, Knowledge Diffusion, and Local Capability Formation," Research Policy 31, no. 8-9 (2002): 1417-1429.

[10] The "Dutch Disease" (and other "Resource Curse" theories) are one form of this in which economies fail to diversify and climb up the value chain. See: Michael Bruno and Jeffrey Sachs, "Energy and Resource Allocation: A Dynamic Model of the "Dutch Disease"," The Review of Economic Studies 49, no. 5, (1982): 845-859.; W. M. Corden, "Booming Sector and Dutch Disease Economics: Survey and Consolidation," Oxford Economic Papers 36, no. 3 (1984): 359-380.; Michael L. Ross, "Review: The Political Economy of the Resource Curse; the Paradox of Plenty: Oil Booms and Petro-States; Natural Resource Abundance and Economic Growth; Winners and Losers: How Sectors Shape the Developmental Prospects of States," World Politics 51, no. 2 (1999): 297-322. Another class of "locking-in" are colonial relationships in which colonial economies are oriented around the metropole. This view is often articulated by the "dependencia" literature. See, for example: Immanuel Maurice Wallerstein, *Mercantilism and the Consolidation of the European World-Economy, 1600-1750* (New York: Academic Press, 1980); Peter Claus Wolfgang Gutkind and Immanuel Maurice Wallerstein, *The Political Economy of Contemporary Africa* (Beverly Hills, Calif.: Sage Publications, 1976). For an interesting, more nuanced explanation of how variation in local conditions of inhabitability across colonies prompted Europeans to build very different institutional architectures which then significantly influenced subsequent colonial and post-colonial economic growth see: Daron Acemoglu, Simon Johnson, and James A. Robinson, "The Colonial Origins of Comparative Development: An Empirical Investigation," The American Economic Review 91, no. 5 (2001): 1369-1401.

[11] Examples of this type of strategy include: the US embargo of Cuba, the Arab League boycott of pre-1948 Israel, the Cold War exclusion of the Soviet bloc from the beneficial GATT free trade regime, and US economic policy toward Japan in the period before Pearl Harbor. See: Edward S. Miller, *Bankrupting the Enemy : The U.S. Financial Siege of Japan before Pearl Harbor* (Annapolis, Md.: Naval Institute Press, 2007); and Michael A. Barnhart, *Japan Prepares for Total War : The Search for Economic Security, 1919-1941* (Ithaca: Cornell University Press, 1987).

War II) and boycotts are all tools that states can employ to weaken target economies. Since the economy provides the foundation for so much of international power, such a weakening of the economy fundamentally carries strategic consequences for the target state. The security externalities that result from a weakening of the economy fall into this category of *Corrosion.*

Bolstering is the security externality resulting from a strengthened domestic economy. *Bolstering* may be most easily understood as the other side of the *Corrosion* coin. If *Corrosion* describes the category of security externalities resulting from a weakening of the target state's economic health, *Bolstering* is the category of security externalities that result when economic interaction makes the state's economy stronger. The causal pathway producing *Bolstering* is one in which economic interaction improves the health of the target's economy. As its economic foundations grow stronger, the target state is better able to generate international power.[12] This strategic strengthening is the security externality called *Bolstering.*[13] Historically, states that consciously chose to pursue such strategies generally used economic interaction to strengthen and support allies.[14] Some of the most famous examples of such strategies include British support for its Napoleonic Allies, Soviet aid and economic ties to Cuba, the Marshall Plan and the formation of the General Agreement on Tariffs and Trade (GATT). States can employ trade credits, foreign aid, loans, Most-Favored Nation status, insurance and other sorts of facilitating guarantees to help promote beneficial economic interaction.

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[12] The logic of this causal pathway is precisely the same as the causal pathway for *Corrosion*, only with the effect heading in the opposite direction.

[13] *Bolstering* is the logical strategic consequence of Ricardo's approach to free trade. For the classic statement of the gains from trade see: David Ricardo and R. M. Hartwell, *On the Principles of Political Economy, and Taxation* (Harmondsworth: Penguin, 1971); David Ricardo and Edward Carter Kersey Gonner, *Economic Essays* (London: G. Bell and Sons, ltd., 1923). Because uncoerced economic interaction is predicated on mutual benefit, examples of absolute strengthening of the target occur in almost every case of economic interaction.

[14] Although, it should be noted that *Bolstering* can just as easily occur with enemies since—strictly speaking—*Bolstering* merely describes the category of security externalities resulting from economic interaction. Whether intentional or not, commercial actors that are trading with the enemy often strengthen the target's economy thus generating the corresponding *Bolstering* security externalities.

Finally, on the "Economy as Means" branch of the typology, there are two distinct types of security effects that stem from economic interaction.[15] First, the economic interaction may generate externalities that are designed to provide *Coercive Leverage*. *Coercive Leverage* is the security externality resulting from economic dependence. The causal pathway operates as follows: economic patterns generate structural dependence as the engaging national economies accommodate and adapt to the economic interaction. This dependence can later be threatened, jeopardized and disrupted, causing damage to the national economies involved. Such vulnerability constitutes the security externality called *Coercive Leverage*. States can capitalize on this vulnerability to force targeted states to comply with the more powerful state's wishes.[16] A strategy employing *Coercive Leverage* generally seeks to establish and foster dependence.[17] The more asymmetric this relationship is, the easier it will be to actually harness the dependence for strategic purposes. States engage in economic statecraft when they seek to manipulate specific economic interaction in order to capitalize on the associated security externalities. Some examples of economic statecraft that often seek to exploit *Coercive Leverage* are sanctions, embargoes, blockades, travel bans, withholding payments (as the U.S. did with tolls collected for the Panama Canal as part of its efforts to oust Noriega), freezing bank accounts, and many of the types of negative "economic statecraft" that are highlighted in Baldwin's work.[18] A recent example of *Coercive Leverage* was China's 2006 decision to cut off oil flows into North Korea.

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[15] Strategies employing *Coercive Leverage* and *Interest Transformation* can be thought of as strategies involving the instrumental use of the economy to affect state behavior.

[16] Drawing on the deterrence literature, coercive leverage can be used to either dissuade a state from changing the status quo (deterrence) or it can be used to compel a state to pro-actively make a change in its behavior (compellance).

[17] For a seminal treatment of Germany's use of this sort of strategy see: Albert O. Hirschman, *National Power and the Structure of Foreign Trade* (Berkeley: University of California Press 1945 [1980—reprint]).

[18] Baldwin categorizes various economic policy tools according to whether they have beneficial or detrimental effects on the target. Usually, states use such tools with an eye toward what I call coercive leverage, however, occasionally these tools can be applied simply to damage the economy (as in "Corrosion" above) or to undermine military production facilities (as in "Hollowing Out" also discussed above). Baldwin offers two tables of examples of positive and negative economic statecraft (pp. 41-42). In the notes to these tables, he provides useful definitions of these various policy tools that states can use to incentivize commercial actors.

In that instance, North Korea was dependent on Chinese supplies of oil for approximately 90% of its oil. China cut supplies to force North Korea back to the negotiating table following its nuclear test on Oct 9, 2006.[19]

The second type of externalities in the "Economy as Means" group are those that are designed to actually transform the goals and interests of the target. Whereas *Coercive Leverage* is employed to enforce State A's *compliance* with State B's interests, *Interest Transformation* actually seeks to *alter* State A's goals and objectives to bring them into closer alignment with State B's interests.[20] The objective of *Interest Transformation* is not only to force State A to behave in a manner that is conducive to State B's interests, but rather to redefine State A's interests, goals and objectives in such a way that State A then actually wants the same thing as State B.[21] This process occurs when certain types of economic interaction generate integration—a condition in which the economies of states are closely connected to each other. These ties often provide both parties with a common stake in the success of the integrated economic entity. In this manner, the interests of the interacting parties are shaped and influenced by the economic interaction. For instance, common currency unions are forms of economic interaction that entail

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[19] Joseph Kahn, "China may be using Oil to Press North Korea," The New York Times, October 31 2006, sec. A; Foreign Desk, p. 12. Moscow's recalling of technical experts, cutting of trade ties and aid and abrogating a loan agreement to Yugoslavia in 1948 and the US pressure on the Pound Sterling in response to the 1952 Suez Crisis are both historical examples of *Coercive Leverage*.

[20] This transformation amounts to a change in state preferences. For more on "preferences" as an analytical concept in international relations see: Jeffry Frieden's Chapter 2 entitled, "Actors and Preferences in International Relations," in David A. Lake and Robert Powell, *Strategic Choice and International Relations* (Princeton, N.J.: Princeton University Press, 1999) pp. 39-76 as well as Andrew Moravcsik, "Taking Preferences Seriously: A Liberal Theory of International Politics," International Organization 51, no. 04 (1997): 513.; Michael W. Doyle, "Liberalism and World Politics," The American Political Science Review 80, no. 4 (1986): 1151-1169. For an interesting application of domestic preference transformation and economic interaction see: Rawi Abdelal and Jonathan Kirshner, "Strategy, Economic Relations, and the Definition of National Interests," Security Studies 9, no. 1 (1999): 119. For a view on the relative influence of supranational actors on state preferences see: Andrew Moravcsik, "A New Statecraft? Supranational Entrepreneurs and International Cooperation," International Organization 53, no. 02 (1999): 267.

[21] A strategy employing transformative leverage seeks actual transformation of State A's interests such that they become *redefined* to be in line with those of State B. Rather than merely seeking compliance from the target state, this strategy seeks to alter the target state's preferences themselves.

significant economic integration and generate considerable convergence of strategic interests.[22] Other historical cases of interest transformation include US relations with the Kingdom of Hawaii (1848-1893) and Hirschman's own cases of Germany's relations with pre-war Eastern Europe in which asymmetric economic relations transformed domestic interests.[23] Externalities that entail such alteration of the goals of state fall into this category called *Interest Transformation*. Chapter Three features a case based on *Interest Transformation* security externalities in the context of Taiwan.

By focusing on the terminal nodes of the typology, we are left with six distinct types of security externalities which cover the full range of possible security externality categories.[24] As was mentioned earlier, the purpose of this effort to create a typology is to provide a useful theoretic tool for categorizing and specifying the various security-related consequences of economic interaction. The typology specifies six types of security externalities which fall into two broad categories: those acting through primarily economic channels and those externalities with directly military effects. Each of these six types of security externalities functions according to its own economic logic.[25] Taken together, this typology answers the question "In what manner does economics affect security?" and maps out the domain of economic statecraft.[26] Having answered what economic statecraft is and how it works, the next few sections turn to the question of why it works.

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[22] The most famous example of this is the European Union and its efforts to forge common strategic interests.

[23] For more on the Hawaii case see: *ibid.* See especially pp. 123-133.

[24] Although this categorization is designed to capture all the various types of security consequences that may stem from economic interaction in a mutually exclusive manner, any given instance of economic interaction may entail security consequences that fall into more than one of these six buckets.

[25] For more details on the types of security externalities and their causal logics, refer to William Norris, "A Theoretical Framework for Analyzing the Relationship Between Economics and Security" Paper presented at the 2009 Annual Meeting of the New England Political Science Association, Portland, Maine, in which I present a detailed description of each specific type of externality that identifies the links between various patterns of economic behavior and the strategic consequences that result.

[26] This typology may be used to more precisely evaluate instances of economic statecraft to provide a specific vocabulary for precisely describing the economic dynamics at work (or feared to be at work) and their related security rationales.

2.3 Theory

As defined earlier, economic statecraft occurs when states deliberately seek to manipulate economic interaction in order to generate the types of security externalities categorized above. This dissertation provides an account of how aggregate economic agents' micro-level incentives and consequent behavior generate national security outcomes at the level of state grand strategy. Commercial actors, acting on their own interests, engage in various forms of cross-border economic interaction. This interaction often generates security externalities. States can create incentives for commercial actors to behave in ways that encourage the creation of security externalities that are conducive to a state's strategic interests. In this way, states can pursue strategies that seek to manipulate these externalities by structuring the incentives of the commercial actors involved. Such manipulation is defined as economic statecraft.

Thus, to understand economic statecraft, one must take a closer look at *how* the state manipulates economic interaction—more precisely, how the state controls the commercial actors responsible for conducting the economic interaction that produces these strategic effects. To conduct economic statecraft, the government must be able to incentivize commercial actors to behave in a manner that is conducive to producing security externalities that are in line with the state's strategic interests.[27] Thus, the importance of the government's ability to control and

[27] My inspiration for the theoretical framework to explore the state's ability to direct its economic interaction came from the principal-agent literature in economics. Principal-Agent theory offers a useful conceptual framework for unpacking the dynamics governing the interaction of the state and the private sector. Gill and Reilly have also suggested the appropriateness of using a principal-agent approach to understanding the challenges China faces in managing its corporate actors in Africa. See: Bates Gill and James Reilly, "The Tenuous Hold of China Inc. in Africa," The Washington Quarterly Volume 30, Issue 3, pp. 37-52. Although the principal-agent approach is a good one, Gill and Reilly do not fully develop the idea. Rather, they use a principal-agent framework to argue that management challenges are difficult and likely to preclude effective coordination from Beijing. In my work, I elaborate the principal-agent theory and go beyond the question of *whether* the principal can coordinate the agent(s). The theory in this chapter identifies the salient conditions that enable state management of commercial actors. This research focuses on identifying the conditions under which the state can control commercial actors. For the initial identification of these factors, I have drawn on the principal-agent literature.

direct the behavior of commercial actors becomes apparent. So what enables a government to exercise control over commercial actors?

Five factors are responsible for determining the outcome of whether the state is able to control the commercial actor(s). First is whether the goals of the commercial agent conflict with the goals of the state. Second is the number of commercial actors in the market—too many and the government will have a hard time controlling them, but if there are only one or two, these commercial actors may be powerful enough to resist government efforts to control their behavior. Third is the degree to which the government is acting with one voice. To the extent the government itself is divided, it will be more difficult to exercise control over commercial actors. Fourth is the reporting relationship between the government and the commercial actor. If the commercial actor is directly owned or managed by the government, it will be easier for the government to direct the behavior of the firm. Fifth is the relative resource endowments between the principal and the agent—if the commercial actor has considerably more resources than the government, it will more difficult for the government to exercise control. Together, these five factors determine whether the government will be more or less likely able to control or direct the behavior of commercial actors. The next section formalizes this basic theory.

2.3.1 The Model

The dependent variable of this study is whether the state succeeds or fails to control, direct or otherwise use commercial actors in the state's pursuit of its strategic goals. This is called "control" for short. The cases will be coded for whether or not the state has been able to use commercial actors to pursue its strategic objectives. In practical terms, one can observe evidence of whether or not the commercial actors do what China wants done strategically *vis a* *vis* a given foreign policy issue area.[28] So the dependent variable (DV) of the dissertation's cases is control—whether the state succeeds or fails to manipulate, control, direct or otherwise use commercial actors in the state's pursuit of its strategic goals. The values for this DV range from high levels of control to absence of state control.

The independent variables (IVs) are the factors that enable the state to bring the behavior of commercial actors into line with its strategic goals. These IVs highlight the conditions that explain why a state can use commercial actors to pursue strategic goals. In cases in which the state is able to control, direct or use commercial actors, these factors will have been responsible for determining the outcome observed.[29]

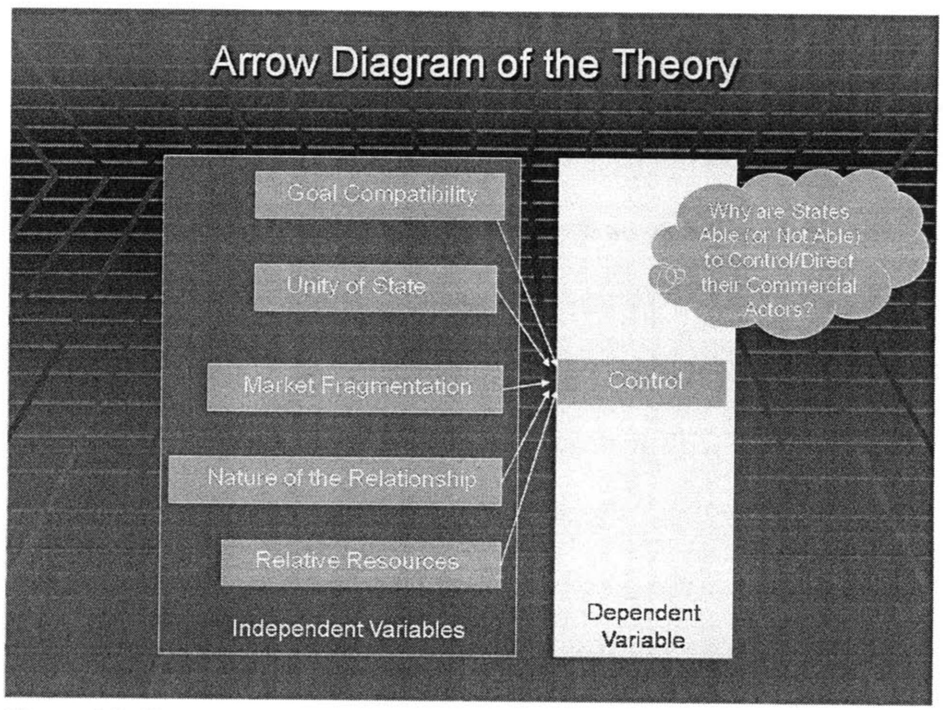

Figure 2.2: Summary of IV-DV Causality

[28] Coding for the dependent variable in the cases will require an examination of what China's particular goals are in a given case context and comparing these objectives with what commercial actors actually did in that case. This sort of comparison will demonstrate whether the state was or was not able to control the commercial actor(s).

[29] For more on dependent and independent variables see John Gerring, *Case Study Research : Principles and Practices* (New York: Cambridge University Press, 2007) p. 21; Stephen Van Evera, *Guide to Methods for Students of Political Science* (Ithaca: Cornell University Press, 1997); and Alexander L. George and Andrew Bennett, *Case Studies and Theory Development in the Social Sciences* (Cambridge, Mass.: MIT Press, 2005) especially Chapter 1.

There are five IVs that are responsible for determining the outcome of the DV (whether or not the state is able to control the commercial actor(s)). The first IV is the intrinsic compatibility between the state's goals and the goals of the commercial actor (the *Goals IV*). How closely are the goals of the commercial actor(s) aligned with those of the principal? If the basic objectives of the commercial actors are closely compatible with the basic goals of the state, one would expect to observe less friction. In such cases, the goals that the commercial actors seek (e.g. profit, market expansion, securing access to basic inputs, improved productivity, etc.) do not conflict with the goals of the state. This facilitates the ability of the state to achieve its goals since motivating the commercial actor to pursue goals that are complementary to what the commercial actor would like to do anyway is fairly easy. Thus, at the simplest level, the key variation on the *Goals IV* that matters in terms of affecting the outcome on the DV is whether the goals of the state and the goals of the commercial actor are conflicting or not. Some indicators to look at when assessing the intrinsic compatibility of the *Goals IV* include whether the commercial actor's goals are defined by the state, the degree to which the commercial actor is driven by purely profit motives, and whether both the goals of the state and the goals of the commercial actor can both be successfully realized (as opposed to mutually exclusive). To the degree the state's goals are compatible with those of the commercial actors, the state will find it easier to control or direct commercial actors in its pursuit of strategic national goals.

The second IV is *Market Structure*. If a market in a particular industry or sector is highly fragmented, it may be more difficult for a state to control the numerous commercial actors. Monitoring, coordinating, and enforcing compliance all become more challenging as the number of commercial actors increase. Conversely, a highly concentrated market with a few large firms may be more easily be directed by the state. However, a monopolistic or duopolistic market structure produces very large, powerful firms with significant autonomy that are likely to enjoy relative bargaining power *vis a vis* the government. Important firms with considerable influence are more easily able to resist state attempts to direct commercial actors, even though the limited number of commercial agents makes the government's monitoring, and enforcement challenges relatively easier. Being the "only game in town" enables firms to more easily resist state attempts to unilaterally direct them. Thus, oligopolistic market structures seem to be best suited to a state being able to control the commercial actors.[30] Such situations are concentrated enough that the firms are easy to monitor, punish, and reward, but not so concentrated that commercial actors can gain leverage *vis a vis* the state.

The third IV is the *Unity of the State.* Whereas the *Market Structure IV* reflects variation in the number of commercial actors involved, the *Unity of State IV* reflects a similar sort of variation on the part of the state. In situations where there may be multiple, competing and conflicting bureaucratic authorities or in situations in which the state is internally divided among competing factions or groups, it will be more difficult to direct and control commercial actors. For instance, when the central state must also contend with provincial and municipal authorities, it may be more difficult to use commercial actors to pursue national strategic goals. Likewise, when the central state is sharply divided by contending ministries or political factions we can expect commercial actors to be more easily able to play one set of interests off the other thus weakening any coherent attempt on the part of the state to control the commercial actors. The values for this IV range from a highly unified state to a deeply divided state. Such divisions typically occur in three realms: across various institutional divides (I call this "inter-bureaucratic" divisions) for example, Ministry of Finance versus National Development and Resources Council; across various levels of government (called "decentralized" divisions) for

[30] "Oligopolistic" market structures are those in which a relatively small number (between two and five or six) of commercial agents compete.

example central government versus provincial government; and across factions (factional divisions) for example rival senior patrons within the Ministry of Foreign Affairs.

The fourth IV is the nature of the *Reporting Relationship* between the state and the commercial actor. This relationship generally consists of three attributes: the nature of the ownership arrangements, the management arrangements and the financing structure. The more direct any of these relationships are between the government and the commercial actors, the easier it will be for the state to exercise control over the commercial actor. For example, in situations of direct state ownership, one would expect higher levels of control. Similarly, a firm whose managers are directly appointed by the government will be more easily controlled than a firm whose managers are elected by private shareholders (*ceteris paribus*). Likewise, a firm that relies significantly upon state sources for its financing is more likely to respect the wishes of the government than one beholden to private shareholders. The values for this *Reporting Relationship IV* range from a direct, tight relationship that is closely monitored to a more distant, arms-length regulatory relationship. The determinants of the nature of the relationship (whether close or more arms-length) typically include three factors: 1.) whether the state has direct ownership over the commercial actor(s), 2.) whether the state has direct management over the commercial actor(s), and 3.) whether the financial arrangements of the commercial actor provide leverage for the state. In situations of direct state ownership, state-appointed managers or state funding, higher levels of state control would be expected.

The fifth IV is the relative capabilities or *Relative Resource* endowments between the state and the commercial actors. This IV reflects the relative capabilities each side enjoys *vis a vis* the other. If the state is well endowed with a considerable budget, large staff of experienced professionals, and a track record of active direction of commercial activities, one would expect control of commercial actors to be higher. The more advanced the nation's organizational capacity to monitor, enforce and regulate commercial actors, the more likely that challenges in exercising economic statecraft will be overcome. Significant bureaucratic and organizational capacity (e.g. leadership, resources, experience, scale, talent, etc.) enables states to overcome problems of information and incentive structure that typically plague business-government coordination efforts. Likewise, if the commercial actor is comparatively well resourced with a deep pool of knowledge and significant financial resources, it should be easier for the commercial actor to exercise its autonomy from the more poorly resourced government entity. If the government possesses more people, money and knowledge relative to the commercial agent, control will be that much easier. The *Relative Resource IV* ranges from being highly skewed in favor of the commercial agent, to roughly symmetrical resource endowments, to being highly skewed in favor of the government. Whether the state is able to effectively exercise close regulation, monitoring and enforcement over the commercial actor is often determined by the degree of asymmetry present in the resources available to the state versus those resources that are available to the commercial actor(s).

This section specified the dependent and independent variables of the study.[31] The ability of the state to control the commercial actor(s) is a function of five factors: first, the intrinsic compatibility of the goals of the state and those of the commercial actor(s); second, the number of commercial actors involved; third, the unity of the state; fourth, the reporting relationship between the state and the commercial actor(s) and finally, the resource endowments of the state relative to the commercial actor(s). Each of these independent variables has a fundamental, hypothesized causal relationship to the dependent variable that determines whether the state can

[31] Although the primary purpose of this project is to develop a theory of economic statecraft, to the extent possible, subsequent chapters will perform initial tests of the theory in the context of a given case. More thorough testing of the theory requires a different research design than the one I use here which is primarily geared toward developing and illustrating the theory itself.

effectively direct commercial actors in pursuit of its strategic objectives. Having specified the theory, the next task is to more explicitly consider how control over commercial actors relates to successful economic statecraft. That is the focus of the next section.

2.4 The Effectiveness of Economic Statecraft

Although economic power is often a difficult lever of international power to wield, when it does occur it can be very important (e.g. Marshall Plan, GATT, Breton Woods, Russian energy policy, etc.). What accounts for the successful use of economic statecraft? Why do countries sometimes realize their strategic objectives utilizing economic tools of statecraft and other times fail? In short, why does economic statecraft work? This section addresses the conditions under which economic statecraft is more or less likely to be effective.

Although state control of commercial actors is crucial for economic statecraft to occur, control alone is not enough to guarantee successful strategic results. In addition to being able to control commercial actors, states must also be able to satisfy three other conditions. Each is a necessary but not sufficient prerequisite determining the likelihood of success of economic statecraft.[32] The first factor that determines the likelihood of success is the purpose that economic statecraft is designed to achieve and how that end matches with the target state's own objectives. As has been noted in the sanctions literature, success of economic statecraft often depends on the objectives being sought.[33] The ends sought cannot be out of proportion with the economic means available to realize those ends. A related concept is that certain characteristics

[32] These preconditions may be thought of individually insufficient but necessary causes. Together these three conditions and state control over the commercial actor represent the sufficient and necessary conditions for successful economic statecraft.

[33] For more on when sanctions work and the importance of purpose commensurability see: Gary Clyde Hufbauer, *Economic Sanctions Reconsidered*, 3rd , Expand ed. (Washington, DC: Peterson Institute for International Economics, 2007); Richard Haass and Meghan L. O'Sullivan, *Honey and Vinegar : Incentives, Sanctions, and Foreign Policy* (Washington, D.C.: Brookings Institution Press, 2000); Lisa L. Martin, *Coercive Cooperation : Explaining Multilateral Economic Sanctions* (Princeton, N.J.: Princeton University Press, 1992).

of target states' domestic regimes can also be important facilitating or inhibiting factors making success more or less likely.[34] *Ceteris paribus*, economic statecraft that has a more modest objective targeting a less recalcitrant state will meet with success more readily than economic statecraft with a grandiose goal targeting a state whose domestic political climate is not conducive to the sought objective. In other words, for economic statecraft to be successful, the ends must be commensurate with the means. To the extent that the objective sought is out of proportion to the economic tools available, economic statecraft is unlikely to succeed. The second factor is the relative magnitude of the economic interaction.[35] For instance, a country whose trade comprises 80% of its GDP will be much more sensitive to disruptions of that trade than one for whom trade plays only a minor role in its overall economy.[36] The relative magnitude of the economic interaction ought to be fairly large for economic statecraft to be effective. The third factor is the elasticity of demand (or, in some cases, supply) for the

[34] See: James D. Fearon, "Domestic Political Audiences and the Escalation of International Disputes," The American Political Science Review 88, no. 3 (1994): 577-592.; Martin, *Coercive Cooperation : Explaining Multilateral Economic Sanctions,*; Han Dorussen and Jongryn Mo, "Ending Economic Sanctions: Audience Costs and Rent-Seeking as Commitment Strategies," The Journal of Conflict Resolution 45, no. 4 (2001): 395-426.; David Lektzian and Mark Souva, "The Economic Peace between Democracies: Economic Sanctions and Domestic Institutions," Journal of Peace Research 40, no. 6 (2003): 641-660.; Benjamin N. Judkins, "Economic Statecraft and Regime Type" (Ph.D. diss., Columbia University, 2004); David J. Lektzian and Christopher M. Sprecher, "Sanctions, Signals, and Militarized Conflict," American Journal of Political Science 51, no. 2 (2007): 415-431.; Michael Tomz, "Domestic Audience Costs in International Relations: An Experimental Approach," International Organization 61, no. 04 (2007): 821. on issues of audience costs, reputation effects, success against autocracies versus democracies, etc. At a conference on China's rising power at MIT in February, 2009 Adam Segal made the point that an important consideration of how effective China's economic statecraft will be is the host/target's domestic political context (Conversations with the Author, February 27, 2009). My sense is that conducive host nation environments will make it easier for success in much the same way that conducive goals would facilitate a greater likelihood of success.

[35] Knorr also discusses the importance of magnitude in determining the likelihood of success. His discussion, however centers around the sending state and its vulnerability in (as well as dominance of) a given economic interaction. See: Klaus Eugen Knorr, *The Power of Nations : The Political Economy of International Relations* (New York: Basic Books, 1975) p. 84.

[36] Especially if that trade is highly concentrated with one or a few states and there are no other real alternative trading partners. To illustrate: before the Soviet Union cut its ties with Albania in 1959, 56% of Albania's imports came from the USSR and 45% of its exports went to the Soviet Union. By the end of 1961 all trade relations with the USSR had ended. Albania underwent a significant and painful economic re-orientation toward China and the West, which eventually replaced the USSR as Albania's dominant trading partner.

economic interaction.[37] For economic statecraft to be effective, the nature of the economic interaction ought to be fairly inelastic. For example, a country whose domestic energy grid is based on light, sweet crude oil is not easily able to substitute alternative goods in place of this type of crude oil. Since energy also provides such a fundamental input for the rest of the economy, this country's demand for light sweet crude would be said to be fairly inelastic. Thus, economic statecraft that seeks relatively modest objectives and is based on relatively large, inelastic economic interaction has a greater likelihood of success, *ceteris paribus*.

The fourth factor determining the likelihood of success is the state's ability to control or direct its economic interaction. The degree to which a state is able to direct its economic interaction is largely a function of its domestic economic system—in particular, the nature of its business-government relations. Various states throughout history (and into the present period) have chosen to organize their domestic economies using a range of business-government relations.[38] The nature of these relations often determines the degree to which the state has control over the specific conduct of its economic interaction with other states. *Ceteris paribus*, states with a greater degree of control over their domestic economy will be better suited to direct their economic interaction and thus more likely to realize success in their attempts to engage in economic statecraft.

So, to be effective at wielding its economic power, a state needs to be able to direct its economic activities. However, as demonstrated by states with centrally directed economies, the

[37] Knorr also puts forward the notion of elasticity, although his use of elasticity is somewhat more narrow than what is presented here. See: *ibid.* p. 85. The section entitled "Definitions" noted that elasticity involves both how badly a state requires a given good as well as how easily this good may be substituted. Knorr tends to focus his analysis on the sending state and as a result tends to ascribe this latter characteristic to the sending state's market power rather than to the receiving state's demand elasticity (as I do). This difference in attribution does not greatly impact our conclusions on the issue—in both cases what matters is how easily a substitute may be found.

[38] This factor is somewhat connected to the literature on state-business relations in that differing domestic business-government paradigms will be pre-disposed to being more or less amenable for the state to actively use economic power—particularly to direct its commercial actors—in achieving foreign policy goals. For an example of this state-business relations literature see: Peter A. Hall and David W. Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford England ; New York: Oxford University Press, 2001).

more a government, rather than markets, is in charge of directing the state's economic behavior, the less efficient the state's economic productivity tends to be.[39] Over time, this lower economic productivity limits the size of a nation's economy. The smaller or less powerful a state's economy is, the less intrinsic weight the state has to throw around (i.e. the less "economic gunpowder" the state possesses).[40] So although a state needs to be able to direct its economic might for economic statecraft to be effective, too much state direction tends to lead to inefficiency and a less robust economy over time. Likewise an economy in which the state is relegated to a very small role may grow to exceptional proportions, but the state will find it very difficult to meaningfully direct this latent economic power in any concerted way. This is the essence of the paradox inherent in the exercise of national economic power.

In resolving this paradox, states have made fundamental decisions about the nature of business-government relations which locates themselves somewhere on a continuum ranging from deep government direction of commercial activities to very little governmental interference in business. Most modern liberal economies have opted to allow for decentralized, market-based allocation of scarce economic resources. This system of economic organization allows for a good deal of flexibility and provides uniquely efficient economic advantages that compound over

[39] The debate over the "Washington Consensus" is an important and complicated one. While the paradox presented here assumes some liberal economic tenets (i.e. that directed economic growth is not as efficient as market-oriented economic activity)—the debate of whether market economies are more productive than directed economies is not one that this dissertation will engage. Rather, it is assumed that directed economic growth is not as efficient as market-oriented economic activity over the long run and focus on developing the implications of this in terms of the paradox. That said, the underperformance of centrally-planned economies is well documented. Economic inefficiencies stem not only from the challenge of the complexity involved, but also from the long-term implications of inefficient capital allocation. See János Kornai, *The Socialist System : The Political Economy of Communism* (Princeton, N.J.: Princeton University Press, 1992). Empirically, the USSR and Eastern Block ultimately failed economically. In Asia, the DPRK's economy seems to be in very bad shape and Chinese *liberalization* has been the key to China's economic success. Although intensive, government planned and directed economic growth is possible (and may even be sustained for some period of time), it does not seem to be the best path for either economic dominance, or long term sustainability.

[40] Of course, if the economy provides a unique, critical good (e.g. something with highly inelastic demand), the state can also derive considerable influence from the inelasticity (rather than the magnitude) dimension of its international economic relations.

time. It has produced very advanced economies that are highly productive and on the whole fairly efficient.[41] Through taxation, the state is able to gain some share of this wealth and allocate it however it would like, but the majority of the economic productivity lies outside the direct control of the state—such is the price that must be paid for efficient resource allocation at the macro-economic level. Since most modern economies have more or less sided on the liberal side of the paradox to maximize their economic welfare (e.g. butter over guns) they have ceded much of the direct control over the conduct of economic interaction to the primary economic actors, namely commercial firms.[42] The result is a decentralized and relatively efficient allocation of scarce resources by relatively autonomous, profit-maximizing actors. This activity is conducted largely through markets and freely floating prices—the key to maximizing economic potential at the national production possibility frontier. However, this business-government arrangement makes it difficult to fully mobilize the nation's latent economic power since the state, when it elects to exercise its international economic power, is forced to act largely through the non-state actors who actually conduct the economic activity—namely the commercial firms. This situation gives rise to the business-government dynamics that play such a key role in determining success or failure of economic statecraft.

However, not all states have opted for a minimal role of government in the economy. Robert Gilpin presents a useful continuum of how deeply the state is involved in a given type of

[41] One of the few sources that addresses this important question of the domestic business-government institutional setting is Stephen Krasner's Chapter 6 "Domestic Constraints on International Economic Leverage," in Klaus Eugen Knorr and Frank N. Trager, *Economic Issues and National Security* (Lawrence: Published for the National Security Education Program by the Regents Press of Kansas, 1977) pp. 160-181. However, Krasner seems to miss the important implication of his own analysis, namely the centrality of the principal-agent relationship (between the state and the commercial firms) for determining the ability of states to effectively wield their economic power.

[42] Samuel Huntington lamented the degree to which economic power was largely unwieldy for the US: "Harnessing economic power to foreign policy goals presents formidable obstacles:...most important, in dramatic contrast to military power, a pervasive ideology that sanctifies the independence, rather than the subordination, of economic power to government."Samuel P. Huntington et al., "Trade, Technology, and Leverage: Economic Diplomacy," Foreign Policy , no. 32 (1978): 63-106. p. 71.

domestic economic exchange system.[43] He argues that the most elementary systems were based on reciprocity characterized by barter and gift-giving, the next most advanced form of economic exchange is redistribution characteristic of early irrigation and storehouse civilizations. This form is closely related to what he calls mobilization exchange in which "the economy's primary function is to advance the security and power of the dominant elite." In the most advanced form of market economy type of exchange, there is "a market place wherein goods and services are exchanged to maximize the returns to individual buyers and sellers." From the perspective of this spectrum, contemporary China presents a particularly interesting case. Although its economy has been liberalizing for thirty years, the Chinese state today remains deeply involved in many economic activities. It seems to fit what Robert Gilpin described as a "mercantilist" economic system: "In terms of our classification of economies above, mercantilism represents a halfway house between a mobilization and a liberal market economy. In other words, the state attempts to influence and channel emerging market forces in a direction which will enhance its security and other national interests."[44] This seems to be an apt description of China's current status and makes China a particularly conducive empirical setting for exploring economic statecraft. As it continues to liberalize, China will increasingly be subject to many of the business-government dynamics that lay at the heart of the theory presented above.

2.5 Case Selection, Methodology and Research Design

Up to this point, this chapter has presented a general theory of economic statecraft to explain both *how* (as explained by the typology) and *why* (as explained by the state-commercial

[43] Gilpin was writing about the historical development of economic interdependence. See Robert Gilpin's Chapter 2 "Economic Interdependence and National Security in Historical Perspective," in Knorr and Trager, *Economic Issues and National Security,* pp. 19-66.
[44] Gilpin argues that mercantilist systems are located between mobilization and market based exchange types on his developmental spectrum. See Robert Gilpin's Chapter 2 "Economic Interdependence and National Security in Historical Perspective," in *ibid.* especially pp. 20-31; quote in the text is from p. 27.

actor dynamics and the three conditional variables) the exercise of economic statecraft works. The remainder of this chapter explains the criteria used to identify both China as fruitful ground for exploring the exercise of economic power as well as why the specific cases of contemporary Chinese foreign policy that have been selected for in-depth research. As mentioned in Chapter 1, this project is designed to build a general theory of economic statecraft. Although the theory is developed in such a way that it can apply to any state that seeks to exercise economic power in the international system, the empirical work in this study is confined only to testing its plausibility in the case of China—a particular context uniquely suited to studying and developing a theory of economic power. The first portion of this section explores why this is so. Having narrowed the focus to China, it is then necessary to articulate what criteria have been used to select the particular cases of Chinese economic statecraft that make up the empirical chapters. I take up this task in the second portion of this section. The final portion discusses the methodology and research design.

2.5.1 Case Selection

China's mixed economy still has a number of characteristics reminiscent of a planned economy. One would expect that these vestiges should facilitate the state's ability to direct and/or guide the economic behavior of the commercial sector to an unusual degree. As a result, China is a relatively unique state in terms of the paradox of economic power discussed earlier.[45] China is among that handful of states that possess both considerable "economic gun powder" (by virtue of its size, population, resources, economic reforms, growth etc.) *and* because it is still a

[45] Other "mixed" regime states may also have these characteristics and would provide good alternative contexts in which to look for cases of effective economic statecraft. Other states that may make good candidates for studying economic statecraft include: Russia (especially in the realm of energy security policy since Russian energy exports carry considerable weight and the industry concentration of the oligarchs allows for state direction) and India (where the government has a history of active commercial direction).

reforming, state planned economic system, China also has significant state capabilities to direct that economic gunpowder. This combination of significant economic power and the ability to direct that economic might has the potential to be an important enabler of economic statecraft as we shall see in the cases.

China is also a rising power that leverages its economic clout.[46] However, we do not yet understand how this increasingly powerful player wields its economic power. Does China use economic power to successfully achieve its strategic objectives? If so, how? Are there patterns to China's success? Are there also patterns of failure? When does it not work? What generalizations can we draw from these experiences? Answering such questions demands a rigorous examination of cases in which China attempted to use economic interaction to pursue its foreign policy goals. Although states have often used military tools to realize their foreign policy objectives, it seems that using military power may be somewhat counterproductive for achieving Chinese strategic interests.[47] Instead, China has consciously and publicly sought to leverage its "soft power" capabilities, especially economic relations, but also cultural and people-

[46] China possesses a large, export-oriented, dynamic economy that has grown at an average rate of around nine percent per year for the past thirty years. China surpassed Germany in 2007 to become the world's third largest economy, with a GDP of $3.5 trillion (to Germany's $3.3 trillion) and in 2010 surpassed Japan to become the second largest economy. See:"China's economy leapfrogs Germany: The Chinese government has increased its estimate of how much the economy grew during 2007," in BBC News [database online]. 2009/01/14 20:31:56 GMT [cited 2009]. Available from http://news.bbc.co.uk/go/pr/fr/-/1/hi/business/7829230.stm and David Barboza, "China Passes Japan as Second-largest Economy," New York Times Aug. 15, 2010. Available on-line at: http://www.nytimes.com/2010/08/16/business/global/16yuan.html The export orientation of China's economic growth means that a significant portion of China's GDP is connected to international economic activity. Based on a crude measure of international economic interaction (2007 trade as portion of GDP as reported by the WTO), China's trade comprises 71% of its GDP. This places China among the top trading countries in the world. In addition, in the spring of 2009, China's central banker, Zhou Xiaochuan, publicly suggested that the world move away from using the dollar as the reserve currency. Discussions in China's State Council have entertained the notion of providing Chinese foreign aid in RMB as part of an effort to increase the international use of China's currency. Manipulating such ties provides a strong foundation for economic statecraft.

[47] China's ongoing military modernization effort has frequently brought to light serious limitations on its power projection capabilities. Moreover, when matched against many of the other military powers in China's region, the PLA does not enjoy a decisive operational advantage across several critical areas (air superiority, anti-submarine warfare, C4ISR, air lift, etc.). This also makes military power a less attractive avenue for pursuing China's interests. Finally, pursuing its objectives via military means has shown a tendency to spur neighbors toward balancing behavior in ways that undermine larger Chinese strategic objectives. Because of fears over China's rise and because of the lessons from China's more bellicose period of foreign policy in the mid 1990's, China has largely moved away from using military force as a primary tool of its statecraft (Taiwan aside).

to-people contact.[48] Since, by its own account, China is trying to use economic statecraft, it makes a good case to look at if one wishes to understand the practice of economic statecraft.[49] Although much of the current scholarship on China's foreign policy recognizes the importance of economics in China's foreign policy, our understanding of the actual implementation of economic power is still not well understood. It is not clear why, when or under what conditions Chinese economic statecraft works. Nor is there consensus over the manner in which economics is used strategically. In my empirical work, I have selected likely cases of China's economic statecraft specifically to explore these questions. This sort of selection is needed if we are to understand how economic statecraft works (and, by extension how/when it does not work).[50]

As stated above, control of commercial actors is likely to result in successful economic statecraft when three other conditions are met. First, the economic interaction must be large enough to matter. Second, the economic interaction should be fairly inelastic—meaning the state cannot do without the economic interaction and it would be very difficult to substitute in alternatives. Third, the strategic objectives sought ought to be relatively modest in comparison to the economic tools employed. These criteria describe the necessary (but not sufficient) conditions for statecraft to succeed. When these conditions are met and the state is able to

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[48] Michael Glosny, "Heading for a Win-Win Future? Recent Developments in China's Policy Toward Southeast Asia," Asian Security, vol. 2, no. 1, 2006, pp. 24–57.

[49] For instance, discussions around the ideas of "comprehensive national power" (综合国力) and China's "soft power" often emphasize economic tools of statecraft. See: Fuquan Tong and Yichang Liu, *世界全方位经济战 Shijie Quanfangwei Jingji Zhan (The World's all Directional Economic War),* (Beijing: Military Science Publishing House, 1991); Zhou Yongsheng, *经济外交 Jingji Waijiao (Economic Diplomacy),* (Beijing: China Youth Publishing House, 2004); Michael Pillsbury, *China Debates the Future Security Environment,* (Washington, DC: National Defense University Press : 2000) especially Chapter 5, "Geopolitical Power Calculations."

[50] Although this sort of research design may seem obvious, there are methodological critiques that do not recognize this basic point that we cannot hope to study a phenomenon if there is not a high likelihood that the phenomenon is present in the case in the first place. For a thoughtful treatment of King, Keohane, and Verba's *Designing Social Inquiry* and its relation to this point, see David Collier, James Mahoney and Jason Seawright's Chapter 6 entitled "Claiming too Much: Warnings about Selection Bias," in Henry E. Brady and David Collier, *Rethinking Social Inquiry : Diverse Tools, Shared Standards,* (Lanham, Md.: Rowman & Littlefield, 2004) pp. 85-102. King, Keohane, and Verba, *Designing Social Inquiry,* is often cited for its discussion of selection bias (pp. 116-130 *inter alia*).

control the activities of commercial actors, economic statecraft will be successful. As such, I have selected cases of Chinese statecraft that involve relatively large, inelastic economic interactions that China seeks to use to pursue relatively modest strategic objectives.[51] By preselecting cases that meet these three criteria, the empirical analysis can focus on the degree to which the state is able to control the behavior of commercial actors. If, under these conditions, the state is able to get the commercial actors to behave in a way that generates security externalities that are conducive to the state's strategic objectives, then the economic statecraft will be successful. If, however, these three conditions are met but the state is unable to control the commercial actor(s), the attempt to engage in economic statecraft will be unsuccessful.[52]

So if China has several characteristics that make it a likely candidate to use economic statecraft, which episodes of Chinese foreign policy would be most likely to involve such a strategy? How should the researcher focus his analytical lens?[53] The first criteria is that the foreign policy episode should be one in which economics plays an important role. For example, some aspects of a state's foreign policy (like free trade agreements, developmental aid, trade delegations, etc.) have inherently larger economic components than others. Thus, areas of

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[51]Such episodes fulfill the three preconditions that are required for economic statecraft to be successful. As such, they also provide valuable guidance for selecting which cases would provide appropriate data for our purposes of understanding economic statecraft. Cases that meet these conditions would likely be a good place to focus if our intent is to better understand how economic statecraft works. If one wishes to understand how and why economic statecraft works, one must begin by looking at probable cases of economic statecraft. For more on theory building and using cases to study a phenomenon in social science see: George and Bennett, *Case Studies and Theory Development in the Social Sciences.*

[52] Without state manipulation of commercial actors, economic statecraft does not exist. This is not to say that security externalities may not, in fact, still be present. It may simply be the case that the state is not able to effectively harness them to coherently pursue its strategic objectives. Refer to the earlier discussion of security externalities that noted that the activities of commercial actors may still entail strategic consequences even if the state is unaware or unable to control the behavior of commercial actors. Under such conditions, the state simply cannot usefully manipulate these security effects (i.e. cannot engage in economic statecraft).

[53] Much of this "analytical lens focusing" has been informed by Gary Goertz's *Social Science Concepts*, in particular see his discussions of case selection and specification of one's theoretical domain. See: Gary Goertz, *Social Science Concepts : A User's Guide,* (Princeton: Princeton University Press, 2006). John Gerring's Chapter 5 "Techniques for Choosing cases" Gerring, *Case Study Research* p. 86 is also very useful as is Evan S. Lieberman, "Nested Analysis as a Mixed-Method Strategy for Comparative Research," The American Political Science Review 99, no. 3 (2005): 435. on "nested cases."

China's foreign policy in which China is looking to leverage its economic power are particularly of interest. In some instances, China has already had success in using this form of international power (e.g. using *Coercive Leverage* bring North Korea back to the Six Party Talks, *Interest Transformation* targeting states that recognize Taiwan, etc.). In other instances, such attempts have largely failed—or at least not yet generated the desired outcome (e.g. reunification with Taiwan, *Coercive Leverage* against France over Tibet, etc.). Cases of both types are useful for understanding how economic power is exercised. In each of the three areas of China's foreign policy I have selected for study (China's sovereign investment, China's extractive resources strategy, and China's cross-Strait economic interaction), economics is a critical tool of China's statecraft. Moreover, the specific cases discussed in the chapters that follow include elements of both success and failure. Examining both types of results provides better insight into the conditions under which economic statecraft is likely to succeed.

In the first case, I examine China's economic statecraft in the context of its cross-Strait relationship with Taiwan. Examining the role of economics in the cross-Strait relationship provides a helpful illustration of several of the types of security externalities discussed above. Since the early 1990s, economics has become a critical feature of the cross-Strait relationship. During this time, the Mainland has sought to incorporate this economic interaction into its larger strategy *vis a vis* Taiwan. Chapters Three and Four will examine the evolution of this effort. In particular, Chapter Three focuses on one of the most significant developments in the cross-Strait relationship in recent years—the historic 2005 visit of KMT Chairman Lien Chan to the Mainland. Although China's approach to Taiwan (and the role of economics within that strategy) has evolved over time, many of the most recent uses of economics have been designed to transform the strategic calculus of Taiwan. Chapter Three highlights how a strategy of economic statecraft seeking to generate *Interest Transformation* security externalities actually works in practice. Chapter Four examines earlier periods of the cross-Strait relationship in which China's economic statecraft revolved around *Coercive Leverage* and *Bolstering* security externalities.

Chapters Five and Six, turn to another strategically significant area in which China has sought to pursue its national interests through the use of economics, namely its international resource extraction strategy. Securing access to raw materials is a critical foundation of China's continued economic development. Without reliable access to supplies of the basic inputs for China's economy, China's ongoing economic progress may be jeopardized. Economic growth has been highlighted as one of the cornerstones of China's grand strategy. Securing access to key inputs has been defined by China's leadership as a critical dimension of national strategy. As such, an examination of China's economic statecraft ought to include an investigation of how the state has sought to secure raw materials. In particular, Chapter Five will look at China's "going out" strategy (作出去 *zuo chu qu*) and the role of the state vis a vis commercial actors in the context of China's drive to secure access to petroleum resources. Chapter Six juxtaposes this experience with a close case study of what was to be China's largest foreign investment ever: Chinalco's $17 billion bid for Rio Tinto. This type of detailed analysis enables process tracing that will illustrate and inform the theoretical framework presented above. Both Chapter Five and Chapter Six examine the role of the state in coordinating China's commercial actors' efforts to secure strategic raw materials.

The final two empirical chapters examine the potential for China's massive foreign exchange reserves to be used as instruments of economic statecraft. Specific concerns revolve around China's ability to direct the investment of these assets. Given the importance of the state's ability to control commercial actors, no entities are better suited for this task than the government owned and operated sovereign wealth funds. China's sovereign wealth funds are direct arms of the state and thus prompt concern over the degree to which they may be used to pursue Chinese strategic objectives. Chapters Seven and Eight evaluate the extent to which these commercial actors present legitimate security concerns. Chapter Seven does this by comparing the State Administration of Foreign Exchange and its role in facilitating China's foreign policy objectives to the National Social Security Fund and its relatively commercial mandate. Chapter Eight applies the framework for evaluating security externalities and control over commercial actors to the China Investment Corporation—China's official sovereign wealth fund.

Although each case has its own intrinsic significance as an important example of how economics and security intersect in Chinese grand strategy, taken together, the cases allow for productive testing and refining of the theory. These three empirical contexts collectively provide good variation in terms of the fundamental nature of the relationship between commercial actors and the state. The commercial actors in the raw materials context are mainly state-owned enterprises (SOEs) while the commercial actors in the Taiwan context are private sector Taiwanese firms (i.e. very distant from the Chinese state). In the case of China's sovereign wealth funds, the commercial actors are actually extensions of the state itself. These three empirical contexts provide good cross-case variation in terms of the dynamics of the basic business-government relationship. Finally, the selection of these three areas for study provides an example of each of the three forms of economic interaction mentioned earlier: trade in the case of Taiwan, investment in the resource extraction cases and monetary tools of economic statecraft in the cases of China's sovereign wealth funds.

2.5.2 Methodology

Without delving fully into what can be a stand-alone agenda for academic research in its own right, this section attempts to locate my research in the growing area of rigorous qualitative research methodology. In this section, I identify both what aspects of the theory the case study approach will be able to test and what aspects of the theory testing must be left for future work.

My research is anchored in a theory building endeavor whose purpose is to understand the circumstances and conditions that would allow a state to effectively use its economic power to achieve strategic goals. As such, I have put forward several ideas that hypothesize various channels of causality. The empirical chapters that follow will seek to test these hypothesized causalities. Since this is primarily a theory-building effort, my objective in what follows is more to refine and develop the theory than to provide a rigorous, large-N test of the theory across many countries over a span of time.[54] This sort of test of how easily this theory can be transported to other countries outside China will have to wait for future research.[55] Even within the universe of China's foreign policy, I will not be able to rigorously test how well the theory holds across *all* instances of China's foreign relations—this task is much too large for a single dissertation. Rather, from the entire universe of all cases of China's foreign relations, I have selected illustrative instances in which economics plays an important role in pursuing strategic

[54] "...[I]nferring and testing explanations that define *how* the independent [variable]causes the dependent variable are often easier with case-study than large-*n* methods." Van Evera, *Guide to Methods,* p.54. For an insightful discussion of such case-based techniques and how they contrast with quantitative hypothesis testing, see the section entitled "Beyond Strict Hypothesis Testing: Theory Generation, Reformulation, and the Iterated Assessment of Hypotheses," in Gerardo Munck's Chapter 7 "Tools for Qualitative Research," in Henry E. Brady and David Collier, *Rethinking Social Inquiry: Diverse Tools, Shared Standards* (Lanham, Md.: Rowman & Littlefield, 2004) pp. 119-120.

[55] "Whether a causal account that fits one historical circumstance will fit others is an open question. What matters here is that a causal mechanism has been identified, and the researcher has some framework within which to begin to investigate the validity of the causal claims. . . The issue of the generalizability of the model can thus be separated from the question of whether the model is an accurate explanation of cause and effect in the situation in which it has been putatively identified." From Timothy McKeown's Chapter 9 "Case Studies and the Limits of the Quantitative Worldview," in *ibid.* pp. 163-164. This reflects the methodological tension between testing for internal versus external validity.

objectives with the intention that such cases of economic statecraft (or attempted economic statecraft) will illuminate and provide opportunities to further specify and test various elements of the theory that tells us something about how and why economic statecraft works.[56]

When developing and testing a theory, it is important to test both for internal validity and external validity. Internal validity may be thought of as testing the internal coherence of the theory. For example, do the posited causal relationships, in fact play out as the theory would suggest? If the theory suggests a causal relationship between two phenomena, what evidence would support or disprove the existence of such a relationship? Such questions guide the empirical testing of internal validity. As suggested by works in rigorous qualitative methodology, this sort of testing is usually best done using within-case variation.[57] As Stephen Van Evera puts it, "If case conditions are uniform, we can discount third variable influence as a cause of observed within-case covariance between values on IV and DV. (The uniform background conditions of the case create a semi-controlled environment that limits the effects of third variables by holding them constant.)"[58] One major advantage of within-case variation is that potentially confounding extra-theoretical factors (like cultural context, historical setting, etc.) that may be accounting for observed changes in the DV are minimized.[59] Such variation

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[56] Timothy McKeown notes that such an approach "contributes to greater learning from the data. *Ex post* model-fitting is a legitimate aspect of a research cycle, which should include the on-going evaluation and (re)formulation of theory." See his Chapter 9 "Case Studies and the Limits of the Quantitative Worldview," in *ibid.* p. 141. For more on defining a universe of cases and specifying a research concept see: Gary Goertz, *Social Science Concepts: A User's Guide* (Princeton: Princeton University Press, 2006) and Gerring, *Case Study Research.*

[57] "Within-case analysis helps researchers assess to what degree the mechanism hypothesized by a theory was present among all the cases under study. Researchers can thus make inferences not only about the extent to which the hypothesized cause was found across cases, but also about the extent to which that cause produced the outcome for each case." Brady and Collier, *Rethinking Social Inquiry,* p.118.

[58] Van Evera, *Guide to Methods* p. 52.

[59] This sort of minimization of extra-theoretical influences mimics a control group in a natural science experimental setting. For more see John Gerring's Chapter 6 entitled, "Internal Validity: An Experimental Template," in Gerring, *Case Study Research,* and Evan S. Lieberman, "Nested Analysis as a Mixed-Method Strategy for Comparative Research," The American Political Science Review 99, no. 3 (2005): 435. Goertz, in *Social Science Concepts,* confirms that matching cases that are varying in their IVs and the values of the DV but are structurally very similar in other respects is a highly desirable research design. John Gerring concurs: "Consider for starters, the logic of cross-case analysis is premised on some degree of cross-unit comparability (unit homogeneity). Cases must be

typically occurs across two dimensions: spatially—from one physical context to another, and temporally—in the same physical context but at different periods in time.[60] The important feature of within-case variation is that it allows us to explore how the various IVs relate to the DV in detail, in a given context. This sort of case work has been shown to be well-suited to testing causality and mechanisms.[61]

Theories can also be tested for external validity. External validity may be thought of as testing whether a theory that explains a given set of data is also able to explain another set of data that shares the same salient characteristics. For example, if the theory holds in a given case, does it do an equally good job explaining another, comparable case? Again, such cases can vary both over time and across different spatial areas. Unlike within-case variation, cross-case variation allows for a comparison of similarities and differences across theoretically interesting dimensions of the empirical material. By looking across a range of mini-cases, such work allows me to test how well the posited relationships hold up in a variety of similar settings that nonetheless differ in important respects.[62]

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similar to each other in whatever respects might affect the causal relationship that the investigator is investigating or such differences must be controlled for." Gerring, *Case Study Research,* p. 50. These recent works follow others that have suggested similar methods. See for example: Rose McDermott, "Experimental Methods in Political Science," Annual Review of Political Science 5, no. 1 (2002): 31; Charles C. Ragin, *Fuzzy-Set Social Science,* (Chicago: University of Chicago Press, 2000); Theda Skocpol, *Vision and Method in Historical Sociology,* (Cambridge Cambridgeshire ; New York: Cambridge University Press, 1984); Adam Przeworski and Henry Teune, *The Logic of Comparative Social Inquiry,* (New York: Wiley-Interscience, 1970).

[60] For more on spatial versus temporal variation see: George and Bennett, *Case Studies and Theory Development in the Social Sciences,* as well as David Collier, Henry Brady and Jason Seawright's Chapter 13, "Sources of Leverage in Causal Inference: Toward an Alternative View of Methodology," in Brady and Collier, *Rethinking Social Inquiry,* pp. 229-266 and Paul Pierson's Chapter 5 entitled, "Big, Slow-Moving, and ... Invisible: Macrosocial Processes in the Study of Comparative Politics," in James Mahoney and Dietrich Rueschemeyer, *Comparative Historical Analysis in the Social Sciences,* (Cambridge, U.K. ; New York: Cambridge University Press, 2003) pp. 177-207.

[61] The case-work oriented approach is suitable for identifying and understanding mechanisms. See: Gerring, *Case Study Research,* p.5.

[62] Such differences enable me to focus on changes in the values of particular parameters of the theory. In the empirical portions that follow I conduct both internal and external validity types of tests. Although the primary purpose is theory development and hence the emphasis is on internal validity testing.

2.5.3 Research Design

The structure of my research draws on recent advancements in the subfield of qualitative methodology. My primary objective is development of a theory of economic statecraft and, as is often the case with most theory development, the central methodological concern is internal validity—does the real-world data support the hypothesized relationships? As such, much of the empirical work seeks to test implications and aspects of this theory.[63] Although the nested mini-case design enables some limited cross-case work, the majority of the testing will rely on within-case variation.[64]

The case-work is broadly structured around a pair-wise comparison research design. The chapters match cases within each of the three empirical contexts (cross-Strait relations, "Going Out" and sovereign wealth funds) to better understand why economic statecraft might have been more or less effective at realizing China's strategic objectives. Cases taken from the same empirical context can be usefully compared when one case shows economic statecraft achieving China's strategic objectives and another case from the same empirical context does not. Exploring the differences between these two instances provides helpful insight into explaining why economic statecraft works. Examining cases within a specific empirical context provides

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[63] In so doing, the case material will be used to test and refute or refine the theory as necessary. John Gerring notes that using case studies is a superior way to establish causality when testing theories. See his *Case Study Research* pp. 45-48. For an excellent resource on using case material to build, test and refine theory see: Alexander L. George and Andrew Bennett, *Case Studies and Theory Development in the Social Sciences,* (Cambridge, Mass.: MIT Press, 2005).

[64] David Collier, James Mahoney and Jason Seawright's Chapter 6 entitled "Claiming too Much: Warnings about Selection Bias," in Brady and Collier, *Rethinking Social Inquiry,* pp. 85-102 does an excellent job of specifying conditions under which it is theoretically productive to select cases on the DV—namely when seeking to understand causal mechanisms within a given case. At the same time they note that cross-case work ought to be conducted by selecting *only* on variations in IVs. This insight informs my research design. For more on nested case design see: Lieberman, "Nested Analysis as a Mixed-Method Strategy for Comparative Research," in which he discusses mini-cases; for an example of using mini-case qualitative analysis see: Virginia Page Fortna, *Peace Time: Cease-Fire Agreements and the Durability of Peace,* (Princeton, N.J.: Princeton University Press, 2004) for a discussion of the advantages of within-case variation for forming and testing causal theories see: George and Bennett, *Case Studies and Theory Development in the Social Sciences,*; Gerring, *Case Study Research*; Van Evera, *Guide to Methods,* for a discussion conceptually distinguishing cross-case from within case variation see: Brady and Collier, *Rethinking Social Inquiry*; Gerring, *Case Study Research.*

the advantages of within-case variation discussed above. At the same time, looking systematically at the factors that seem to account for when the state is able to control its commercial actors across all three contexts provides a degree of external verification. The case-work serves two important functions in terms of the development of theory. First, these chapters provide useful illustrations of how particular security externalities actually work in practice. Second, the evidence from the cases help to understand why the state was or was not able to control commercial actor(s) in any given episode. By examining the empirics of these cases, we can determine the roles that various factors played in explaining the outcome of the case. Exactly how did China's attempts to use economic statecraft unfold? What were the strategic results of these activities? Data from these cases will help to further refine the theory.

The empirical work focuses on using process tracing techniques to identify evidence from the cases that bears on the causal relationships put forward earlier in this chapter.[65] For example, evidence that shows that the tools, policies, rules, regulations, or laws that are available for the state to punish or reward commercial actors are limited or non-existent would indicate a relatively weak bureaucratic capacity to enforce and the *Relative Resource IV* would be skewed in favor of commercial actors. The state can also attempt to directly offset the problems of asymmetric information and enforcement. This can be done by improving monitoring capabilities, or improving enforcement capabilities. These would help skew the *Relative*

[65] Causal process tracing techniques will be used to analyze the empirical data from the cases. Stephen Van Evera borrows from Alexander George and Timothy McKeown to define process tracing as the technique in which "the investigator explores the chains of events or the decision-making process by which initial case conditions are translated into case outcomes. The cause-effect link that connects independent variable and outcome is unwrapped and divided into smaller steps; then the investigator looks for observable evidence of each step." Stephen Van Evera, *Guide to Methods for Students of Political Science,* (Ithaca: Cornell University Press, 1997) p. 64. He cites pp. 34-41 of Alexander George and Timothy J. McKeown, "Case Studies and Theories of Organizational Decision Making," Advances in Information Processing in Organizations 2 (1985): 21-58. He also suggests Gary King, Robert O. Keohane, and Sidney Verba, *Designing Social Inquiry : Scientific Inference in Qualitative Research,* (Princeton, N.J.: Princeton University Press, 1994) pp. 226-228 for additional information on process tracing. For more on process tracing see John Gerring's Chapter 7 in John Gerring, *Case Study Research : Principles and Practices,* (New York: Cambridge University Press, 2007).

Resource IV back in favor of the state. Based on the indicators presented in the discussion of the IVs, the case analysis will identify relevant evidence that bears on the theoretical framework presented earlier.

Another challenge of research design is the issue of establishing a baseline for analysis. How should the analyst know if the observed economic interaction is actually the result of strategically-manipulated economic statecraft as opposed to normal economic interaction performed for purely commercial reasons? How should one distinguish between economic statecraft and the ordinary course of commercially-motivated interaction? At the heart of this challenge lies distinguishing between the "normal economic behavior" of commercial actors and the state's strategically motivated manipulation designed to achieve foreign policy objectives by instrumentally using commercial actors. The most clear-cut cases are those in which a commercial actor faces commercially undesirable consequences yet does something in spite of the commercial costs because the state directs them to. Such cases show a clear victory for state control. The Rio Tinto case illustrates this quite nicely. Chinalco, a $9 billion market cap company, loses $10 billion on their foreign investment and is then lauded by the government for their "success." These facts strongly indicate non-commercial behavior. The clearest cases of economic statecraft are those instances when commercial forces pull one direction but state preferences pull in another. The cases of economic statecraft that are examined in the chapters that follow exhibit these types of non-commercial characteristics.

2.6 Conclusion

This chapter put forward three important concepts that offer analytic leverage for thinking about economic statecraft. First, economic statecraft is properly understood in the context of security externalities. The behavior of commercial actors generates various patterns of economic interaction that carry strategically significant consequences for state security as reflected by the typology of security externalities.

Second, states must resolve a series of business-government coordination challenges if they are to be effective at mobilizing and directing their economic power. Specifically, five independent variables seem to be important determinants of whether a state will be able to mobilize and direct its economic power: 1.) the intrinsic compatibility of goals between the state and the commercial actors that carry on the economic activity of the state, 2.) the commercial market structure, 3.) the unity of the state, 4.) the nature of the reporting relationship between the commercial firm(s) and the state, and 5.) the relative distribution of resources between the state and the commercial actor(s). Each of these factors has a posited relationship to the ability of the state to control or direct the behavior of commercial actors.

Third, for control over commercial actors to translate into successful economic statecraft, three other preconditions must be met: 1.) the scope and scale of the objective(s) to which economic statecraft is directed cannot be over-ambitious relative to the economic tools used to pursue those objectives, 2.) the relative magnitude of the economic interaction ought to be large enough to be significant, and 3.) the economic interaction ought to be fairly inelastic. These three preconditions for successful economic statecraft are used as screening criteria for the selection of empirical cases of Chinese economic statecraft. The empirical chapters that follow illustrate how specific types of security externalities play out in the context of China's international resource extraction activities, its deployment of state capital and in the context of China's strategic use of economics in its relationship with Taiwan. These cases provide useful material for (primarily internal validity) testing and refinement of the theory.

At this point it may be useful to take a step back and summarize the implications of these propositions. In so doing, the outline of a general theory of economic statecraft begins to take shape. Certain types of economic interactions carry significant strategic implications which manifest themselves in the form of security externalities. States often take an active interest in these security consequences. As states seek to manipulate economic interaction (and its associated security externalities) they are engaging in what is known as *economic statecraft*. For economic statecraft to be a useful tool of national power four conditions must be present. One of these—the state's ability to exercise sufficient control over the conduct of its economic interaction—has not received adequate attention in the literature and thus provides the focal point for the dissertation's empirical research. Precisely how states go about manipulating their economic interaction requires the state to work with, encourage, restrain, or otherwise direct and control the commercial actors that are ultimately responsible for conducting that economic interaction. Of course, such efforts to control are bound to face challenges. These challenges are a function of a given state's business-government dynamics.[66]

In short, the theory is an account of how aggregate economic actors' micro-level incentives and consequent behavior generate national security outcomes at the level of state grand strategy. This middle-range theory provides an integrated explanation of what economic statecraft is, the manner in which economics effects security, the conditions under which economic statecraft is likely to be effective, and a theoretical framework of specific challenges a state must resolve if it is to successfully wield its economic power in pursuit of national strategic objectives.[67] The empirical chapters that follow provide detailed illustrations of specific security

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[66] Of course, business-government relations need not only vary by state. They may also vary over time, or by region, industry, or even by firm as mentioned earlier.

[67] The theory fills a significant gap in the literature by linking microeconomic, firm-level behavior with the macro-level grand strategy of states to explain how states use firms to pursue their strategic goals. Taken together, these elements provide an important bridge between vague, general notions of "economic power" and the actual behavior of firms in a modern, global context. The resulting theory illuminates the micro-foundations of economic statecraft as it is practiced in grand strategy.

externalities and apply the theoretical framework to understand and evaluate particular episodes of China's economic statecraft.

Chapter Three

The Mainland's Economic Statecraft and Interest Transformation on Taiwan

3.1 Overview of the Taiwan-China Case

Arguably for Beijing, no strategic concern (other than regime survival itself) features more importantly than that of Taiwan—particularly its potential independence. The China-Taiwan relationship entails a significant economic dimension. This chapter and the next explore the strategic role of economics in the cross-Strait relationship. China's strategic use of economics can be usefully broken into three phases—each of which highlights a different strategy of economic statecraft based on several of the types of security externalities presented in the last chapter.[1]

In the first phase, China was mainly focused on generating the *Bolstering* security externalities for the Mainland that would result from Taiwanese capital investment and management expertise. Both of these valuable contributions were scarce during the early stages of China's opening up and reform efforts.[2] As China was isolated from the international community in the aftermath of the Tiananmen Square Massacre, financial and trade ties to Taiwan continued to be an important source of both financial and human capital for the

[1] These periods are not really as neat as this conceptual abstraction makes them out to be. In the real world, various tools of economic statecraft may be in operation throughout each of these historical periods. However, for purposes of empirical analysis, the periods can be usefully distinguished from each other by the broad underlying strategic logic and the dominant theory of victory that underpins China's approach to economic statecraft during that particular phase.

[2] "During the relatively early years of cross-strait engagement, when China relied more heavily on Taiwan for investment, Chinese officials—especially local officials—went out of their way to reassure Taishang investors that their businesses would be insulated from downturns in Beijing-Taipei relations."Murray Scot Tanner, *Chinese Economic Coercion Against Taiwan : A Tricky Weapon to use* (Santa Monica, CA: RAND Corporation, 2007) p. 113

Mainland. As the economic interaction expanded and deepened throughout the 1990s, China began to consider the possibility of using this economic interaction as a coercive lever of power.

This marks the transition to the second phase in which Beijing focused its economic statecraft on exploiting *Coercive Leverage* types of security externalities. During this period, China emerges from the East Asian Financial Crisis relatively unscathed and in a much stronger position of economic power relative to the Southeast Asian economies and a fading Japan. As China entered the WTO and the cross-Strait economic interaction was poised to take off, the increasing asymmetry in the relationship made a coercive strategy appear more attractive. However, as discussed in the following chapter, efforts to lean on Taiwanese investors and blunt threats to jeopardize their Mainland investments to achieve political goals have been, for the most part, crude and relatively ineffective.[3] This generally bellicose approach actually proved to be counterproductive as the population on Taiwan rallied to the flag during the 1996, 2000 and 2004 presidential elections.[4]

In the aftermath of the 2004 elections, China revisited its cross-Strait economic statecraft strategy. With the consolidation of Hu Jintao's leadership, a third phase has emerged. This period is characterized by a strategy that seeks to exploit *Interest Transformation* security externalities that result from the ever-deepening economic interaction across the Strait. Mainland China's economic statecraft has gotten more sophisticated and now seems capable of

[3] Tung Chen-yuan and Scot Tanner have both done very good work highlighting how China's efforts to use coercive leverage during this period were somewhat clumsy and not very effective. See: *ibid.* and Chen-yuan Tung, "China's Economic Leverage and Taiwan's Security Concerns with Respect to Cross-Strait Economic Relations" 2002.

[4] Although it should be noted that Mainland China does seem to exhibit some degree of learning across these three election cycles. In the run up to the 1996 election, China fired missiles alarmingly close to Taiwan as part of a series of exercises. This did have a crude, destabilizing economic impact (particularly on Taiwan's stock market), although most analysts would argue that the attempt to intimidate Taiwan resulted in greater public support of Lee Tung-hui. In the 2000 election, there were broad efforts to punish "Green" businesses (those that supported the DPP/Taiwanese independence) as well as strongly worded statements by Zhu Rongji. But by 2004, China had focused its coercive strategies on specific individuals and targeted businesses. Taken together, these three cycles provide support for the notion that China's use of *Coercive Leverage* became more sophisticated as lessons from previous efforts were analyzed and incorporated.

generating fifth column effects that can shape Taiwan's definition of its interests. Such dynamics are explored below in the detailed case study of China's elimination of the tariffs on fruit exported to the Mainland. Tanner and others have provided in-depth analysis on the coercive approach in China's economic statecraft, but it seems that the most effective form of China's economic statecraft may involve strategies that leverage *Interest Transformation* types of security externalities.[5] More research ought to be directed toward this type of security externality to better understand how economic interaction fits into the strategic political dynamics of the contemporary cross-Strait relationship. As Tanner noted in his research: "Virtually every expert consulted for this [*Chinese Economic Coercion Against Taiwan: A Tricky Weapon to Use*] project agreed that Taiwan businesspeople engaged in commerce with the Mainland—known as Taishang for short—are the most important conduit through which Beijing hopes to exercise its economic influence."[6] Yet, we know very little about *how* such influence actually might transpire.[7] To begin to shed some light on this form of economic statecraft, this chapter focuses on an in-depth examination of a particular episode in which China sought to employ an economic statecraft strategy designed to exploit *Interest Transformation* security externalities.

3.2 Phase 3 (Fall 2004-Present): Seeking *Interest Transformation*

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[5] China seems to have learned that "Coercive Leverage" forms of economic statecraft may not be as productive as the more subtle and longer term oriented strategies of "Interest Transformation." Unfortunately, most of the coercively-oriented analyses (Tung, "China's Economic Leverage and Taiwan's Security Concerns," Tanner, *Chinese Economic Coercion Against Taiwan*, etc.) miss this more subtle type of economic statecraft. To address this gap in our understanding, this chapter focuses on one particular episode of this type of economic statecraft, namely, the 2005 opposition party visits to the Mainland and the subsequent elimination of tariffs on Taiwanese fruit.

[6] *ibid.* p.111.

[7] Abdelal and Kirshner also call attention to what Albert Hirschman called influence effects. Both works note the need for additional scholarship designed to understand exactly how this sort of economic statecraft works in practice. For more see: Rawi Abdelal and Jonathan Kirshner, "Strategy, Economic Relations, and the Definition of National Interests," Security Studies 9, no. 1 (1999): 119. and Albert O. Hirschman, *National Power and the Structure of Foreign Trade* (Berkeley and Los Angeles: University of California press, 1945).

The heart of this chapter focuses on the Mainland's use of economics to alter Taiwan's definition of its own interests. Exactly how does such a strategy work? What are the causal pathways by which economic interaction can be used to change the way a target perceives and defines its own strategic objectives? This section examines an episode that helps shed light on these questions. At the center of this episode lies the spring, 2005 visit of Taiwan's opposition party to the Mainland and the subsequent elimination of tariffs on Taiwanese fruit.

From April 26 through May 3, 2005, Lien Chan (连战, Chairman of the Kuomintang Party—the KMT) paid a visit to Mainland China. This was a monumentally historic visit as it represented "the first time that Lien personally set foot on the mainland soil since he left in 1945, and also the first-ever visit by a KMT chairman to the mainland in 56 years, ushering in a new stage for the relations between the KMT and the Communist Party of China (CPC)."[8] In the course of this trip, Lien visited Nanjing, Beijing, Shanghai and his birthplace in Xian.[9] While in Beijing on April 29th, he met with Hu Jintao, General Secretary of the Communist Party. The significance of this handshake for cross-Strait relations was considerable: it signaled that the then opposition party KMT was capable of reaching across the Strait and making progress in reconciling the two sides of one of the most volatile flashpoints in the Asia-Pacific. The visit was intended to undermine the credibility of the narrowly re-elected President of Taiwan, Chen Shui-bian whose policy of seeking independence for Taiwan was an anathema to Beijing. The message was clear: the then-ruling DPP (Chen's party) is not able to meaningfully engage the Mainland. Driving home this point was a similar visit by the other significant opposition leader,

[8] "Taiwan Fruit Arrives in Wake of Lian-Soong Visits to Chinese Mainland," Xinhua General News Service, May 15 2005.
[9] Ghulam Ali, "China's Taiwan Policy," The Nation May 13, 2005.

James Soong Chu-yu (宋楚瑜), two days later.[10] But perhaps most interesting from the standpoint of the study of economic statecraft was the offer made to Lien at the end of his trip in Shanghai. At the conclusion of that visit, China offered several goodwill "gifts" to Lien (and explicitly to the people of Taiwan).[11] Among these were scholarships for students from Taiwan to study in the Mainland, easing of Mainland restrictions on Mainland tourists that wanted to visit (and spend their money in) Taiwan, lowering of tariffs on fresh fruit exported from Taiwan to Mainland China, and two pandas to be given as goodwill ambassadors to Taiwan.[12] These concessions were designed to signal a changed Mainland strategy that emphasized "carrots" rather than "sticks." The Mainland sought to build bridges directly with the people of Taiwan rather than work with their elected DPP representatives. This strategy was referred to as "公权力" [trans: "public power"] and sought to leverage pressure on the DPP by appealing directly to the citizens of Taiwan.[13]

Recall that economic statecraft occurs when the state seeks to generate strategic consequences (in this case, *Interest Transformation*—specifically, reversing trends towards Taiwanese independence under the DPP leadership) by influencing the behavior of commercial

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[10] Soong was chairman of the People First Party (PFP) in Taiwan—a party that split from the KMT just before the 2000 presidential election. It and the KMT were the two main opposition parties comprising the "pan-Blue" alliance that opposed Chen's DPP-led "pan-Green" alliance. Soong's delegation visited the Chinese mainland from May 5th though the 13th. Like Lien, it was the first time Soong had returned to the Mainland since leaving in 1949. Soong also met Hu and visited the cities of Xian, Nanjing, Shanghai and Changsha. "Taiwan's Soong due in Beijing Amid Ray of Hope," Agence France Presse -- English, May 10, 2005.

[11] "With a Gift of Giant Pandas, Taiwan Opposition Leader Leaves China," Agence France Presse, May 3, 2005.

[12] Elizabeth Davies, "China Lowers Bamboo Curtain with Gift of Pandas to Taiwan," The Independent (London), May 4, 2005, p. 25.; Clarissa Oon and Lawrence Chung, "China Offers 'Gifts' to Taiwan ; it Lifts Curbs on Tourists to Island, Scraps Tariffs and Offers Two Pandas," The Straits Times (Singapore), May 4, 2005; Bill Savadove, "Lien Back with 'Gifts' but Taipei is Wary; Beijing Offers Pandas, Plus Concessions on Tourism to Island and Fruit Imports," South China Morning Post, May 4, 2005, p. 1.

[13] For how the lowering of fruit tariffs fit into the broader strategy of 公权力 see: 中华人民共和国商务部，"商务部新闻发言人宣布将对 15 种台湾水果实施进口零关税措施" [trans: PRC Ministry of Commerce, "Ministry of Commerce Spokesman Announces Implementation of Zero Tariff Handling Measures for 15 Types of Taiwanese Fruit,"] July 28, 2005 Press Release. Available at: www.mofcom.gov.cn. Also, a senior leader of the Chinese Communist Party, Jia Qinglin (贾庆林, Chairman of the People's Political Consultative Conference, and Vice Chairman of the Taiwan Affairs Leading Small Group) set out China's emerging Taiwan strategy in his January 28, 2005 speech. Available in Chinese at: http://news.sina.com.cn/c/2005-01-28/20344978641s.shtml

actors (in this case, Taiwanese fruit farmers). The state (in this case, Mainland China) has a range of tools at its disposal to incentivize commercial actors to behave in a manner conducive to the state's strategic objectives (in this case, shifting Taiwanese farmers' support from their traditional DPP representatives towards the pan-Blue coalition). In this episode of economic statecraft, China eliminated the tariffs on Taiwanese fruit that was being exported to Mainland China. This offer was part of a larger set of concessions (like the scholarships for Taiwanese students to study on the Mainland) strategically targeting groups of Taiwanese that traditionally supported Chen Shui-bian and the DPP.[14] "By rejecting these offers, the ruling Democratic Progressive Party is putting itself in a difficult position. Almost all these policies benefit segments of the Taiwanese population. When this adds up, the ruling party is going to face the consequence of losing the support of these people..."[15] By appealing to the fruit producers' economic self-interests China's move was designed to drive a wedge between the DPP and its constituents.[16] "Since its red-carpet welcome of Taiwanese opposition leaders Lien Chan and James Soong in late April and early May, the Mainland's strategy has been to try and win the hearts of the Taiwanese people while isolating the island's pro-independence forces. The farm benefits target south Taiwan - a key support base for the island's pro-independence government

[14] China offered to allow more Taiwan students to study in China and stated that it would recognize Taiwan-issued degrees for purposes of Mainland employment. Beijing also pledged to grant scholarships to Taiwanese students as well as extending to Taiwanese students the privilege of paying similar (i.e. reduced) tuition fees—equivalent to those that Mainland Chinese students were charged. See Chua Chin Hon, "Taiwan Gets More Sweeteners from China," The Straits Times (Singapore), May 14, 2005. In addition to the educational concessions, China also permitted a greater number of Mainland tourists to visit Taiwan (although the Taiwanese government still had its own restrictions on the number of Mainland visitors it would permit to enter). It also offered to establish direct air cargo links to help facilitate the transportation of perishable fruit. Finally, China offered a gift of two pandas to the Taipei Zoo. This offer was eventually declined by Taiwan on the grounds that international trafficking of endangered species is not permitted.
[15] Professor Emile Sheng of Taiwan's Soochow University as quoted in: *ibid.*
[16] 王丰 [Wang Feng], "'连宋' 登陆两岸经贸谋新突破" [trans.: "Lien-Soong" Land, Seek New Cross-Strait Economic/Trade Breakthrough"] 《财经》 2005 年 05 月 16 日.

and a major fruit-growing area.[17] The strategy was designed to weaken the DPP's electoral clout on Taiwan. Since China has implemented this *Interest Transformation* strategy, the DPP has failed to win another major election.[18] In addition, Taiwan's independence movement has largely withered.[19]

The offer to eliminate the fruit tariffs is of particular interest from the perspective of economic statecraft. By providing a unilateral concession designed to facilitate Taiwanese exports of fruit to Mainland China, China was attempting to undermine a key support base for Chen Shui-bian and the DPP. This strategy provides a useful illustration of the *Interest Transformation* security externality. So how did China execute this strategy of *Interest Transformation*? An in-depth examination of this episode will provide an opportunity to explore the specific causal mechanisms underpinning this type of economic statecraft. Before charging into the specifics of the case, let us briefly examine the backdrop against which this episode unfolded. I then examine the key actors involved and the specific events of the episode. This is followed by a discussion of the results and evaluation of this episode of economic statecraft.

3.2.1 Context of the Case

There are three important factors that shaped and provide background context for this episode. The first was the DPP's pattern of electoral successes and Taiwan's growing independence movement of the 1990s and early 2000s. The second factor concerned Taiwan's electoral geography—who votes how and where. The third contextual factor that set the stage for

[17] Clarissa Oon, "China Scraps Import Tariffs on Taiwan Fruits ; Beijing Acts on Pledges made during Taipei Opposition Visits," The Straits Times (Singapore), June 2, 2005.
[18] Of course, many factors account for voter behavior and I do not mean to claim that China's economic statecraft was the *only* driver of the KMT's return to power. Indeed, economic performance more broadly is often cited as an important indicator of electoral success and, during this period, Taiwan's economy was not doing well. However, I would argue that this made Beijing's targeted economic enticements all the more compelling.
[19] For a convincing treatment of this perspective see: Robert S. Ross, "Taiwan's Fading Independence Movement," Foreign Affairs 85, no. 2 (2006): 141.

this episode involved Mainland China's response to these events and the evolution of China's approach to leveraging domestic political dynamics on Taiwan.

DPP's Electoral Successes

In this episode, Mainland China was seeking to alter the domestic political landscape on Taiwan. A thorough analysis of this episode of economic statecraft ought to place the events of the spring and summer of 2005 in the context of Taiwan's recent electoral history. Of particular importance was the Democratic Progressive Party (DPP)'s pattern of increasingly successful electoral victories that can be traced from the origins of Taiwan's democratization in the late 1980s right up to the eve of this episode.[20] Since its founding, the DPP had displayed a disquieting ability to consistently demonstrate its growing popularity among the Taiwanese electorate. Mainland China sought to stem the DPP's track record of increasingly significant electoral successes. In particular, Mainland China would be seeking to reverse what it perceived as increasingly bold efforts to move toward independence under the leadership of President Chen Shui-bian and the DPP.

The DPP and its pro-independence electoral agenda grew more and more politically viable through the 1990s. Having first contested in the Legislative Yuan (LY) Election of 1986 as an illegal party, in the 1989 Legislative Yuan Election, the DPP won 21 seats.[21] This figure was significant because it crossed the legal threshold of a party needing to hold at least 20 seats in the legislature to be able to propose legislation. In the 1992 LY Election, the DPP won 50

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[20] The DPP's origins are intertwined with the story of Taiwan's democratization. Charles Chi-hsiang Chang and Hung-mao Tien, *Taiwan's Electoral Politics and Democratic Transition : Riding the Third Wave* (Armonk, N.Y.: M.E. Sharpe, 1996).

[21] John Fuh-sheng Hsieh and Emerson M. S. Niou, "Issue Voting in the Republic of China on Taiwan's 1992 Legislative Yuan Election," International Political Science Review / Revue Internationale De Science Politique 17, no. 1 (1996): 13-27 especially p. 21.

seats.[22] The DPP would continue building electoral momentum through the 1995 and 1998 LY Elections. In the run up to the 1996 Presidential Election, the Mainland conducted a series of provocative military exercises (including missile launches) in the vicinity of Taiwan.[23] This bullying led to a popular backlash against Beijing that expressed itself as a high level of public support for Lee Tung-hui who was elected with 54% of the vote.[24] Although Lee was the KMT candidate, his pro-Taiwan/anti-unification sentiments were fairly well-known.[25] During Lee's Presidency, "Localization" (本土化) efforts picked up steam. The DPP (and its independence agenda) also gained more and more popularity.

As the century turned, the DPP finally took the reins of power. In the March 18, 2000 Presidential Election, DPP candidate Chen Shui-bian benefitted from a split in the KMT party.[26] The popular James Soong Chu-yu (宋楚瑜) was not given the KMT nomination and chose to run as an independent while Lien Chan ran as the KMT's candidate. As a result, Chen received 39.3% of the votes beating out Soong (with 36.8%) and Lien (with only 23.1%) to become the first non-KMT president of Taiwan.[27] The DPP was widely viewed as having moderated its radical independence position to enhance its "electability" for this election. With the 2001 LY Election, the DPP also became the largest political party in the legislature.[28]

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[22] Andrew J. Nathan, "The Legislative Yuan Elections in Taiwan: Consequences of the Electoral System," Asian Survey 33, no. 4 (1993): 424-438, figures taken from p. 425.
[23] For more on these events see: Nancy Bernkopf Tucker, *Dangerous Strait : The U.S.--Taiwan--China Crisis* (New York: Columbia University Press, 2005); Suisheng Zhao, *Across the Taiwan Strait : Mainland China, Taiwan, and 1995-1996 Crisis* (New York: Routledge, 1999); Chen Qimao, "The Taiwan Strait Crisis: Its Crux and Solutions," Asian Survey 36, no. 11 (1996): 1055.
[24] Tun-jen Cheng, "Taiwan in 1996: From Euphoria to Melodrama," Asian Survey 37, no. 1, A Survey of Asia in 1996: Part I (1997): 43-51, figures taken from p. 44.
[25] Eventually Lee would form his own pro-independence Taiwan Solidarity Union (TSU) party and leave the KMT. The TSU would later join with the DPP to anchor what would become known as the "Pan-Green Alliance."
[26] Yu-shan Wu, "Taiwan in 2000: Managing the Aftershocks from Power Transfer," Asian Survey 41, no. 1, A Survey of Asia in 2000 (2001): 40-48 especially p. 41.
[27] Figures taken from footnote 14 on p. 733 of E. Niou and P. Paolino, "The Rise of the Opposition Party in Taiwan: Explaining Chen Shui-bian's Victory in the 2000 Presidential Election," Electoral Studies 22, no. 4 (2003): 721-740.
[28] In response, the KMT forged a "Pan-Blue" alliance with Soong's People First Party (PFP) and the pro-China New Party (NP) in a desperate move to maintain control of the Legislative Yuan. This coalition stood in opposition to the

The DPP's growing electoral momentum was further solidified with the March 20, 2004 re-election of President Chen Shui-bian and his outspoken independence-oriented vice president, Annette Lu Xiu-lian (吕秀莲). In a tight race, Chen and Lu took 50.11% of the vote narrowly beating the Lien-Soong Pan-Blue ticket who garnered 49.89% of the vote.[29] Although the final result was likely tipped in the DPP's favor as a result of the assassination attempt on Chen and Lu the day before the election, the result was seen as a watershed for the DPP. The DPP had demonstrated its ability to defeat a unified Pan-Blue ticket (unlike in the 2000 election, there was no KMT-PFP split that divided the competition). Despite such united opposition from the long-time ruling party, the DPP presidential ticket still managed to win re-election.

Throughout the early 2000s, the KMT sought to stem the DPP's momentum and regain its control over Taiwan's domestic politics. Much of the DPP's popularity eminates from its position as the anti-KMT party. Perhaps most controversially, the DPP has been a long time supporter of an independent Taiwanese identity. This is often manifested as efforts to move Taiwan toward formal *de jure* independence. This constituted a red line for Mainland China and was the primary reason that the DPP's success also frustrated Beijing. The issue of opposing Taiwan's independence provided the initial common cause between Taiwan's opposition parties and the Chinese Communist Party.[30] Chen's re-election in 2004 coincided with Hu Jintao's consolidation of Mainland China's top leadership posts and seems to have prompted a re-

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"Pan-Green" alliance between the DPP and the TSU. The best the KMT could do was to create a blocking coalition to deadlock the legislature and block President Chen's DPP agenda.

[29] Figures are from Table 1 on p. 110 of Ching-hsin Yu, "The Evolving Party System in Taiwan, 1995-2004," Journal of Asian and African Studies 40, no. 1-2 (2005): 105-123.

[30] During his visit, James Soong signed an agreement with Hu Jintao opposing Taiwanese independence. See: "No Taiwan Independence , no Military Conflicts: Communique," Xinhua General News Service, May 12, 2005.

examination of Mainland China's strategy toward Taiwan.[31] This strategic shift constitutes the second background factor to which we now turn.

Recent Developments in Mainland China

The offer to drop the tariffs on fruit was not the first attempt by the Mainland to use economic tools to undermine the DPP's support base. As discussed later in Chapter Four, Mainland China had earlier used economic statecraft to threaten Taiwanese investors over their support for Chen Shui-bian and the DPP. Previously, Beijing had also engaged in some limited and rather heavy-handed efforts to mobilize "pro-pan-Blue and anti-pan-Green" Taishang on the Mainland. Support included efforts to organize meetings and to facilitate charter flights for pro-Beijing Taishang to return home to vote in elections.[32] However, these efforts were largely ineffective. Many fewer actually went home to vote than had been hoped. In addition, China's coercive leverage with the Taishang seems to have been rather limited. Anti-DPP harassment of Taishang on the Mainland was publicized domestically in the Taiwanese press and served to underscore the DPP's pro-Taiwan credentials among the electorate.[33] In 2004, Chen Shui-bian narrowly won re-election. Frustrated, the Mainland initially lashed out once again to punish prominent Taishang that had supported the pan-Green efforts. Despite the tough talk, Scot Tanner has noted that these efforts had only limited real bite.[34]

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[31] "In Beijing, Chen Shui-bian's reelection touched off a bitter internal debate over how much political leverage Beijing is getting from its economic ties with Taiwan." Tanner, *Chinese Economic Coercion Against Taiwan,* p. 126.

[32] "China Employs New Wrecking Tactics," Taipei Times February 12, 2004 p. 8.

[33] Tanner, *Chinese Economic Coercion Against Taiwan,* pp. 119-120. This result provides a good illustration of how policies designed to achieve *Coercive Leverage* (harassment of the DPP-Leaning Taishang) can often undermine *Interest Transformation* strategies.

[34] *ibid.* Especially pp. 113-126. For more on China's efforts to use coercive leverage see the section on Phase 2 below.

By the Fall of 2004, the Mainland, having largely failed to derail the DPP's electoral success using coercive strategies, had begun to shift its economic statecraft strategy.[35] This shift was designed to prevent independence by engaging in a long-term strategy that sought *Interest Transformation* on Taiwan rather than engaging in *Coercive Leverage* to enforce compliance with Beijing's wishes.[36] This shift in strategy seems to have reflected Hu Jintao's broader emphasis on stability in China's grand strategy.[37] Seen from this perspective, coercion tends to be counterproductive and force falls a bit out of fashion as both represent destabilizing dynamics. Under this line of reasoning, Beijing needed to influence the whole relationship (particularly since brute force and coercion seemed to generate effects that ran opposite to China's goals of encouraging reunification).[38] China's reassessment of the utility of coercive leverage was an important backdrop to the opposition party visits and the fruit tariff discussed below. In particular, there was a renewed emphasis placed on preventing Taiwan's independence as opposed to forcing reunification on Taiwan.[39] On January 28, 2005, Jia Qinglin (贾庆林), Chairman of the People's Political Consultative Conference and Vice-Chairman of the Taiwan Affairs Leading Small Group, gave a speech entitled, "坚决遏制 '台独'分裂活动维护台海地区和平稳定继续争取两岸关系朝着和平统一的方向发展" [trans: "Resolutely Contain

[35] The election result that saw Chen Shui-bian re-elected president in 2004 seems to have been the catalyst prompting this strategic re-evaluation of China's approach to Taiwan. Chow Chung-yan and Josephine Ma in Beijing, "Beijing 'to Rethink its Cross-Strait Strategy'," South China Morning Post, March 22 2004, p. 4.

[36] Chong-Pin Lin, "More Carrot than Stick: Beijing's Emerging Taiwan Policy," China Security 4, no. 1 (2008): 1-27. Lin was formerly Taiwan's deputy minister of national defense and previously served as the first vice chairman of Taiwan's Mainland Affairs Council.

[37] With the assumption of chairmanship of the Central Military Commission, Hu completed his consolidation of leadership around this time. This consolidation of China's leadership provided Hu with greater latitude to establish guiding principles for China's strategic direction. "On Sept. 24, 2004, five days after Hu took over the chairmanship of the Chinese Communist Party's Central Military Commission, he reportedly approved at an internal meeting a new guideline on Taiwan Policy which reflected his patience: 'strive for negotiation, prepare for war, and fear not Taiwan's procrastination' (*zhengqu tan, zhunbei da, bu pa duo*)." *ibid*: p. 25, endnote 9.

[38] Cary Huang, "Taiwan Tactics Aim to Win Hearts and Minds," South China Morning Post, May 10, 2005, p. 1.

[39] For an example of China's previous efforts to push for reunification sooner rather than later see: "一个国的原则与台湾问题" 白皮书 [trans: "One Country Principle and the Taiwan Question" White Paper] in the People's Daily Feb. 22, 2000, p. 1 available on-line at: http://www.people.com.cn/GB/channel1/14/20000522/72540.html. Before that, Jiang Zemin articulated his Eight Points in a January 30, 1995 speech.

'Taiwan Independence' Separatist Activities; Safeguard Peace and Stability in the Taiwan Strait Region; Continue the Endeavour To Ensure That Cross-Strait Relations Develop Towards Peaceful Reunification,"] in which he laid the foundation for a strategy that emphasized the prevention of Taiwanese independence.[40] Also, when Hu Jintao took over the CMC, he apparently made clear that the PRC had no reason to fear Taiwan's procrastination when it came to the issue of reunification.[41] "...[T]he timetable for cross-Strait unification, constantly discussed under Jiang's Tenure, has been shelved under Hu."[42] This perspective was also articulated in Hu's March 4, 2005 speech on China's Taiwan policy. In that speech, Hu noted that the current status quo is one in which Taiwan is a part of China.[43] China came to realize that it could afford to play the long game with Taiwan.[44]

The reassessment of China's Taiwan strategy seems to have eventually culminated in the legal codification of China's new strategy: the Anti-Secession Law (ASL) which was passed on March 14, 2005. Although this law was initially viewed as aggressive and providing the legal pretext for China's military resolution of the Taiwan question, it has since been interpreted in a

[40] He gave the speech in the context of "updating" the Mainland's commitment toward Taiwan. See: 坚决遏制"台独"分裂活动维护台海地区和平稳定继续争取两岸关系朝着和平统一的方向发展 Speech at the Meeting Marking the 10th Anniversary of the Issue of Comrade Jiang Zemin's Important Speech, "Continue the Struggle To Promote the Accomplishment of the Great Cause of Reunification of Our Motherland" Available in Chinese at: http://news.sina.com.cn/c/2005-01-28/20344978641s.shtml For an indication its significance, see: "Chen Calls Jia's Speech Important Guide on Taiwan Issue," Xinhua General News Service, January 29, 2005.

[41] Suisheng Zhao noted this on p. 92 of Suisheng Zhao, "Conflict Prevention Across the Taiwan Strait and the Making of China's Anti-Secession Law," Asian Perspective 30, no. 1 (2006): 79-94. It comes from a personal interview that he conducted in Beijing in October of 2005. It also seems to be corroborated by my footnote 37 above.

[42] Lin goes on to note: "A number of dates for unification, to be achieved with force if necessary, were considered at different stages including 2002, 2005, 2007, 2010, and 2020, although Jiang never publicly ruled a final decision on it." Lin, "More Carrot than Stick: Beijing's Emerging Taiwan Policy", p. 3. Lin notes that these dates were not reported officially via Xinhua or Renmin Ribao but rather through Hong Kong media outlets.

[43] See: "Four-Point Guideline on Cross-Straits Relations Set Forth by President Hu," Xinhua General News Service, March 4, 2005; "Do Best to Seek Peaceful Reunification, but Never Tolerate Taiwan Independence : President," Xinhua General News Service, March 4, 2005.

[44] This contrasts with the previous policy that stressed the need for reunification. For a useful overview of Hu Jintao's "new thinking" in China's Taiwan policy see: 郭伟峰, (ed.) 胡锦涛与两岸关系新思维 [trans: *Hu Jintao and New Thinking on Cross-Strait Relations*] (香港：中国评论学术出版社 2005) [trans: Hong Kong: China Review Academic Press 2005].

more favorable light.[45] The ASL formally shifted China's strategic perspective on Taiwan. Previously, the Beijing authorities were driven by a perceived need for a short timeline for reunification.[46] They felt that they were racing against a closing window of opportunity in which a democratic Taiwan was growing further and further apart from the Mainland. Under this paradigm, time was not on China's side and the cross-Strait dynamics were moving rapidly toward independence. However, by early 2005, Beijing had changed its strategic view to one in which deepening economic and improving cultural ties worked in China's favor. Over time, Taiwan would become increasingly connected to the Mainland. According to this new strategic view, time *was*, in fact, on China's side. The ASL codified a new strategic perspective that held that since Taiwan was actually already a part of China, there was no need to force "unification" but rather the imperative ought to be to prevent independence.[47] It is significant that the law was named the "Anti-Secession Law" and not the "Pro-Unification Law." Instead of trying to push for speedy reunification, China had reoriented itself toward maintaining the status quo. This reorientation argued that moves toward formal independence would not be tolerated.[48] The change is an important one. Rather than merely providing justification for impending military

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[45] See, for instance: J. Adams*et al*, "Taiwan: The Cold Shoulder ; Beijing is Setting Up Legal Cover for an Attack on the Island, and Unnerving Leaders in Taipei," Newsweek (2005): 32. On the more favorable interpretation see John Q. Tian, *Government, Business, and the Politics of Interdependence and Conflict Across the Taiwan Strait*, (New York: Palgrave Macmillan, 2006) p. 52. "...[R]ather than intimidate the Taiwanese, the ASL was meant more to unshackle the hands of Beijing's Taiwan Affairs officials to promote cross-Strait engagement from internal hawkish opposition . . ." Lin, "More Carrot than Stick: Beijing's Emerging Taiwan Policy," p. 5.

[46] For instance, the 2000 Taiwan White Paper added the stipulation that military force would be used by Beijing if Taiwan failed to resolve the question of reunification indefinitely. See: "一个国的原则与台湾问题" 白皮书 [trans: "One Country Principle and the Taiwan Question" White Paper] available in the People's Daily Feb. 22, 2000, p. 1. On-line at: http://www.people.com.cn/GB/channel1/14/20000522/72540.html. The timing of the white paper's release seems to have been designed to influence the March 18, 2000 Taiwanese Presidential election. On the eve of that election, Chinese Premier Zhu Rongji once again reiterated Beijing's intolerance of an indefinite resolution of the issue of reunification.

[47] See: 郭伟峰, (Guo Weifeng, ed.) 胡锦涛与两岸关系新思维 [trans: *Hu Jintao and New Thinking on Cross-Strait Relations*] (香港：中国评论学术出版社 2005) [trans: Hong Kong: China Review Academic Press 2005] especially part two on the Anti-Secession Law as the product of this "new thinking."

[48] In the event that Taiwan attempted to declare independence, then the ASL would provide a legal pretext for military options.

action, the ASL was designed to reinforce the existing status quo and to reposition China as a defender of the status quo situation (in which Taiwan is a part of China).[49] This shift would also carry important implications for the effectiveness of economic statecraft. By seeking to reinforce the status quo rather than attempting to use economic statecraft to impose reunification on a short time horizon, Beijing brought its strategic objectives more into line with what economic statecraft could feasibly hope to achieve in the cross-Strait context—i.e. maintenance of the status quo. In international relations, preserving the status quo is much easier than proactively forcing a target to make a difficult change.[50] As noted in Chapter Two, this sort of "Purpose Commensurability" is one of the prerequisites of effective economic statecraft.

With the ASL, China reoriented away from a short time horizon paradigm that sought to pressure Taiwan into re-unification. In its place, Hu Jintao installed an emphasis on stability and stressed the need to maintain the status quo across the Taiwan Strait.[51] Both of these favored a longer-term perspective. This shift in strategic perspective in Mainland China was the second important contextual factor that would shape the Mainland's use of economic statecraft in this episode.

Taiwan's Electoral Geography

The final contextual factor for this episode concerns Taiwan's electoral geography and the historical concentration of the DPP's support base in the southern areas of the island. Popular political support in Taiwan is very regionally-oriented. Just as there are "Blue" and "Red" states in the US domestic political landscape, Taiwan has "Blue" and "Green" counties

[49] Zhao, "Conflict Prevention Across the Taiwan Strait and the Making of China's Anti-Secession Law," especially pp. 92-93 in which Zhao discusses Hu Jintao's new Taiwan policy.
[50] Recall Schelling's deterrence versus compellence logic in Thomas C. Schelling, *Arms and Influence* (New Haven: Yale University Press, 1966).
[51] Edward Friedman, "China's Changing Taiwan Policy," American Journal of Chinese Studies 14:2 (October 2007), pp. 119–34; and Lin, "More Carrot than Stick: Beijing's Emerging Taiwan Policy."

which have tended to trend toward specific parties from one election to the next. Although there is some variation from one election to the next, the DPP's bastion of political support has remained concentrated in these southern portions of the island. These counties were the crucible of the early democratization movement on Taiwan (while under the single-party KMT rule) and were the regional basis for the *dangwai* (党外) movement and the DPP's consolidation of several disparate opposition groups under the collective political banner of the nascent opposition Democratic Progressive Party.[52] This area continues to be the strongest region of DPP support. It is also the area of the country most closely identified with pro-independence sentiments.[53] It also happens to be Taiwan's fruit basket—the geographic area most conducive to the production of many of the tropical fruits that Taiwan produces. That confluence of economics and politics provides the basic ingredients for this episode of economic statecraft.

Appendix A contains maps that provide a useful graphical indictor of Taiwan's electoral geography. As is apparent, the strongest DPP support has tended to be located in the south. Although little in Taiwanese politics is static, this pattern of southern support has largely held true from one election to the next. In particular, the following counties have generally tended to vote DPP: Pingtung (屏东), Kaohsiung (高雄), Tainan (台南), Chia-I (嘉义) and Yun-lin (云林).[54] As will be discussed in more detail below, these areas have traditionally been very supportive of the DPP and its independence agenda. They are also the primary growing regions for much of Taiwan's tropical fruit production that became the economic vehicle for this particular episode of economic statecraft.

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[52] Shelley Rigger, *Politics in Taiwan : Voting for Democracy* (London ; New York: Routledge, 1999).
[53] J. Lay, K. Yap, and Y. Chen, "The Transition of Taiwan's Political Geography," Asian Survey 48, no. 5 (2008): 773.
[54] Memories of KMT abuse run deep in this part of Taiwan. See for example: Ray Cheung, "Where the Kuomintang is Despised; in Pingtung, Elderly Voters Remember the Party's Brutal Rule," South China Morning Post, December 8, 2004, p. 6.

To review, three background conditions are important for contextualizing this episode of economic statecraft. First, in the lead up to the spring 2005 opposition party visits to the Mainland, the DPP had been enjoying an increasing electoral momentum. The DPP's electoral success grew from when they first entered the political scene as an illegal party in 1986 to the legislative elections of the 1990s and culminated in the presidential election and then re-election of Chen Shui-bian in 2004. Second, in the aftermath of Chen's 2004 re-election, the Mainland revised its strategic approach toward Taiwan and began focusing on using economics as a tool of an *Interest Transformation* strategy (rather than for *Coercive Leverage*). Finally, the DPP support base has been geographically concentrated in the South. The tools of economic statecraft that were used in this episode sought to leverage this fact. The next section introduces the key actors in this episode and discusses their chief objectives.

3.3 The Key Players

In economic statecraft, the self-interests of the key actors are the linchpin for generating economic behavior that will produce the desired security externalities. In this case, the Mainland Communist Party eventually learned how to exploit KMT/PFP interests to undermine Chen and the ruling DPP. This strategy honed in on one of the DPP's key constituencies and sought to demonstrate how shifting their political support away from the DPP and toward the opposition parties would benefit the commercial actors' own narrow economic self-interests. In so doing, the Mainland was able to affect the selection of leadership on Taiwan and thus helped derail what had been an increasing momentum toward independence. Instead, today's cross-Strait dynamics are moving toward deeper and deeper economic integration under the KMT's

President Ma Ying-jeou.[55] This section identifies the major groups involved in this episode and their relative priorities.

The over-arching goal of Mainland China in this episode is to, at a minimum, prevent independence.[56] China's maximal goal is to foster re-unification with Taiwan.[57] Because of Beijing's strategic shift to preserve the status quo, China had set a much lower bar for what it sought to achieve. This made success more likely in this episode of economic statecraft. With regard to the Taiwanese business community specifically, China's main objectives were to create "a politically irresistible domestic lobby."[58] The strategy was to create a set of vested domestic interests that would lobby in favor of closer cross-Strait ties.[59] To do this, Mainland China sought to "further deepen cross-strait economic relations as a source of greater future leverage for Beijing."[60] The opposition party visits and the subsequent concessions signaled that the KMT (not the DPP) was able to deliver progress on cross-Strait issues. These activities were designed to diminish the electoral prospects for the DPP.[61] Scot Tanner concurs that "Beijing's most fundamental and enduring tactical goal . . . has been encouraging a subtle form of 'regime change' in Taiwan."[62] Although Tanner notes that Beijing has "sought to exploit the growing cross-strait relationship to undermine the domestic political power of Taiwan officials whom it

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[55] A prominent example of Ma's efforts is the Economic Cooperation Framework Agreement (the ECFA) which will lower the tariffs and permit market access for about 500 Taiwanese goods into the Mainland.
[56] Formal independence has been a red line for China for quite some time. See for example: Lin, "More Carrot than Stick: Beijing's Emerging Taiwan Policy"; Emerson M. S. Niou, "Understanding Taiwan Independence and its Policy Implications," Asian Survey 44, no. 4 (2004): 555-567.
[57] As Tanner puts it: "But Beijing's predominant tactical concern remains trying to reshape the political mainstream in Taiwan's emerging democracy, so that Beijing's anti-independence demands and pro-reunification overtures to Taipei will be greeted with increasing political acceptance." Tanner, *Chinese Economic Coercion Against Taiwan,*p. 105.
[58] *ibid.* p.111
[59] For an illustrative description of such dynamics see: Abdelal and Kirshner, "Strategy, Economic Relations, and the Definition of National Interests." Their discussion of the Hawaii case is particularly useful.
[60] Tanner, *Chinese Economic Coercion Against Taiwan,* p.111.
[61] Lillian Lin and P. C. Tang, "Beijing Trying to Isolate Chen by Wooing His Foes: Newsweek," Central News Agency - Taiwan, April 25 2005.
[62] Tanner, *Chinese Economic Coercion Against Taiwan,* p.105.

regards as pro-independence and build support (or at least acceptance) for reunification among Taiwan's citizenry and elite," he does not spend much time exploring exactly how this is occurring.[63] The mechanics of this transformative process is exactly the type of dynamic that this episode sheds more light on. Although Tanner touches on *Interest Transformation* briefly in his analysis of cross-Strait economic statecraft, his work is almost exclusively focused on the security externality of *Coercive Leverage*. He finds (correctly I think) that this tool of economic statecraft was not very effective for Beijing during the late 1990s and early 2000s (during the period called "Phase 2" that is covered in the next chapter). What is more interesting is exactly how the Mainland seeks to transform Taiwan's domestic interests via this longer term strategy of *Interest Transformation.*

It seems that the State acted in a unified way to achieve its objectives. In this episode, there is no evidence of bureaucratic divides. The Ministry of Commerce followed the cue of China's senior leadership.[64] The Taiwan Affairs Office of the State Council also seems to have been onboard with the strategy put in place.[65] There was also no public evidence of factional divides among senior patrons within the Chinese Communist Party. The policy shift seems to have come after Hu had completed his consolidation of power.[66] Finally, in this episode, there were no incentives driving a wedge between the central government and local municipalities. Provinces did not contradict or seek to undermine the center's policies. This was largely because

[63] *Ibid.* p.105

[64] MofCom frequently made reference to China's larger strategic approach to Taiwan in its policy statements see for example: 中华人民共和国商务部， "商务部新闻发言人宣布将对 15 种台湾水果实施进口零关税措施" [trans: PRC Ministry of Commerce, "Ministry of Commerce Spokesman Announces Implementation of Zero Tariff Handling Measures for 15 Types of Taiwanese Fruit,"] July 28, 2005 Press Release.

[65] Chen Yunlin, minister of the Taiwan Affairs Office reportedly referred to the "tariff-free entry of Taiwanese fruit" as "a concrete effort by the Mainland to promote the fundamental interests of Taiwan compatriots." From: "Mainland Drops Taiwan Fruit Tax" China Daily July 29, 2005. This is very similar to the language used in Hu's March 3, 2005 speech.

[66] Jiang had already handed over chairmanship of the Central Military Commission in Mid-September, 2004 (earlier than anticipated) to Hu Jintao.

the provinces most directly concerned by the strategy (e.g. Fujian) already had good ties to Taiwanese businesses.[67] In addition, these provinces were generally in favor of increased economic interaction especially given that their consumer markets were getting more and more wealthy and local officials sought to enhance consumer access to fruit and other luxury items.[68] Given the absence of center-local tensions, factional divisions and bureaucratic frictions in Beijing, the state can be classified as having acted in a unified manner during this episode.

The second major player in this episode is the KMT. At the time of the visits, the KMT was Taiwan's opposition party. The KMT sought to undermine public support for the ruling DPP.[69] By targeting one of the DPP's important electoral constituencies that stood to personally benefit from policies that the DPP was ideologically opposed to, the KMT calculated that the KMT's electoral prospects would be improved. They wanted to do this by showing that the KMT was able to deliver on issues of political rapprochement with the Mainland.[70] Such rapprochement would better position the KMT to build beneficial economic relations across the Strait. "The tactical considerations behind the visit are simple. Mr. Lien wants to send the message to [the] Taiwanese that he and his party can manage cross-strait relations better than President Chen and his DPP, a message Beijing is happy to reinforce."[71]

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[67] For example, Fujian had already attracted some $1.9 billion of Taiwanese investment in the agricultural sector. In the wake of this episode, there were plans to create "cross-strait agricultural co-operation experiment zones" between the cities of Fuzhou and Zhangzhou. Lillian Yang, "Gates Open for Island's Produce," South China Morning Post, July 19, 2005, p. 4; "Cross-Straits Exchanges Expand with Growing Business," China Daily July 15, 2005.

[68] See: Bill Savadove, "Consumers Bemused at New Varieties of Taiwanese Fruit," South China Morning Post, May 21, 2005, p. 6. and Lilian Wu, "Taiwan Fruits could be Exported to Fujian Via Kinmen and Matsu," Central News Agency - Taiwan, June 18, 2005.

[69] Goh Sui Noi, "KMT Win a Victory for Ties with Beijing," The Straits Times (Singapore), December 5, 2005; "KMT Spokesman: Development of Cross-Straits Relations Trend of Times," Xinhua General News Service, May 2, 2005.

[70] *Ibid.* ; Lilian Wu, "KMT Will Monitor Fruit Exports to China to Protect Farmers' Interests," Central News Agency - Taiwan, July 29, 2005; Goh Sui Noi, "KMT Chief Lien Chan Invited to Visit China," The Straits Times (Singapore), April 1, 2005 and Lilian Wu, "Coa to Step Up Educational Campaign on Fruit Exports to China," Central News Agency - Taiwan, August 13, 2005.

[71] "A Historic Visit to China," The Japan Times, May 5, 2005.

Lining up on the other side of this fight was the national government of Taiwan under the leadership of Chen Shui-bian and the DPP. The government wanted to conduct any cross-Strait negotiations that might occur as a result of the unofficial, political party visits strictly through official channels.[72] In particular, the Chen government sought to channel talks on the fruit issue through the Taiwan External Trade Development Council (TAITRA, 中华民国对外贸易发展协会) and to a lesser degree through the Mainland Affairs Council (MAC, 大陆委员会) and the Council of Agriculture (CoA,农业委员会)—Taiwan's senior level, executive branch government body charged with administration and oversight in agriculture.[73] The administration sought to leverage the situation by conducting negotiations in the framework of the WTO and worked to frame the discussion as being one of external trade.[74] By internationalizing the talks, the administration apparently sought to use the episode to reinforce the international autonomy of Taiwan. Throughout this episode, the Taiwan government sought to prevent the private sector actors from getting out ahead of the government.

The commercial actors themselves—Taiwan's fruit farmers—sought to secure access to the Mainland consumer market.[75] This market was attractive both for its future growth potential and, in the near term, as a market capable of absorbing that particular year's bumper fruit crop.[76] To facilitate access to the Mainland market, the farmers also sought to build up the supporting trade infrastructure for perishable goods including direct transportation links, quarantine and

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[72] Sofia Wu, "MAC to Take Action on Local Groups Undermining Government Authority," Central News Agency - Taiwan, July 03, 2005.
[73] Wu, "CoA to Step Up Educational Campaign on Fruit Exports to China,"and Elisa Kao, "Taitra Chief: Media is Spoiling Government's Plan on Fruit Exports," Central News Agency - Taiwan, August 13, 2005.
[74] Deborah Kuo, "BoFT to Work to Boost Taiwan Fruit Exports to China Via WTO," Central News Agency - Taiwan, April 08, 2005 and Flor Wang, "Use WTO Framework for Cross-Strait Produce Trade: Tainan Magistrate," Central News Agency - Taiwan, March 18, 2005.
[75] "In the case of commerce across the Taiwan Strait, China has deliberately reached out to select groups or sectors in Taiwan, such as fruit farmers, airline companies, petrochemical firms, and the tourist industry, that have a particular interest in gaining or maintaining access to the mainland market." Steve Chan, "The Politics of Economic Exchange: Carrots and Sticks in Taiwan-China-U.S. Relations," Issues & Studies 42, no. 2 (2006): p. 4.
[76] "KMT Defends Farmers Delegation," China Post, June 24, 2005.

inspection protocols, expedited customs clearing procedures, etc.[77] The farmers worked through industry associations when interacting with the Mainland—in particular, the Taiwan Provincial Farmers Association (台湾省农会), led by its KMT-affiliated executive secretary, Chang Yung-cheng (张永城). Farming on Taiwan is still a very fragmented industry (in 2004, there were more than three hundred farmers associations in Taiwan). As a result, the marketplace is fairly competitive making Taiwan's farmers quick to seize upon any competitive advantage. The farmers are also very unlikely to want to give up or jeopardize such advantages like access to a new export market once they get it.[78]

The next section examines how the Taiwanese farmers were largely responsive to Beijing's efforts to manipulate their own narrow self-interests. Beijing sought to use the farmers' self-interests to shift their support toward the opposition parties and thus undermine their support of Chen Shui-bian's DPP.[79] The Chen government (like Lee's before it) was not able to rein in Taiwan's cross-Strait economic engagement with the Mainland. The economic activity of these commercial actors generated the security externality of *Interest Transformation* on Taiwan. To explore this important business-government dynamic, the next section analyzes the events of 2005 in more detail.

[77] "Imports of Taiwan Fruits into Guangdong Will Speed Up" in IPR Strategic Business Information Database, June 21, 2005 and Bill Savadove, "Cross-Strait Trade Starts to Bear Fruit; Importers Hope for Direct Links to Follow Tariff-Free Access," South China Morning Post, June 20, 2005, p. 6.
[78] "Significantly, once commercial ties are entrenched, these exchanges create vested domestic interests in favor of further expanding these ties." From Chan, "The Politics of Economic Exchange" p. 14.
[79] See: "Chen Warns of Sour Fruit Trade Ties with China," China Post June 16, 2005; Jacky Hsu, "Tariffs Lifted on 15 Fruits from Taiwan; Farmers Welcome Move but Taipei is More Cautious," South China Morning Post, July 29, 2005, p. 8; Luis Huang, "China's Duty Free Entry of Taiwan Fruits a Political Need: President," Central News Agency - Taiwan, May 11, 2005; Flor Wang, "China Said using Fruit Export Issue as Gambit to Sway Taiwan Voters," Central News Agency - Taiwan, August 1, 2005; and Deborah Kuo, "China Importing Taiwan Fruit a Conspiracy: Vice President," Central News Agency - Taiwan, October 30, 2005.

3.4 Chinese Manipulation of Fruit Exports

Before 2005, Taiwanese exports of fresh fruit to the Mainland were fairly limited. The majority of trade with the Mainland was indirect—shipments had to pass through a third party port. Most cross-Strait trade would first pass through Hong Kong. This added costly shipping time to perishable products like tropical fruit, thus restricting the amount of trade.[80] In addition to the logistical constraints on cross-Strait trade, the Mainland Chinese government had import barriers in place that also limited access to China's market. Initially, China only permitted entry for five types of fruits from Taiwan.

Following China's shift to an economic statecraft strategy based on *Interest Transformation* externalities, China began to target Taiwan's fruit exports for further expansion. In November 2004, Hsu Hsin-liang (许信良—a former DPP Chairman who had left the DPP and favored closer ties to China) visited the Mainland. Following this visit, China added seven more types of fruit to the list of permissible imports to the Mainland. This brought the total types of Taiwanese fruit that were permitted access to the Mainland market to twelve. At the conclusion of Lien's April 2005 visit, China would offer to further reduce barriers to access by lifting the tariffs on ten types of fruit. In the following months, the list of permitted fruits would be further expanded from twelve to eighteen and tariffs were completely eliminated on another five types of fruit.[81] By the time these measures took effect on August 1, 2005, China had granted tariff-

[80] Although a limited direct trade link had been established between Fujian Province and Taiwan in July 2003, this route was only authorized for shipments weighing under 100 tons and with a value of less than USD $100,000. These were fairly small amounts by international shipping standards.
[81] 中华人民共和国商务部，"海峡两岸经贸交流协会：有关实施台湾水果零关税措施的沟通协商我们并未片面制定台湾协商代表" [trans: PRC Ministry of Commerce, "Association for Cross-Strait Economic Exchange: We By No Means Unilaterally Appointed Taiwan's Consultative Representative to the Talks on Implementation of the Zero-Tariff Measures for Taiwanese Fruit,"] July 28, 2005 Press Release. Available at: www.mofcom.gov.cn

free market access to fifteen of the eighteen types of fruit now permitted to be imported from Taiwan.[82]

The production of this fruit on Taiwan was concentrated in areas that had historically supported the DPP. The earlier discussion of Taiwan's electoral geography showed that Pingtung, Kaohsiung, Tainan, and Chiayi all had a track record of voting heavily for the DPP. As indicated in the table, the permitted fruit with the largest export figures were all concentrated in traditionally DPP-leaning areas.

Table 3.1: Taiwanese Fruit Granted Tariff-free Market Access[83]

Type of Fruit	**Major Production Area**	**Peak Harvest Season**	**Export Growth (to China 2004 vs. 2005)**
Mango[84]	Pingtung County, Kaohsiung County and Tainan County	Summer	11 times ($31,068 vs. $335,921)
Pineapple[85]	Chiayi County	Year-Round	89 times greater ($1,740 vs. $154,590)
Custard Apple (a.k.a. Wax Apple)[86]	Kaohsiung, Pingtung Taitung Counties. (Taitung is the largest production area)	July to February	110 times greater ($1,399 vs. $154,263)
Star Fruit (a.k.a. Carambola)	Changhua	Year Round	Doubled ($69,138 vs. $155,214)
Papaya	Tainan County, Pingtung County and Kaohsiung County	August to October	5 times greater ($10,937 vs. $57,298)
Guava	Throughout Taiwan	November to February	24 times ($6,088 vs. $144,807)

[82] 中华人民共和国商务部，"大陆 8 月 1 日起正式对 15 种台湾水果实施进口零关税" [trans: PRC Ministry of Commerce, "Effective August First: Mainland to Formally Implement Zero Import Tariff for 15 Types of Taiwanese Fruit,"] July 28, 2005 Press Release. Available at: www.mofcom.gov.cn

[83] This table shows the top six types of fruit with the largest export volumes. In addition to the six listed in the table, China also granted the following types of fruit tariff-free treatment: pomelo, coconut, plum, jujube/date, betel nut, persimmon, bell fruit, loquat, and peach. Information on specific types of fruit grown in various regions of Taiwan is drawn from information on the Taiwan Council of Agriculture website: http://www.coa.gov.tw/show_index.php or in English at: http://eng.coa.gov.tw/list.php?catid=8796 Export data comes from Taiwan's Bureau of Foreign Trade.

[84] Mangoes are exported mainly to Hong Kong, Singapore, Mainland China, and Japan.

[85] The primary export destinations of pineapples are: Japan, Hong Kong, Singapore, and Canada.

[86] Taiwan has become the largest custard apple cultivating country in the world.

Mainland China seems to have designed and implemented its strategy of *Interest Transformation* in a fairly unified, coordinated manner. The Taiwan Affairs Office, the Ministry of Commerce, the General Secretary and the State Council all seemed to be playing from the same sheet of music. Hu Jintao, himself, seems to have provided the strategic guidance for the Mainland's strategy *vis a vis* Taiwan. For example, in his March 4, 2005 address, Hu "unequivocally" (明确) proposed that the Mainland ought to "earnestly resolve" (切实解决) the problem of Taiwanese produce having a small market share in the Mainland.[87] Wen Jiabao also voiced his support. "He declared that Beijing 'will take measures to boost sales on the Mainland of farm produce from Taiwan, particularly from southern Taiwan. We will do whatever benefits the Taiwan people,' he emphasized."[88] In addition, the provinces like Fujian stood to benefit from enhanced economic ties with Taiwan.[89] So there was very little center-local tensions within the state. The state was unified in its pursuit of economic statecraft that sought to employ an *Interest Transformation* strategy *vis a vis* the Taiwan farmers. China's Ministry of Commerce led the implementation of the larger national strategic effort to woo the Taiwanese populace directly. Most of the initial contact was between local Taiwanese farmers associations and the Chinese Ministry of Commerce.[90]

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[87] See: "Do Best to Seek Peaceful Reunification, but Never Tolerate Taiwan Independence: President," Xinhua General News Service March 4, 2005 for excerpts of his speech. Hu's quote was frequently cited both in official Mainland press releases covering the fruit tariff developments and in policy statements from the Ministry of Commerce. See for instance: 中华人民共和国商务部, "商务部新闻发言人宣布将对 15 种台湾水果实施进口零关税措施" [trans: PRC Ministry of Commerce, "Ministry of Commerce Spokesman Announces Implementation of Zero Tariff Handling Measures for 15 Types of Taiwanese Fruit,"] July 28, 2005 Press Release. For the full text of the English version of the speech see the Taiwan Affairs Office website: http://www.gwytb.gov.cn:8088/detail.asp?table=OneCP&title=One-China%20Principle&m_id=27

[88] Ting-I Tsai, "Taipei: Yes, we have no Bananas," Asia Times, Oct 28, 2006.

[89] "Agricultural Exchange Conforms to Aspiration of People Across Taiwan Straits," Xinhua Economic News Service, September 9, 2005.

[90] Although MofCom was important (especially with regard to implementation and execution), it does seem that the Mainland's strategy was clearly coordinated from the top, specifically via the Taiwan Affairs Office of the State Council. "Mainland Association Invites Taiwan Counterparts to Talk about Fruit Sale," Xinhua General News Service, June 1 2005; "Chinese Mainland Hopes Taiwan Authorities to Push Fruit Exports to Mainland," Xinhua General News Service, July 8, 2005.

The Chen administration was largely cut out of the loop given its strategy of pre-conditions and attempts to make the issue one of international trade. By trying to treat the issue as a foreign trade issue (even going so far as to seek to conduct negotiations in the WTO forum), the DPP sought to assert the island's sovereignty and international status.[91] Indeed, since March of 2005, senior Chinese MofCom officials had been claiming that the DPP Administration was dragging its feet and was opposed to Taiwan farmers selling produce to China.[92] Following the Lien visit, MofCom wanted to negotiate the terms of fast-track customs clearing and quarantine. In response, Chen designated the semi-official Taiwan External Trade Development Council (TAITRA) to work with the Mainland officials on matters of certificates of origin, and other bureaucratic matters.[93] However, working through TAITRA would make the matter seem like any other of Taiwan's *international* trade negotiations.[94] China refused to talk with TAITRA and instead insisted on talking with the Taiwan Provincial Farmer's Association "in a bid to downgrade Taiwan's status."[95] Beijing was unwilling to treat the matter as an international one. The result was a diplomatic impasse. From this rhetoric, it is apparent that the issue area of Taiwan's fruit exports to Mainland China was already highly politicized before the original KMT visit even took place. Being able to enter into this highly-charged political environment and deliver favorable results to the farmers in Taiwan further reinforced the KMT's claim that it was more effective at managing the tricky cross-Strait dynamics.

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[91] Lilian Wu, "Taiwan Not Restricting Fruit Exports, Wants Cross-Strait Talks," Central News Agency - Taiwan, July 22, 2005.
[92] "DPP's Ideology Hinders Fruit Trade," Business Daily Update, July 28, 2005, p. 27.; "DPP Plays Politics with People's Interests," China Daily, June 28, 2005.
[93] See Mainland Affairs Council's daily briefings for June 17, 2005 and July 8, 2005 available at: http://www.mac.gov.tw/ct.asp?xItem=47565&ctNode=6462&mp=3 and: http://www.mac.gov.tw/ct.asp?xItem=47561&ctNode=6462&mp=3 respecitvely.
[94] "The most important reason for this is that TAITRA has rich experience in the international arena and is specialized in assisting negotiations with foreign countries," MAC vice chairman as quoted in "Mac, Coa Decline Opposition's Invitation" China Post July 7, 2005.
[95] Joseph Wu, DPP-appointed Chairman of Taiwan's Mainland Affairs Council as quoted in Taiwan news, "PRC Scraps Tariffs on 15 Taiwan Fruits" also see: "China using Fruit Trade to Downgrade Taiwan : Official," Asia Pulse, July 27, 2005.

In the wake of the Lien visit, the KMT skillfully used the regionally-oriented Taiwan Provincial Farmers Association (TPFA) as the point of contact to represent the farmers' interests.[96] The Taiwanese fruit farming industry structure is very fragmented consisting of mainly small to medium-scale independent farms. These farmers will often sell their produce through intermediary brokers who distribute the fruit internationally for export. As a result, the industry does not often coordinate its activities very closely (as was evidenced by the over planting and consequent surplus of citrus crops in the late 1990s/early 2000s). To the extent that the industry is organized, it relies on associations like the Taiwan Provincial Farmers Association to represent its interests. In 2005, the head of the TPFA was Chang Yung-cheng, a KMT-affiliated official.[97] By conducting contact through the channel of the TPFA, the KMT was able to achieve three objectives at the same time. First, it could ensure political consistency by routing the liaison through a KMT-controlled body. It could also ensure that credit for any success would rest with the KMT rather than allowing the government to step in and claim credit for the DPP administration. Finally, the non-official, sub-state nature of the TPFA allowed Beijing to make the case that it was not negotiating terms at the national level, but rather with a regional trade association.

Naturally, the DPP wanted to re-assert its control of the negotiations.[98] Most of the cross-Strait contact had been between Taiwanese farmers associations and the MofCom. However, working out matters of inspection and quarantine was clearly a governmental realm.[99] The DPP-appointed Chairman of the Mainland Affairs Council, Joseph Wu Chao-hsieh (吳釗燮

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[96] "Taiwan Farmers Group to Send Team to China for Talks on Fruit Exports - Report," AFX - Asia, June 19, 2005; "Farmers' Group to Visit China, Discuss Exporting Fruits," China Post June 19, 2005

[97] "Farmers Interested in Exports to China," China Post May 13, 2005.

[98] "Premier to Barnstorm Across Taiwan on Fruit Exports to China," Asia Pulse, July 28, 2005; "Hsieh Cautions Farmers on Fruit Sales to China," China Post July 30, 2005; and "Mac to Review all China Trade and Investment Projects," China Post July 28, 2005.

[99] "Chen Insists on Gov't-to-Gov't Talks regarding Farm Exports to China," China Post July 15, 2005 and "Taiwan Farmers' Assoc. Not Authorized to Negotiate with China," Asia Pulse, June 23, 2005.

), met with the farmers associations in Kaoshiung in an attempt to persuade them to move more slowly and work more directly through the government in this matter.[100] However, he was unsuccessful. On the eve of the Taiwan Provincial Farmers Association's follow-up visit to discuss trade clearing logistics, the DPP threatened that non-designated groups that negotiated terms with the Mainland were potentially conducting illegal operations. "If any civic group takes any actions [*sic*] that violates the law, the government must take appropriate action."[101] Although this stern warning did result in delaying the delegation's trip by a week, it did not prevent the momentum from building.[102] Eventually, China would opt to unilaterally adjust its own tariff policy without any real engagement of officially-designated Taiwanese government channels.

In this case study, the Chen administration seems to have been caught flat-footed. They wanted to negotiate the terms of any trade agreement only through their designated semi-official body, TAITRA. However, the administration was never able to wrest control of the momentum. Instead, it seemed to be struggling to catch up with the local commercial producers who were eager to secure a market to for their bumper crop before the peak harvest time of late summer. As is often the case in Taiwanese cross-Strait business-government dynamics, the Taiwanese state was unable to effectively control its commercial actors. The state actor in this case, the government in Beijing, also did not have any direct authority over the commercial actors, however, it was able to exercise some degree of control since it managed the regulatory

[100] Sofia Wu, "Mac to Take Action on Local Groups Undermining Government Authority," Central News Agency - Taiwan, July 3, 2005.

[101] Straits Exchange Foundation vice-chairman You Ying-lung (游盈隆) as quoted in "Mac, Coa Decline Opposition's Invitation" China Post July 7, 2005. According to the government's official position, "civic groups were free to visit the mainland provided they did not make any unauthorized deals. He [You] said violators would be punished by law . . ."

[102] "Hsieh Cautions Farmers on Fruit Sales to China," China Post July 30, 2005; "Taiwan Farmers' Assoc. Not Authorized to Negotiate with China," Asia Pulse, June 23, 2005; Lilian Wu, "Farmers' Association Rethinks Strategy on Trip to China," Central News Agency - Taiwan, June 20, 2005; Y. F. Low, "Mac Urges Farmers' Association to Respect Government Authority," Central News Agency - Taiwan, June 24, 2005.

mechanisms that permitted Taiwan's fruit to gain access to the Mainland Chinese market. In this episode, we observe the Mainland government using state policy to structure the incentives that the Taiwanese commercial actors faced. By manipulating these incentives (i.e. by demonstrating that the Mainland was willing to grant beneficial concessions to economic interests represented by the KMT—but not the DPP—authorities), Beijing hoped to undermine Chen Shui-bian's support base by building up the credibility of his main political rival, the opposition party KMT.[103] Mainland efforts to move forward by working with the KMT placed the DPP in a difficult domestic political position. Any attempt by the DPP to re-assert its regulatory or governing authority was berated as politicizing the issue or as blocking progress that would directly benefit Taiwanese farmers.[104]

In the end, the Mainland did not wait for a government-sanctioned interlocutor, but rather unilaterally eliminated the tariffs.[105] On July 28, 2005 China's Ministry of Commerce announced that it was unilaterally lifting tariffs on the fifteen fruits listed in the table above.[106] The new preferential regulations were to take effect on August 1, 2005—just was Taiwan

[103] "Taiwan Opposition Delegates Push for Closer Economic Links with China," Agence France Presse, March 31, 2005.
[104] In meetings on the issue with farmers at the time, there was "...a call from opposition Kuomintang (KMT) Chairman Lien Chan and some legislators who said that the government should put aside its anti-China ideology for the benefit of Taiwan's farmers. Lien said the government should respond quickly to China's offer to allow 18 categories of Taiwan fruits into the mainland duty free without politicizing or complicating the issue so that Taiwan's farmers can reap the benefits." From: "Farmers Interested in Exports to China," China Post May 13, 2005. N.B.: Although China did offer access for 18 categories of fruit, only 15 of these were given tariff-free treatment. On the issue of politicization, also see: "KMT Defends Farmers Delegation," China Post, June 24, 2005; Wu, "KMT Will Monitor Fruit Exports to China to Protect Farmers' Interests,"; Jacky Hsu, "Taipei Tries to Soothe Angry Farmers," South China Morning Post, July 28, 2005, sec. NEWS, p. 6.; "DPP's Ideology Hinders Fruit Trade," Business Daily Update, July 28, 2005, p. 27.
[105] "The announcement marks a unilateral Chinese move to dismantle trade barriers. We welcome any free trade measures that would benefit our farmers." Taiwan News, "PRC Scraps Tariffs on 15 Taiwan Fruits" Available at: http://taiwansecurity.org/TSR-Strait-2005.htm.
[106]中华人民共和国商务部，"商务部新闻发言人宣布将对 15 种台湾水果实施进口零关税措施" [trans: PRC Ministry of Commerce, "Ministry of Commerce Spokesman Announces Implementation of Zero Tariff Handling Measures for 15 Types of Taiwanese Fruit,"] July 28, 2005 Press Release.

entered the peak of its major harvesting season.[107] The measures also included fast-track provisions to facilitate rapid customs and quarantine measures. The elimination of the tariff reduced consumer prices paid for Taiwanese fruit in the Mainland by fifteen to twenty percent.[108] Taiwan's Mainland fruit sales were estimated to have gone up 30-50% in the months following the implementation of the tariff reduction. In addition to eliminating the fruit tariff, the Mainland launched an aggressive marketing and promotional campaign touting Taiwan's fruit.[109]

This expedited access to the China market was made even more significant as a source of relief to Taiwanese farmers given the recent drop in their business revenues. With the introduction of new farming techniques and improvements in agricultural technology, supply of high-quality fresh fruit on Taiwan had increased dramatically. In the early 2000s, the domestic market for all of this produce was saturated. Since 2002, prices of Taiwanese fruit had fallen by thirty to forty percent.[110] The effect of this over-production was passed on directly to the farmers. On the eve of this episode, Taiwan's fruit producers were anxiously searching for new markets in which to off-load their products.[111]

By eliminating the tariffs on these fifteen types of fruit, China effectively provided access to just such a large consumer market for Taiwan's fruit exports.[112] Moreover, the Mainland

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[107] *Ibid.* For the peak harvest season of various types of fruit that received the tariff-free treatment, see chart presented earlier.

[108] 中华人民共和国商务部，"两岸农产品贸易渐入佳境 (黑龙江省)," [trans: PRC Ministry of Commerce, "Cross-Strait Agricultural Produce Trade to Gradually Enter a State of Ecstasy,"] August 1, 2005 Press Release (Heilongjiang Province Edition).

[109] See for instance: "Measures to Help Sell Taiwan Fruits on Mainland Market Effective," Xinhua General News Service, September 28, 2005; "China Spokesman Says Measures Taken to Aid Taiwan Fruit Market," BBC Septemeber 28, 2005; and "台零关税水果销情火爆对海南水果没有压力," 人民日报海外版 2005 年 08 月 12 日 [trans: "Taiwan Tariff-Free Fruit Sales Brisk; Pose No Pressure on Hainan Fruit,"] August 12, 2005 People's Daily (Overseas ed.). Available at: http://news.xinhuanet.com/taiwan/2005-08/12/content_3342317.htm Also see: "Fruit Show Adds Market Value to Chinese Farm Produce," Xinhua General News Service November 12, 2005); and "China's Mainland to Set Up Business Zones for Taiwan Farmers," Xinhua General News Service, June 1, 2005.

[110] "Fruits from Taiwan Embark Mainland with Wider, Easier Access," Xinhua Economic News Service, May 19, 2005.

[111] "Farmers Interested in Exports to China," China Post May 13, 2005.

[112] "Taiwanese Fruits Available to More Mainland Areas," Asia Pulse, June 7, 2005.

market held out the promise of considerable future growth. The Mainland presented a large, relatively untapped source of market demand. In terms of the *Elasticity* dimension of this episode of economic statecraft, Taiwan had few suitable alternative export markets to turn to for future growth. Japan (the major developed economy located nearby) already represented around half of all Taiwanese fresh fruit exports.[113] That market seemed fairly well penetrated with little room for growth. The American and Canadian markets were also large, mature markets but strict quarantine and food safety requirements constrained access for most growers. In addition, the distances involved made transportation logistics a deterrent to further expanding these markets for such perishable goods as tropical fruit. Markets for tropical fruit in Southeast Asia were already highly competitive given the natural climatic advantages producers there enjoyed. Mainland China presented a large, growing population of increasingly wealthy consumers with a common cultural tie in close proximity to Taiwan. Moreover, Taiwanese fruit already enjoyed strong brand recognition as a premium product that could command higher margins than domestically-produced Chinese fruit. However, as of 2004, Taiwan's limited access to this market resulted in exporting only USD \$340,000 of fresh fruit to China.[114] The Mainland market was significantly under exploited on the eve of the opposition party visits. The attractive potential of China's domestic consumer market is a powerful commercial incentive that China used to good strategic effect in this episode.

Although fruit production may not be a large part of Taiwan's national exports and at first glance may seem like a relatively insignificant aspect of cross-Strait economic interaction, its importance derives from the major role it plays in the regional economies of the counties

[113] Taiwan's largest destination market was Japan (\$18.2 million) followed by Hong Kong (\$8.1 million), the US (\$5.7 million), Singapore (\$2.5 million), Canada (\$1.7 million) and Mainland China (\$340 thousand). From: Taiwan Bureau of Foreign Trade, Statistical Database on Foreign Trade.

[114] In 2004, Taiwan exported some \$38 million worth of fresh fruit in total but only \$340,000 to the Mainland (an under-developed market). From: Taiwan Bureau of Foreign Trade, Statistical Database on Foreign Trade.

comprising the DPP's electoral heartland. Since fruit production is concentrated geographically in Taiwan across areas that have traditionally been DPP strong-holds, what might otherwise appear to be nationally insignificant amounts of economic interaction take on much greater strategic significance. The move to allow market access to Taiwanese fruit stood to benefit a highly concentrated set of economic interests. Moreover, these beneficiaries made up a strategic constituency in Taiwanese domestic politics—Chen Shui-bian's support base.[115] The ability of the KMT to break the diplomatic impasse and deliver the export outlet to relieve the farmers' surplus both underscored the inability of the ruling DPP to effectively navigate cross-Strait relations and served as a prominent reminder of how the KMT's pragmatic orientation might better suit the farmers' own self-interests.

3.5 Results

What were the effects of China's actions in this episode? This section examines the consequences of the lowering of fruit tariffs. The data on Taiwan's fresh fruit exports suggest the economic side of the Mainland's policy has been successful. As mentioned previously, in 2004, Taiwan exported around USD$340,000 worth of fresh fruit to the Mainland. In the aftermath of this episode, fresh fruit exports to China showed a five-fold increase in 2005.[116] The Mainland market has continued to be a source of export growth for Taiwanese fruit farmers. In 2009, exports of fresh fruit to Mainland China hit $5.3 million—almost 16 times the baseline

[115] "In reaching out to Taiwan's business community, Beijing has not only sought to attract the relocation of large companies such as those in the petrochemical industry or to establish business links with others such as airlines, but it has also promoted ties with the island's fruit farmers and medium sized firms engaged in labor-intensive production. The latter groups constitute key supporters for the DPP." From: Chan, "The Politics of Economic Exchange," p. 17. Also see: Joel Wuthnow, "The Integration of Cooptation and Coercion: China's Taiwan Strategy since 2001," East Asia 23, no. 3 (2006): p. 26.

[116] As is often the case when working with Chinese statistics, I have encountered a number of discrepancies in the course of my research. The most reliable, consistent and complete figures seem to be those provided by the Taiwan's Bureau of Foreign Trade. The figures I use are drawn from their Statistical Database on Foreign Trade available in English at: http://cus93.trade.gov.tw/ENGLISH/FSCE/. Fresh fruit exports fall into "Chapter 8" CCC codes, covering edible fruits and nuts.

2004 figure. The first link in the causal chain of *Interest Transformation* seems to have been borne out: economic interaction grew considerably as a result of the Mainland's policy. But did this interaction entail strategically significant consequences?

The answer lies in the electoral performance of the DPP in the aftermath of this episode. This is not to claim that China's use of economic statecraft is the sole determinant of the KMT's success.[117] However, since undermining the DPP's electoral performance was the strategic goal of the Mainland in this episode, it is only right to examine the subsequent electoral results. The elections are the ultimate indicator of whether such a strategy worked. That said, of course elections are affected by a wide range of factors, economics being only one of many. The outcome of this episode, namely the DPP's electoral defeats in subsequent elections, may be over-determined in this case since voter behavior is always a complicated outcome to explain. Nevertheless, there was a change in voter preferences in the regions that were targeted and this change corresponded to the elimination of the fruit tariff.

The election most immediately following the opposition party visits was the May 14, 2005 National Assembly election. However, this election is not a reliable indicator for four reasons. First, this vote was a *de facto* referendum on the proposed constitutional amendments that were designed to move Taiwan's political system toward favoring large, nation-wide parties (as opposed to the plethora of smaller, largely single issue or locally-driven political parties). The vote was largely treated as a technical matter related to consolidation of Taiwan's democratization. Unlike most elections in Taiwan, this vote was not really about cross-Strait ties or even about explicit public policies, rather it was a largely procedural referendum. Second, the election was not campaigned along traditional coalition lines (i.e. Pan-Blue versus Pan-Green). Rather, the election fissures were between large parties (the KMT and the DPP) on one side and

[117] Voter behavior is obviously driven by a wide range of factors and considerations.

the smaller parties (e.g. TSU, PFP, and a host of other even smaller parties) on the other. The proposed reorganization of the government would consolidate power in the hands of the larger, national parties and make it more difficult for smaller parties to play an influential role in national politics. As a result, the smaller parties unsurprisingly aligned against the two (normally opposing) largest parties. Third, most politicians, parties, and the general public treated the vote as a relatively unimportant matter of institutional housekeeping. In comparison to most Taiwanese elections, the political parties and candidates did not spend very much money on the election. Finally, record low turnout makes this election an inappropriate indicator. Only about 23% of an otherwise historically participatory Taiwanese electorate voted in this election.[118] Bad weather in the Northern portions of the island also likely kept voters at home further skewing any meaningful results beyond the constitutional amendments. For these reasons, this election will not be considered when assessing the results of this episode of economic statecraft.

The May 2005 National Assembly election was followed by two locally-oriented elections: the December, 2005 三合一选举 [trans: Three-in-One Election] for county magistrates, councilmen and township governors and the December 9, 2006 municipal elections for Mayor of Taipei and Kaohsiung.[119] Unfortunately, these two sets of elections are also a bit problematic to use as indicators since they are largely local level (as opposed to national) contests. However, to the extent that they can be taken as a bellwether of political sentiment on Taiwan, the KMT outperformed the DPP in both sets of elections.[120]

In the December 2005 elections, the KMT won control of fourteen of Taiwan's twenty-three counties (with the PFP and the New Party each also winning one county—bringing the

[118] Taiwanese voter participation is regularly well over 50%. It is not unheard-of to see voter turnout of greater than 80%.
[119] These two largest of Taiwan's municipalities are administered directly under the central government and hold elections on their own independent schedule.
[120] Noi, "KMT Win a Victory for Ties with Beijing."

total Pan-Blue counties to sixteen).[121] The DPP won only six counties.[122] Particularly significant was the loss of Chia-yi—a long-time bastion of the DPP and its predecessor democracy movement the *dangwai.* "It was like losing the locomotive of southern Taiwan, where people have been strongly backing the DPP for years."[123] In terms of the popular vote, the KMT garnered 50.96% of the vote while the DPP won only 41.95% of the total.[124] "Observers said the outcomes demonstrated voters' disappointment at the DPP, who has failed to break the cross-strait deadlock or revive the economy."[125] Chen's popularity hit an all-time low of 21% following the election.[126] Using the previous "Three-in-One" election of 2001 as the baseline for comparison, the DPP's share of the popular vote fell from 2001's 45.27% while the KMT's share gained substantially from its 2001's 35.06% figure.[127]

In the December 2006 elections, the KMT also handed the DPP significant losses. The KMT won in Taipei (both the position of Mayor and a majority of the City Councilors). This is not all that unusual since Taipei has historically been a KMT stronghold. However, a more anomalous result is that the KMT also came close to winning the Kaohsiung mayor election. In this normally DPP strong hold, the KMT received 49.27% which was not enough to beat the DPP's 49.41%. Still the difference was only a little more than a thousand votes, indicating that

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[121]See: "KMT Victory a Turning Point for Taiwan," South China Morning Post, December 7, 2005, p. 16 and Lawrence Chung, "Opposition KMT Sweeps to Victory in Local Elections," South China Morning Post, December 4, 2005, sec. NEWS, p. 1.

[122] Lawrence Chung, "Stunned DPP Loses Traditional Stronghold," South China Morning Post, December 4, 2005, sec. NEWS, p. 6. The DPP had held ten counties from the 2001 election.

[123] Quote is from Lin Hung-chan (林宏展), spokesman for defeated DPP candidate, Chen Li-chen (陳麗貞) at Chen's election headquarters admitting that losing Chia-yi was a significant defeat for the DPP. Hsiu-chuan Shih, "KMT Makes History in Chiayi City," Taipei Times, Dec 4, 2005, p. 2.

[124] Staff, "KMT Wins in a Landslide," China Post, Dec 4, 2005.

[125] *ibid.*

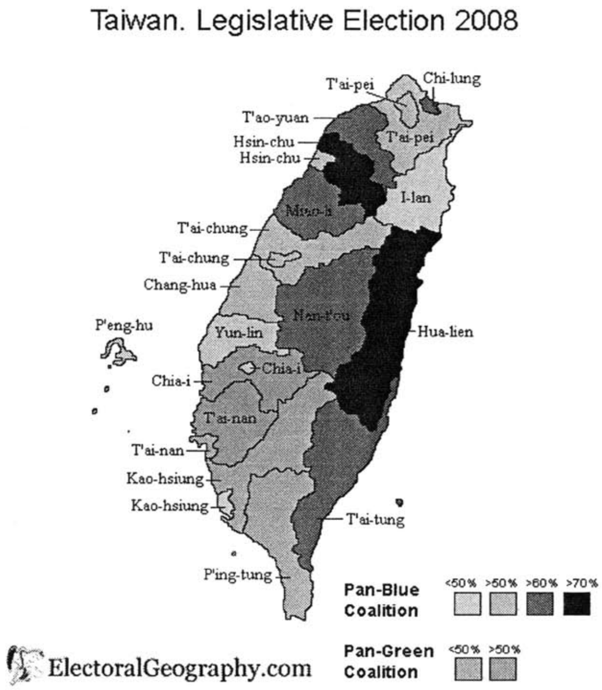
[126] Lawrence Chung, "Chen's Popularity at an all-Time Low; More than Half the Public Say the Taiwanese President should Step Down After His Party's Defeat in Weekend Elections," South China Morning Post, December 6, 2005, sec. NEWS, p. 8.

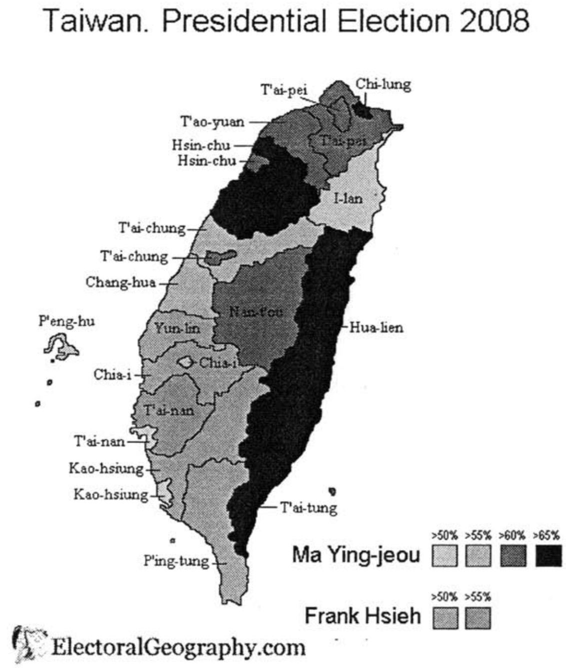
[127] It should be noted that the KMT's 2001 figure is not a very good baseline for comparison since the PFP-KMT split was near its height in 2001 and a significant portion of the "pan-Blue" vote was likely siphoned off from the KMT's share of the popular vote in 2001.

the KMT had made significant headway in one of the DPP's key districts. Moreover, the KMT did actually win a majority of the Kaohsiung City Councilors seats (17 compared to the DPP's 15 seats). To the extent that the 2006 Municipal Elections can be used as an indicator, the results in Kaohsiung seem to suggest that the Spring 2005 visits were effective in undermining support in the region for the DPP. In previous municipal elections, the DPP had won the Kaohsiung mayoral election in 2002 (with a comfortable 50.04% of the vote vs. the KMT's 46.82%) and in 1998 when it wrested control of the city from the KMT (with 48.71% of the vote vs. the KMT's 48.13%).[128]

Although these the elections in December of 2005 and 2006 may be indicative of an eroding DPP grip on power, confirmation of the DPP's electoral downfall really comes in 2008—the next cycle of national-level elections in Taiwan. The results of these two elections (the January 12, 2008 Legislative Yuan Election and the March 22, 2008 Presidential Election) show a clear defeat for the DPP and a validation for the KMT's cross-Strait policies. The electoral maps below depict the erosion of support for the DPP. Of particular significance is the loss of regional areas of traditional Pan-Green support in the counties targeted in this episode of economic statecraft. The twenty-three counties are shaded to indicate the popular vote: darker shades of either green or blue represent a larger margin of support for either the pan-Green or pan-Blue in that county. As expected, the pan-Blue win by the largest majorities in their traditional strongholds of the north. However, what is most striking is the weakness of pan-Green support among their traditional base in the south.

[128] Hwee Hwee Ong, "Battle for Taiwan's Two Top Cities," The Straits Times (Singapore), December 6, 2006.





In the Legislative Yuan Election, the pan-Greens fared poorly. Even among the counties in which the pan-Green won a plurality, in only two counties did they manage to win more than 50% of the vote. This stands in striking comparison to the pan-Blue margin of victory which garnered greater than 60% of the popular vote across six counties and swept up a total of eighteen of the twenty-three total counties. This equated to a supermajority—86 of the total 113 legislative seats—that went to the pan-Blue alliance. The remaining 27 seats went to the DPP.[129] The DPP's major pan-Green partner, the independence-issue driven TSU, won no seats in this election.

A similar story is told by the presidential contest between the pan-Blue candidate Ma Ying-jeou (马英九) and the pan-Green candidate Frank Hsieh Chang-ting (谢长廷). In this election, the pan-Blue candidate took home 58.45% of the popular vote, providing Ma Ying-jeou

[129] T. Gold, "Taiwan in 2008: My Kingdom for a Horse," Asian Survey 49, no. 1 (2009): 89.

with a landslide victory. Frank Hsieh would garner only 41.55% of the vote. [130] Taiwan's presidential elections have historically been very closely fought elections making this margin of victory unusual. As was the case in the Legislative Yuan election, the pan-Blue carried more regions with a greater margin of victory than the pan-Green. Even in the areas that make up the pan-Green base of support, the races were much more closely fought with the pan-Green winning by more than 55% in only one county. [131] The shift away from the pan-Green agenda is striking when the 2008 elections are juxtaposed with the comparable 2004 LY and Presidential elections.

3.5.1 Baselining the Results

These strategic results ought to be considered in reference to some baseline for economic statecraft in this context. In particular, rigorous analysis would seek to establish a baseline along three aspects of the episode. First, were the results meaningful? Second, how do we know that economic statecraft generated these strategic results? Finally, how do we know that this episode constituted economic statecraft as opposed to simple commercial calculations? In other words, to examine economic statecraft, one must be able to distinguish what constitutes economic statecraft from simple, straightforward "normal" commercial activity.

On the first issue of whether the economic statecraft in question generated strategic results, the evidence shows that there was clearly an electoral shift that took place on Taiwan. Using the previous electoral patterns as a baseline, there is a significant swing away from the DPP and in favor of the KMT. This change was major and it does seem to suggest that China's economic statecraft undermined one of the DPP's key support bases. Second, how much of that

[130] Alexander C. Tan, "The 2008 Taiwan Elections: Forward to the Past?" Electoral Studies 28, no. 3 (2009): 505.
[131] *Ibid.*: especially pp. 505-506.

change can be attributed to the economic statecraft? Although the results of this episode are clearly evidenced in the subsequent electoral behavior, it is difficult to establish how large of an impact the issue of fruit tariffs *per se* had in determining voter behavior. I do not want to over state the importance of this episode. Voters were likely already getting unhappy with Chen (especially regarding corruption issues and his administration's economic management) and that certainly lowered the DPP's popularity going into the 2008 elections. However, it is interesting to note that wider economic dissatisfaction might have actually increased the saliency of the fruit tariff since the affected parties would have been that much more sensitive to *any* source of economic relief. Fruit exports also constitute only a very small portion of Taiwan's overall exports (with fruit exports to China being smaller still). However, the concentrated nature of the beneficiaries in Taiwan and the growth potential of the Chinese market do seem to suggest strategic importance in this episode.[132]

One helpful indicator is that the highest-ranking leaders in both China and Taiwan seemed to have accorded the issue a substantial degree of public attention. For example, we observe Hu Jintao specifically outlining the strategic significance of relieving Taiwanese farmers.[133] Wen Jiabao also echoed these points.[134] Of course, leading KMT officials sought to score political points throughout this episode. But perhaps most tellingly, Taiwan President Chen Shui-bian, himself, seemed to indicate that this matter of granting Taiwan fruit tariff-free status was an important one: "China's recent announcement of duty free treatment for exports of certain fruits by Taiwan's farmers to the Chinese market is just a decision unilaterally taken by

[132] It is also important not to underestimate the significance of signaling in this episode. Improved cross-Strait economic ties were import to sectors of Taiwan's economy well-beyond fruit or even agriculture more broadly.
[133] "When talking about the marketing of Taiwan's farm produce in the mainland, Hu said the issue 'involves the fundamental interests of the broad masses of the Taiwan farmers,'" as quoted in "Do Best to Seek Peaceful Reunification, but Never Tolerate Taiwan Independence : President," Xinhua General News Service, March 4, 2005.
[134] "He declared that Beijing 'will take measures to boost sales on the mainland of farm produce from Taiwan, particularly from southern Taiwan. We will do whatever benefits the Taiwan people,' he emphasized." From: Tsai, "Taipei: Yes, we have no Bananas."

Beijing based on political needs. "[135] To the extent that national leaders must prioritize their limited time and attention, we can interpret the attention they afforded to this episode as indicative of its causal significance.

So if the effect was strategically important and it seems that the economic statecraft was a major contributor to generating that result, how should the reader know if the observed economic interaction is actually the result of strategically-manipulated economic statecraft as opposed to normal economic interaction performed for purely commercial reasons? How should one distinguish between economic statecraft and the ordinary course of commercially-motivated interaction? At the heart of this challenge lies distinguishing between the "normal economic behavior" of commercial actors and the state's strategically motivated manipulation designed to achieve foreign policy objectives by instrumentally using commercial actors.

In this episode, the evidence suggests that the decision to lower tariffs on the fifteen types of fruit was a strategically-motivated one designed to influence the political outcome in Taiwan rather than a purely commercially-driven desire to improve the terms of trade. Perhaps most importantly from the point of view of distinguishing between politically manipulated versus commercially-oriented policy, the tariffs that were lowered did not include bananas. This is important because bananas are by far, Taiwan's single largest type of fruit export.[136] If this episode were a purely commercial endeavor, why would the largest type of fruit be excluded? Any *commercially*-driven effort to expand Taiwan's fruit exports should have included its largest type of exported fruit. Lychees, Taiwan's third largest type of fruit export, were also excluded

[135] President Chen made these comments during a meeting with board members of the Outstanding Farmers Association of the ROC. His speech was perceived as defensive in response to what he clearly viewed as strategically threatening overtures from the Mainland. See: Luis Huang, "China's Duty Free Entry of Taiwan Fruits a Political Need: President," Central News Agency - Taiwan, May 11, 2005.

[136] Ting-I Tsai, "The Beijing-Taipei Fruit Fracas," Asia Times, Aug 26, 2005. Taiwan exports more bananas than any other type of fruit. According to Taiwan's Bureau of Foreign Trade, banana exports in 2004 were more than double the next largest type of exported fruit (mango—which was afforded tariff-free treatment from Beijing).

while mangoes (occupying the number two position behind bananas) were included.[137] The reason for the selective targeting of specific types of fruit can be found in the confluence of Taiwan's electoral geography and where certain types of (mainly tropical) fruit are produced in Taiwan. For example, the production of mangoes is (not coincidentally) concentrated in Pingtung, Tainan and Kaohsiung Counties—all DPP strongholds. Consequently mangoes were slated for tariff elimination while bananas and lychee (both of which lacked this sort of strategic geographic concentration) were not.

Another indicator of the strategic rather than commercial orientation of this policy was that Mainland China did not seek to gain access to Taiwanese markets for its own fruit producers. If the tariff reduction were part of a larger commercially-oriented effort to remove barriers to trade, one might have expected to see tariff reduction on China's side as part of a more comprehensive bargain to increase cross-Strait trade. As it was, the tariff-reduction targeted specific types of fruit and was not part of a broader free trade discussion. Moreover, the lowering of trade barriers was a unilateral concession on China's part.

Finally, oranges—one of the types of fruit most prone to overproduction in Taiwan—were not even permitted entry into China.[138] If the purpose of the lowering of the tariffs on certain types of fruit were actually commercial (i.e. to help relieve over-production), one would have expected to see oranges, the type of fruit that was arguably most prone to over-production, included in the relief effort as well. The evidence suggests that the intent in this episode was not simply to help relieve all Taiwanese farmers, but rather to relieve *strategically significant*

[137] According to Taiwan's Bureau of Foreign Trade, in 2004, Taiwan exported about USD$4.5 million worth of Lychee.

[138] Because of improvements in fertilizers and pesticides as well as the long lead time for growing oranges and the high sunk costs of up-rooting planted trees, this type of fruit has been particularly prone to overproduction in Taiwan. Lilian Wu, "Taitra Lending Hand in Selling Oranges," Central News Agency - Taiwan, November 27, 2004; Deborah Kuo, "Parties Play Orange' Card as Citrus Prices Nosedive," Central News Agency - Taiwan, November 24, 2004.

farmers. By demonstrating the benefits that the targeted farmers stood to gain from a KMT-led cross-Strait relationship, the Mainland sought to undermine the DPP's support.

Each of these elements seems to indicate that Mainland China's move to grant access to some types of fruit had non-commercial, strategic motives. This operation was not really about a commercially-motivated move to provide market access for Taiwan's fruit on a commercial basis. Rather the evidence seems to suggest that the lowering of tariffs was a deliberate policy of economic statecraft specifically calculated to alter the domestic electoral interests of a key support base for Chen Shui-bian. By undermining Chen's support, the Mainland hoped to curb Taiwan's proclivity toward independence. This strategic objective was one of Beijing's paramount goals *vis a vis* Taiwan. In this episode, Mainland China pursued that goal by instrumentally using commercial actors to help achieve its strategic objectives.

3.6 Evaluating the Case

This section evaluates this episode of China's economic statecraft in light of the theoretical framework presented in Chapter 2. First, this section reviews how this episode stacks up across the three conditions for effective economic statecraft (*size, elasticity* and *purpose commensurability*). This case seems to meet all three conditions. Arguably, the *size* of the economic interaction (Taiwan's fruit exports to Mainland China) is fairly insignificant in absolute terms. However, the concentration of this economic interaction among a strategically significant constituency in Taiwan's domestic politics seems to have made up for what might be otherwise low levels of economic interaction. In terms of *purpose commensurability*, China's shift toward using economic statecraft to reinforce the status quo in which Taiwan did not move further toward independence is much easier realized than trying to force reunification with the Mainland. In addition, using economic statecraft to undermine support for Chen Shui-bian was made even easier by public disillusionment with Chen's handling of the Taiwanese economy. The *elasticity* dimension of this episode was discussed earlier. Essentially, the Mainland China export market presented a unique, promising source of demand for Taiwan's fruit. This demand could not easily be substituted and was important to Taiwan's fruit farmers (particularly given their bumper harvest that year).

Second, this section reviews the coding of this episode in terms of the independent variables that account for the Mainland's ability to motivate the commercial actors to behave in a manner that generated the strategic effects it sought. These values are summarized in the chart on the next page. In terms of the overall effectiveness, China's use of economic statecraft in this episode seems to have been effective at destabilizing the Chen administration and undermining the public support for the DPP in some of its key support bases.[139] The most important factor accounting for China's success seems to have been the Mainland's ability to pursue a unified approach to implementing a strategy that made the most of political divisions within Taiwan. Mainland China identified a vulnerability in Taiwan's ruling party and instituted trade policies that sought to drive a wedge between the Taiwanese government and some of its key supporters. By providing economic benefits to an influential domestic constituency and by working through the opposition party to deliver these benefits, the Mainland was able to pursue a strategy that sought to alter Taiwan's definition of its interests. Although a strategy based on exploiting this type of security externality is generally a long-term one (national interests do not turn on a dime), this episode offers a concrete illustration of exactly how this sort of transformation takes place over a fairly condensed time scale. By focusing on this sort of in-depth treatment of one

[139] "If this strategy is intended to divide and confuse, it seems to be working. Taiwan's independence-leaning president, Chen Shui-bian, has appeared far less assured in dealing with the goodwill gestures than he did shrugging off the earlier verbal and legal attacks. His ratings have fallen and his ruling Democratic Progressive Party has never looked more divided." Jonathan Watts, "Beijing's Panda Hug Divides and Confuses Taiwan," Manchester Guardian Weekly, May 13, 2005 - May 19, 2005, sec. 172, p. 10.

particular series of events, we can better understand exactly how economic statecraft actually works in practice.

iwan Case Summary Table

	IV Coding	Evidence	DV Outcome
	Compatible for near term; Mutually exclusive re: Taiwan independence	China wants to minimally prevent Taiwan independence, maximally promote reunification; Taiwan farmers want an export market, and also seem to prefer Taiwan independence. Both farmers and China's goals can be achieved on the economic front—e.g. China can open market and farmers can gain access, but mutually exclusive re: larger issue of Taiwan independence.	Control likely (especially for matters related to economic access); Observe erosion of support for independence-oriented DPP stemming from disillusionment with DPP governance especially cross-Strait policies that do not deliver the benefits that the KMT demonstrate capacity to deliver to farmers.
'e	Competitive	Many small-scale Taiwanese fruit farmers; over 300 professional associations	Control can be achieved by leveraging the competitive dynamics among fruit producers (e.g. no one can afford to be shut out of Chinese market). However, monitoring farmer behavior (e.g. whether they vote for KMT instead in next election) not feasible.
	Unified	Effort was coordinated and led from top with no competing bureaucratic arguments from ministries; Hu Jintao's consolidation of power limits potential for competing personal factions to undermine; Municipal/provincial centers of authority also want to see improved Taiwan economic ties.	Control likely based on coordinated policy.
	Indirect; Only able to exercise regulatory control at point of entry	Government Ownership: None; Private sector actors Management: None; Private sector actors with no funding or investment from Mainland. Only required reporting is regulatory compliance with customs/quarantine/inspection regime	Control likely to be blunt (e.g. allow market access or not) since minimal points for calibration.
:es	Skewed in favor of Mainland	Mainland had most relevant expertise since market access granted by Mainland government/customs; Mainland government had larger budget and personnel resources given scale of MofCom and difficulties coordinating among the many disparate Taiwan farmers	Control likely since relative resources between the Chinese state and the Taiwanese farmers almost completely favored the Chinese state; it was the only one in a position to eliminate the tariffs. That said, relative resources did not seem to be a very important factor in this episode

Examining the goals of China and the goals of the commercial actors in this episode is very interesting because they seem to be compatible in the short term (both seek to enhance the farmers' access to the China market) but their longer term goals (farmers' desire for Taiwanese independence and China's desire for reunification) are mutually exclusive. Indeed, with instances of *Interest Transformation* types of economic statecraft, altering the commercial actors' goals lies at the heart of this type of security externality. It is the tactical objective of the economic statecraft itself. The hope is that these commercial actors then influence the very definitions of the target state's interests.

In this episode, there are many small fruit farmers. The market would be characterized as highly fragmented. As expected, this does pose some challenges for the state when it comes to coordinating the commercial actors. It is particularly difficult for the Taiwanese state to monitor and enforce its preferences on the fruit farmers. For example, efforts on the part of the ruling DPP to re-assert its leadership over the cross-Strait negotiations were unsuccessful. This is a theme that one observes over and over when examining Taiwan's efforts to rein in its commercial actors. Because the commercial actors are numerous and agile and because the commercial attraction of the Mainland is such a strong draw, they often find ways to circumvent the Taiwanese state's efforts to direct or control their behavior. However, the Mainland is able to exert a certain amount of control over these actors since the Mainland is able to influence the commercial actors' commercial operating environment. By targeting the commercial incentives and influencing the conditions under which the private Taiwanese firms operate, the Mainland is able to channel the firms' behavior (to a degree). As implied by the theory, the cross-Strait activities of these firms often generate strategic externalities whether or not the state on either side of the Strait is able to control or direct the behavior of firms.

One of the main factors that accounts for the ability of the Chinese state to effectively manipulate the commercial actors in this episode is that the state acted in a unified manner. The strategic orientation for China was articulated at the highest levels of national leadership. This vision was echoed throughout the implementation of the strategy. Finally, unlike in previous attempts to utilize a *Coercive Leverage* approach to managing cross-Strait commercial actors, there were no countervailing incentives for local municipalities to undermine the central government's objectives.

Since the commercial actors in this episode of economic statecraft were farmers on Taiwan and since Mainland China does not really have any jurisdiction over them beyond the customs and tariff regulatory regime, the reporting relationship between the commercial actors and the state in this episode is indirect. The relationship can be characterized as a light regulatory relationship that takes place mainly at the point of import entry into Mainland China. The state in this case study has the ability to regulate customs requirements and not much else. Unsurprisingly, this is exactly where we see the state using its policy tools (to drop the tariff and expedite the processing of Taiwanese fruit). Taiwanese farmers are not Chinese state-owned enterprises like those examined in later chapters, nor are they extensions of the Chinese government as is the case for the sovereign wealth funds. The Taiwanese farmers are privately managed, privately capitalized and privately owned enterprises. For the Chinese state to control their behavior requires that the state manipulate the commercial conditions under which they conduct their normal pursuit of profit. The reporting relationship between the Mainland Chinese state and Taiwanese farmers seems to be just about as indirect as possible. From the perspective of the reporting relationship independent variable, this episode should be a hard case for economic statecraft to have worked. Because these business-government dynamics are so fundamentally different from those examined in later chapters, this case is an instructive one to explore from a theory-building perspective.

Finally, the relative resources in this episode seem to have been slightly skewed toward the Mainland. In terms of expertise, it determined the conditions under which the fruit would or would not be granted access to the Chinese market. The state had a larger budget and more personnel than the Taiwanese farmers did. In addition, the large number of farmers complicated effective coordination beyond their common interests that were represented by the various professional associations. That said, the evidence does not suggest that this IV was particularly salient in this episode.

3.7 Conclusion

This chapter examined China's efforts to employ an *Interest Transformation* strategy. Operationally, China pursued this strategy by hosting Taiwan's opposition party visits to the Mainland in the Spring of 2005. Subsequently, China eliminated tariffs on specific fruits exported from Taiwan to the Mainland. By altering the self-interest calculus of Taiwan's fruit farmers, Beijing sought to undermine the key support base for independence-minded President Chen Shui-bian and the DPP. This case identified a discreet instance of economic statecraft that sought to leverage a strategy based on *Interest Transformation* security externalities, thus demonstrating how this type of economic statecraft actually works in practice. Through process-tracing focused on micro-level empirics, this case demonstrated exactly how states conduct such a strategy, the mechanisms by which particular instances of economic interaction may be converted into strategic consequences, and the conditions under which such efforts are more or less likely to succeed in realizing their strategic objectives.

Through a detailed examination of the events and circumstances surrounding the spring 2005 opposition party visits and the subsequent elimination of tariffs on Taiwan's export of fruit to the Mainland, this case showed how the Taiwanese farmers that were targeted by this strategy shifted their support away from Chen Shui-bian and their traditional backing of the DPP. Leading up to this episode, Taiwan had been on a path of increasingly more aggressive moves toward independence led by President Chen Shui-bian and the independence-oriented DPP. The opposition KMT was able to demonstrate its ability to work constructively with the Mainland to benefit the narrow commercial interests of Taiwan's fruit farmers. Taiwan's political opposition (not the ruling DPP) was thus credited with opening up the Mainland market as an export destination. The actions were part of a KMT effort to steal votes from the DPP base. The Mainland also sought to undermine the DPP and shift the Taiwanese electorate toward a less independence-oriented footing. Like most commercial actors, the Taiwanese farmers had a strong profit motive. Their narrow economic interests prompted them to shift support toward the KMT and away from the DPP. As a result, DPP support among one of its core constituencies was eroded. By undermining the DPP while strengthening the opposition KMT, the Mainland was able to help bring a new leadership to power in Taiwan. While probably not the only factor contributing to the electoral demise of the DPP, these policies certainly did not help boost DPP popularity in its regional center of gravity on Taiwan. In this episode, Mainland China used its economic interaction to pursue its primary strategic objective *vis a vis* Taiwan, namely decreasing the likelihood of Taiwanese independence.

Before settling on this advanced form of economic statecraft that seeks to redefine Taiwan's interests, China experienced an extended period of learning in its attempt to use economic statecraft to realize its strategic objectives *vis a vis* Taiwan. The next chapter briefly traces this learning process and identifies the key junctures along the path that led China to its current strategy of *Interest Transformation*.

Chapter Four

Coercive Leverage and Bolstering Across the Strait

4.1 Introduction

This chapter outlines the two phases of the cross-Strait relationship that preceded China's efforts to produce *Interest Transformation* security externalities. Before embarking on the transformation strategy discussed in the last chapter, China attempted to leverage Taiwan's growing economic dependence in a coercive manner. During this phase of the cross-Strait relationship, economics—to the extent that it was used strategically—was mainly employed as a tool of *Coercive Leverage.* Such efforts often came across as heavy-handed and clumsy. Frequently, such measures were not only ineffective, but they often were counter-productive as efforts to impose Beijing's will led to a nationalist backlash on the part of the Taiwanese electorate. Because this type of security externality (and the logic of a strategy of economic statecraft used to exploit such externalities) is different from the strategic logic highlighted by the episode discussed above, it is useful to juxtapose the two here against the common background conditions of the cross-Strait relationship as part of an effort to understand exactly how various forms of economic statecraft work.

To provide a holistic treatment of the strategic role of economics in the cross-Strait relationship, the latter portion of this chapter will also examine the earliest phase of the cross-Strait relationship. During Phase 1, China's strategic use of economics sought to engender the *Bolstering* type of security externalities. During this phase, China mainly sought the natural, economic benefits accruing from the cross-Strait economic interaction. Studying all three phases allows for an understanding of how China's economic statecraft strategies have matured and developed over time.

4.2 Phase 2 (1996-Summer 2004): Using Economics as a Tool of Coercive Leverage

Whereas Phase 3 began with the growing recognition that the Mainland's efforts to use coercive means to achieve its strategic objectives were not effective, Phase 2 begins with the growing realization that the asymmetry in the cross-Strait economic relationship was increasingly favoring the Mainland. Although the Mainland largely felt that it was more dependent on Taiwan during Phase 1 of the economic relationship, Phase 2 began as the Mainland had emerged from the economic isolation imposed in the aftermath of Tiananmen. By virtue of its size and rapid pace of development, the Mainland was increasingly becoming the dominant player in the cross-Strait economic relationship. This asymmetry would only increase as China emerged in a stronger relative position following the East Asian Financial Crisis and the bursting of the internet bubble. The level of economic interaction further accelerated when both Taiwan and China entered the WTO. With this realization came the temptation to leverage Taiwan's increasing dependence on the Mainland. In particular, Mainland China sought to pressure Taiwanese firms that had invested in Mainland China in an effort to influence the outcome of presidential elections in Taiwan. In the work that follows, I focus on several examples of Mainland China's attempts to coerce Taiwanese businesses that have ties to the Mainland. Before delving into specific instances of coercive leverage, it is useful to examine the strategic calculus underpinning China's economic statecraft during this phase of the cross-Strait relationship.

4.2.1 Mainland's Strategic Logic

The strategic logic that underpinned Mainland China's economic statecraft during this period is not complicated. It is the same basic logic that guides any *Coercive Leverage* attempt: economic dependence can be jeopardized and this ability to threaten generates coercive capabilities. In Taiwan's case, it is a trading nation whose economy is oriented around international trade. Increasingly during this phase of the cross-Strait relationship, Taiwan's economic dependence on China in particular begins to loom larger and larger. Since Taiwan's international businesses are the commercial actors that are conducting Taiwan's international commerce, they are a critical element driving Taiwan's economic success. As these firms become more deeply invested in Mainland China, their success increasingly depends on the success of their Mainland operations. By threatening to adversely affect the ability of these firms to operate in the Mainland, China reasoned it could gain coercive leverage over them. To avoid punishment, China might demand that these firms act in a manner that is conducive to China's larger strategic interests. This is the basic logic driving Chinese economic statecraft during this phase.

In the mid/late-1990s, China had reason to believe that a cross-Strait strategy predicated on exploiting *Coercive Leverage* security externalities would work. Beijing had employed a similar strategy to derail democratic reforms in Hong Kong.[1] Also, Beijing thought that its impending entry into the WTO would provide it with additional economic leverage.[2] Finally, China's perception of its coercive military power was also rising during this time. In the early 1990s, China engaged in confrontational behavior in the South China Sea and in 1995-1996, in

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[1] "Similarly, Beijing gained the support of Hong Kong's business community in opposing democratic reforms by the last British governor, Chris Patten, with threats to ruin their businesses after 1997."Bruce Gilley and Julian Baum, "Crude Tactics," Far Eastern Economic Review 163, no. 26 (2000): 25.

[2] "The implicit threat is to close Taiwan out while the rest of the world is rushing in," Bob Ross as quoted in *ibid.*

response to Lee Tung-hui's provocations, China conducted missile exercises off Taiwan's coast. Given these conditions, it is somewhat unsurprising that China's economic power would also be conceptualized in coercive terms. As China increasingly came to see itself as a rising power in the Asia-Pacific, it is unsurprising that China viewed its growing economic clout as yet another instrument of coercive capacity through which it ought to have been able to pursue its strategic objectives. Efforts based on such *Coercive Leverage* strategies characterize Phase 2. This phase spans the period of cross-Strait relations roughly from the 1995/1996 Taiwan Missile Crisis to shortly after the 2004 Presidential Election. The next two sections will briefly examine the presidential elections of 1996, 2000, and 2004 as three episodes that allow interesting comparisons on how China's strategic use of economics developed during this phase.

4.2.2 China's Coercive Leverage

In the 1996 election, Mainland China refrained from using coercive economic leverage against Taiwanese investors *per se*. In fact, during the 1995-1996 Missile Crisis, when China was explicitly using military tools of national power to pursue its strategic objectives, the Mainland authorities went to great pains to reassure Taiwanese investors that their economic activities on the Mainland would be insulated from any cross-Strait political friction.[3] The cross-Strait economic interaction had been growing rapidly until the mid-1990s instability dampened enthusiasm. Even at this low point in cross-Strait relations, the Mainland went to great pains to reassure Taiwanese investors that their investments would be insulated from broader cross-Strait frictions. "'The cross-straits economic and trade co-operation and other exchanges are in the

[3] "During the 1995-1996 and 1999-2000 Taiwan Strait incidents, the localities—particularly in the coastal areas—reiterated their pledge to protect the interests of TIE [Taiwan Invested Enterprises]. . ."Chen-Yuan Tung, "Cross-Strait Economic Relations: China's Leverage and Taiwan's Vulnerability," Issues & Studies 39, no. 3 (2003): 137-175. p. 169. Although to be fair, Tung is correct to note that it is uncertain to what degree these local preferences determined (or at least constrained) Beijing's behavior.

fundamental interests of the people on both sides of the Taiwan Straits and *have an important bearing on the development and prosperity of the Chinese nation*. Therefore they are not to be affected by political disparities across the Taiwan Straits,' said Chen Yunlin, Deputy Director of the Taiwan Affairs Office of the State Council, at a meeting with Taiwan investors in Fujian, a province facing Taiwan. 'No matter what happens, the rights and interests of Taiwan business people investing in the mainland will always be protected and will not be harmed . . .China's mainland 'is committed to provide better investment environment for Taiwan business people *for the prosperity of the Chinese nation in the 21st Century*,' Chen said."[4]

Contrary to *Coercive Leverage*, this reassurance was explicitly designed to offset any trepidation Taiwanese firms might have had regarding Beijing's intentions. This effort to reassure Taiwanese firms was largely driven by the fact that the Mainland still felt dependent upon Taiwanese capital and management expertise for its own economic development.[5] It sought to reassure investors and calm jittery capital markets. During the missile crisis, the Mainland sought to restrict its use of coercive power to the military realm in a heavy-handed attempt to intimidate Taiwanese voters and dissuade them from electing Lee Tung-hui as president. The heavy-handed effort backfired and Lee Tung-hui was elected by a wide margin. Following the 1996 election, China sought to apply greater pressure on Taiwan to prevent further moves toward independence.

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[4] "Political Disparities Won't Affect Taiwan Investors : Official," Xinhua News Agency, August 7 1995 [My italics added.] For evidence of additional reassurances, also see speeches of other senior Mainland officials and government media coverage at the time: "Wang Daohan Pledges to Protect Legitimate Rights of Taiwan Investors," Xinhua News Agency, October 29 1995; "Taiwan Investors' Interests on Mainland Reassured," Xinhua News Agency, September 7 1995; "Wang Daohan : Situation Across Straits Will Not Affect Investment," Xinhua News Agency, October 16 1995; and "Taiwan Investors' Interests Well Protected," Xinhua News Agency, September 26 1995; "China's Pledge to Taiwan Investors," Xinhua News Agency, March 25 1996.

[5] China's coastal economic engines of growth, particularly Fujian, was still highly reliant on Taiwanese capital and management expertise. This perspective will be discussed in more detail in the section on Phase 1 below.

However, the modality of China's coercion shifted from the military to the economic realm. This shift was largely driven by the counter-productive backlash that China experienced when attempting to use military tools of national power. For instance, China's aggressive posture in the South China Sea prompted a renewal of ASEAN's ties to the U.S. and a strengthening of cooperation among Southeast Asian nations largely directed against China. The Missile Crisis prompted the U.S. Seventh Fleet to intervene in the Taiwan Strait and the U.S.-Japan Alliance (which had been under re-evaluation in a post-Cold War context) was strengthened—largely driven by insecurity in the region.

Having learned through these recent experiences that military force was strategically ineffective, China sought to employ economic tools of coercion to pursue its objectives *vis a vis* Taiwan. Using this economic power involved targeting, threatening and "leaning" on Taiwanese businesses that were invested in the Mainland. Such firms are often called *taishang* (台商). China's efforts would be directed at targeting specific firms and their leaderships to dissuade them from supporting a pro-independence agenda.

The next two elections provided multiple instances of China attempting to use coercive leverage against Taiwanese firms that were invested in the Mainland. In 2000 and again in the 2004 election there were reported instances of coercion, intimidation or threat against Taiwanese firms. In the run-up to and aftermath of the 2000 election, Chinese attempts to "lean" on Taiwanese firms were scattered, blunt and poorly implemented. Unsurprisingly, they seem to have had little effect. However, during the 2004 election, it appears that Beijing refined its implementation tactics and honed in on specific firms and individuals. This more sophisticated approach seemed to have generated somewhat better results. As noted in the last chapter, in the aftermath of the 2004 election, China embarked on a reconsideration of how it had been using economic statecraft. This would eventually produce the strategy based not on *Coercive Leverage*, but rather on *Interest Transformation*. The evolution of China's cross-Strait economic statecraft would eventually mature into the long-term oriented *Interest Transformation* strategy that we observe today.

4.2.3 Leaning on Taiwanese Investors

The general practice of economic statecraft at this stage was broad and heavy-handed. China targeted many firms and sought to influence how they and their employees voted. Economic statecraft during these early days of *Coercive Leverage* can be roughly characterized as a direct application of the strategic mindset of intimidation and bluster that lay behind China's military coercion transposed into the economic realm. Still, using economic rather than military power represents an improvement over China's techniques of 1996. Before delving into the specifics of this case, it is useful to note two characteristics of the 2000 election.

First, as Taiwan democratized throughout the 1990s, its businesses also grew more and more politically active. As is the case in many democracies, political campaign contributions became an important factor of electoral success. In addition, Taiwanese businesses would provide candidates with endorsements. The support of large employers carried substantial weight for political candidates. Many of Taiwan's most successful multinational firms were viewed as thought leaders and widely admired in Taiwanese society. In addition, Taiwanese firms, like many businesses around the world, often sought to cultivate helpful political connections via active participation in the political process. On the eve of the 2000 election, many of Taiwan's most important firms were playing an advisory role for President Lee Tung-hui (the incumbent president who would retire in 2000). Although Lee was a member of the

KMT, his strong sentiments toward Taiwanese independence and efforts to "Localize" (本土化) Taiwan made him distrusted by Beijing. Mainland China viewed Taiwanese firms that cooperated with Lee suspiciously.

Second, the 2000 Taiwan Presidential Election was a very tight three-way electoral race and Mainland China sought to influence the outcome. The establishment KMT had been split by Soong's independent run. During the election campaigning, it was widely suspected that outgoing President Lee's real endorsement was for the DPP candidate, Chen Shui-bian and not for the official KMT candidate Lien Chan. The Mainland Chinese government was quite clear regarding its own preferences on who should be the next president of Taiwan. A few days before the Taiwanese electorate went to the polls, Zhu Rongji issued stern comments to the effect that Taiwanese voters were not allowed to choose a candidate that will seek independence for Taiwan. This was a thinly veiled attack on Chen Shui-bian whose DPP had long called for Taiwanese independence. Predictably, these comments angered Taiwanese voters and helped tip the scales in favor of Chen Shui-bian who had already begun to pull ahead in a tight race. Soong's split from the KMT party (Lien) divided what would have otherwise been the leading block. In the end, the DPP's Chen inched out Soong and won the election.

The Mainland was predictably displeased with this result and issued a very public statement criticizing the *taishang*. On April 8, 2000 Li Bingcai (李炳才), deputy director of China 's Taiwan Affairs Office of the State Council, issued a sternly-worded statement chastising *taishang* for "scrambling for profit" while "openly clamor[ing] for Taiwan independence and advocate[ing] the 'Lee Tung-hui Line,' which preaches the breakup of the motherland. It has exerted a bad influence."[6] His comments implied further pressure against *taishang* that did not

[6] "China Will Not Yield on Matter of Principle - Official," Xinhua General News Service, 8 April 2000.

uphold the "One China" principle. His condemnation was echoed by Tang Shubei (唐树备), executive vice-president of China's Association for Relations Across the Taiwan Straits (ARATS).[7]

Even before the election, several prominent *taishang* came under scrutiny during this period. For instance, Stan Shih Chen-jung (施振榮, Chairman of Taiwan's largest personal computer maker, Acer Group) had been a national policy adviser to Lee Tung-hui and seemed to have close ties to Chen Sui-bian. Shih had attracted attention for a DPP campaign advertisement that was using his image.[8] He had to issue a public statement declaring that he would not be present in Taiwan during the elections and that he wished to remain neutral. After Chen's victory, Acer products were removed from Mainland shelves and Shih had to make a special trip to the Mainland to publicly pledge his support for reunification.[9] Shih, who had normally enjoyed good access to officials and industry leaders was snubbed during an April, 2000 technology conference in Beijing. In responding to this pressure, an Acer executive was quoted as saying, "we definitely consider this is very serious for Acer business group in China… We have to be careful and sensitive in our response."[10] Acer had invested US$150 million in the Mainland and planned to expand its facilities there. In the end, Shih tried to distance himself from politics like many other *taishang*.

Acer was not the only Taiwanese business with political links. Continental Engineering Corporation, China Motor Corporation, I-Mei Foods Company, Ltd and E. Sun Bank all agreed to join Chen's national policy advisory group. The CEO of Taiwan High-speed Rail, Nita Ing (

[7] Tang alluded that *taishang* did little to promote reunification while reaping profits. Chung-yan Chow, "Business Leaders Warned on Independence," South China Morning Post, 10 April 2000.
[8] Dermot Doherty, "Taiwan's Business Leaders Take Sides before Vote " Dow Jones Newswire, 16 March 2000.
[9] Mure Dickie and James Kynge, "Business in Taiwan Heeds Warning on Independence," Financial Times, Apr 11 2000, p. 12.
[10] *ibid.*

殷琪), and Taiwan Semiconductor Manufacturing Chairman, Morris Chang (张忠谋), also served as policy advisors to Chen Shui-bian.[11] The CEO of Evergreen Shipping, Chang Yung-fa (张荣发), was another strong Chen supporter and long-time advocate of Taiwanese independence. Chang provided an important endorsement of Chen in the lead-up to the election and agreed to serve on Chen's policy making committee. China's liaison in Hong Kong, He Zhiming (何志明), reportedly warned Hong Kong businesses to be wary of choosing Taiwanese partners since pro-independence businesses would "face serious consequences."[12] This pressure was significant because a good deal of Evergreen's shipping was routed through Hong Kong (much of Taiwan's Mainland shipping moved through Hong Kong because of the lack of direct trade links). After the election, Evergreen retrenched and said it wanted closer economic links with the Mainland and that it did not support Taiwanese independence.[13] Evergreen's Mainland operations did not seem to be materially impacted by Chang's political activities although he too seemed to lower his political profile in the aftermath of the 2000 election.

One of the most high-profile supporters of Chen Shui-bian was the petrochemicals and plastics company Chi Mei (奇美) founder and CEO, Hsu Wen-lung (许文龙). Like Shih, Hsu had been an advisor to Lee Tung-hui and was known for his outspoken support for Taiwanese independence. Hsu provided a crucial endorsement to Chen about two weeks before the polls. In his endorsement, Hsu noted that Chen was the heir of Lee Tung-hui and was "the candidate

[11] Doherty, *Taiwan's Business Leaders Take Sides before Vote*
[12] "'Individual leading business figures have, on the one hand, openly supported Taiwan independence on the island, and on the other, obtained advantages from their economic activities in the mainland,' the official, He Zhiming, told a group of pro-Beijing businessmen. 'This is absolutely not permitted. I believe all of you, on listening to these remarks, will know how to choose when seeking Taiwan trading partners.'" From: John Pomfret, "China Warns Taiwan Firms Not to Back Sovereignty; Beijing Says Businesses Risk Losing its Trade " The Washington Post, 3 June 2000, sec. A, p. 9. The Hong Kong government denied this position "but the damage was already done." See the June 5, 2000 editorial in The Asian Wall Street Journal entitled: "China's Threats --- Withholding economic opportunities to influence Taiwan will backfire," p. 8. Also see: J.R. Wu, "Taiwan Businesses Can Still Seek the Good Earth but Wary," June 25, 2000. Dow Jones International News.
[13] Dickie and Kynge, *Business in Taiwan Heeds Warning on Independence,*

best able to follow the departing president's 'line.'"[14] Hsu also agree to serve as a policy advisor to the new Chen administration. Such blatant support infuriated Beijing. After the election, Chi Mei's Mainland factories and operations were subjected to surprise inspections, environmental regulations, tax, customs, and labor investigations.[15] "Starting in mid-May, teams of about 40 Chinese investigators descended on three factories run by Chi Mei in China's Jiangsu province and investigated them for a week . . . they [the investigators] intimated strongly that they had been dispatched to the factories because of Hsu's support for Chen. . .The Chinese officials 'were very blunt,' he said. 'They said our president had supported Chen. They had labeled him a Taiwan independence activist.'"[16]

Although Chi-Mei did receive harassing investigations, as Scot Tanner noted in his work on the *taishang*, most of these Mainland threats against pro-independence leaning *taishang* did not escalate into substantive actions taken against the offending companies.[17] The primary reason for this was the divergent perspectives between the central government (that sought to employ coercive leverage against Chen's supporters) and the local municipalities that hosted the Taiwanese businesses' investments in the Mainland. These local officials were much more pre-disposed toward ensuring that the *taishang* continued to provide important jobs and economic activities in their regions. There were numerous reports of local officials countermanding the centrally-issued threats.[18] In the end, the attempt at coercing these firms met with limited (if any) success, although China's *Coercive Leverage* tactics did seem to cause most *taishang* to

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[14] Mure Dickie and James Kynge, "China in Warning to Taiwan Businesses," Financial Times, Apr 10 2000, p. 10.
[15] Gilley and Baum, *Crude Tactics,*
[16] Pomfret, *China Warns Taiwan Firms Not to Back Sovereignty; Beijing Says Businesses Risk Losing its Trade*
[17] Murray Scot Tanner, *Chinese Economic Coercion Against Taiwan : A Tricky Weapon to use* (Santa Monica, CA: RAND Corporation, 2007).
[18] See for instance: "Business Trumps Politics," The Economist (U.S. Edition), July 28, 2001.

determine that it was more prudent to take a lower political profile, rather than risk attracting unprofitable attention.

One of the firms that did not buckle and as such continued to receive pressure from the Mainland was Chi Mei Group, led by its outspoken founder and long-time Chen supporter, Hsu Wen-long. In 2004, Chi Mei was considering expanding its operations on the Mainland to move into liquid-crystal display (LCD) distribution and assembly. Specifically, Hsu was planning to open another Mainland factory in either Shanghai or Ningbo for the Chi Mei TFT/LCD manufacturing subsidiary. The Mainland threatened that it would impose investment restrictions and subject any Chi Mei operations to intense regulatory scrutiny if Hsu persisted in his pro-independence advocacy. The Chairman of Taiwan's Mainland Affairs Council claims that Beijing had threatened Hsu with "investment restrictions and nonstop regulatory scrutiny of his Mainland operations. 'They applied a lot of pressure.'"[19] In June 2004, Chinese newspapers criticized Hsu Wen-lung by name and noted that all "Green" (i.e. pro-independence) businesses were no longer welcome on the Mainland. Chi Mei's Taipei Stock Exchange-listed TFT/LCD subsidiary took a 5% hit on the news. In the end, Hsu Wen-long would publish an open letter on March 26, 2005 criticizing Chen for going too far. In his letter, Hsu admitted that Taiwan's push for independence was a "recipe for disaster."[20]

It seemed that the Mainland's decision to focus on one of the most prominent supporters of Chen's independence stance was designed serve as an example to other *taishang*. Hsu made a good candidate to target since he seemed to be among the most unrepentant of the pro-DPP *taishang* following the 2000 election. Recognizing that they could not effectively enforce strict punishment measures on all the *taishang*, Beijing sought to single-out the most high-profile of

[19] Brian Bremmer and Matt Kovac, "China's New Taiwan Tack," BusinessWeek May 16, 2005.
[20] *Ibid.*

them and make an example of him. Hsu's response indicated that this more targeted effort to bring coercive pressure to bear on Chi Mei did have the effect of forcing Hsu to publicly back down from his previous support for Chen. These events provide a good example of how the Mainland uses its "king-making" capabilities to encourage or discourage the commercial success of enterprises in the Mainland. Those entities[21] that are not seen as being sufficiently supportive are excluded from lucrative contracts, are subject to intrusive regulatory oversight or may become targets of anti-corruption campaigns or any other variety of more subtle discriminatory measures. For those organizations and individuals that toe the line, Beijing has the ability to bestow very lucrative rewards, but Beijing also has the capacity to make life difficult for those entities that are out of favor. Such state favors (or disfavors) are often granted on the basis of political compatibilities with preferred government policy and objectives. Asymmetry and the increasing structural centrality of cross-Strait economics to Taiwan make this mechanism of *Coercive Leverage* seem more likely to be effectively employed to further Beijing's objectives in the future. This more sophisticated, targeted strategy—while still seeking to make use of the *Coercive Leverage* security externalities—seems to presage China's later efforts to engage in economic statecraft that was explicitly designed to not only enforce compliance with Beijing's wishes, but to alter the preferences of the commercial actors such that the commercial actors actually *wanted* the same objectives that Beijing sought.

By the time the 2004 election had arrived, the Mainland scaled back its efforts to interfere in a heavy-handed manner. What efforts did target *taishang* focused on the most out-spoken supporters of Chen and brought the full power of the central government to bear. In 2004,

[21] I use the term "entities" to denote that targets of this type of economic power are not only limited to the Taiwan case. Local governments, businesses, specific individuals, newspapers, or NGOs are some examples of entities that may be targets of such practices. The Hong Kong case provides several cases that illustrate how Beijing uses this sort of economic power.

Beijing was much more nuanced in its use of economics to pursue its strategic objectives. "Throughout most of the campaign, moreover, Beijing appeared to demonstrate much greater sophistication about influencing democratic politics than it had shown in the past. . . .Beijing largely refrained—though not entirely—from the type of finger-wagging public threats against the Taiwan electorate that had proven disastrously counterproductive in the 1996 and 2000 elections."[22] This evolution seems to provide some indication that the regime was learning how to more effectively use economic statecraft in its efforts to manage cross-Strait dynamics. Efforts in 2004 were more directed and targeted specific, high-profile measures against the most blatant pro-independence *taishang*. This more targeted approach yielded somewhat better results as Chi Mei's founder, Hsu Wen-lung publicly recanted his support for Taiwan's independence. However, *Coercive Leverage* still failed to prevent Chen's winning re-election in 2004. As mentioned above, in the aftermath of his re-election, the Mainland re-considered its *Coercive Leverage* -based approach to economic statecraft. This re-orientation marked the origins of the *Interest Transformation* strategy that the Mainland continues to use today.

The next section evaluates China's efforts to employ a strategy of economic statecraft that sought to exploit the *Coercive Leverage* type of security externalities. China's strategy is evaluated in terms of the theoretical framework presented in Chapter 2.

4.2.4 Evaluating the *Coercive Leverage* Strategy

So did China's economic statecraft in this phase work? China's objectives were to influence Taiwan's elections—specifically to prevent the more independence-oriented candidate from winning. To achieve this objective, China sought to target key business supporters. In 1996, 2000, and 2004 the independence-oriented candidate won. These results suggest that no,

[22] Tanner, *Chinese Economic Coercion Against Taiwan*, p.118.

strictly speaking, China's efforts to lean on the *taishang* did not succeed. That said, China *was* mildly effective at making life difficult for these firms. In the end, there is evidence that the *taishang* will be less likely to actively support contentious political positions going forward. Eventually, after blunt pressure from China several of the *taishang* seemed to back down or at least take a lower political profile and attempt to "fly below the radar." However overall, this coercive approach was strategically not successful because it generated a public backlash among the Taiwanese electorate. China's bullying validated the DPP's independence credentials and triggered nationalist support among the Taiwanese electorate who did not look favorably on the Mainland's efforts to intimidate Taiwan. In the end, China's heavy-handed tactics actually probably helped improve Chen's electoral position. So these attempts at economic statecraft were not successful for the Mainland. What went wrong?

First, did this instance meet the requirements for successful economic statecraft? In terms of size of the economic interaction and elasticity, it seems that yes, *taishang* were big enough to matter and China represented a unique enough partner for their operations that they did not have many alternatives to replace China as an operations center. However, when we examine the commensurability of China's goal (preventing Chen and the pro-independence DPP from holding power) with the tools of economic statecraft that China sought to employ (coercive leverage), it seems that the objective may have been outsized relative to the economic means available. *Coercive Leverage* may be useful for forcing compliance on a target, but for influencing Taiwan's election, a strategy based on *Interest Transformation* would have been more potent as China eventually learned during Phase 3 (as discussed above).

In terms of the factors that account for whether the state is able to control commercial actors, the divergent goals of the commercial actors and the state feature prominently in explaining where China's efforts may have faltered. The incentives of the commercial actors (*taishang*) were not aligned with the goals of the state. In the most successful cases, it seemed that the state could force *taishang* to hide below the radar to avoid ruffling feathers on the Mainland. However, the *taishang* that China targeted never *really* wanted to undermine Chen. Moreover, China had no real strategy to alter these commercial actors' preferences. Pressure was simply coercive and designed to ensure compliance (rather than redefine the *taishang*'s political views). This phase shows the limitations of using economic statecraft predicated on a coercive leverage strategy. Achieving China's goals required a strategy that was designed to exploit *Interest Transformation* security externalities. This was the strategic error that China committed in this instance: using the wrong tool for the strategic objective being sought. States must be attuned to what commercial actors want to accomplish and how doing what the state wants to see done might work to the advantage of the firms. In this case, China made it clear that life on the Mainland would be better if the *taishang* did what Beijing wanted. But in practice, many *taishang* understood that it was really the local and municipal officials who constituted the "state" that could determine how bad or good the *taishang*'s local Mainland operating environment would be.

The state's coercive capabilities were not as powerful as they could have been given that the state was not a unitary actor in this instance. The state suffered from division between the local municipalities and the central government with regard to their respective willingness to actually punish the *taishang*. Many Taiwanese investors had developed deep relationships with local authorities in Xiamen or Fuzhou to help ensure stability and political support for their investments.[23] Indeed, increasingly, local authorities' own political advancement hinged on their

[23] Such local support is critical in successful investments. According to Taiwanese businessmen, "policies, negotiations, or agreements signed by Taipei and Beijing help very little; what really controls the daily life is the

local economic performance. In many instances, this economic growth was heavily reliant on continued Taiwanese FDI and management human capital. The local cadre faced strong motivations stemming from their performance evaluation process that was heavily weighted toward regional economic performance. This gave them strong incentives to keep the Taiwanese firms happily invested in their region since these Taiwanese employers were a dynamic engine of regional economic growth. However, this narrow interest created tension and divisions between the central government in Beijing and the local municipalities where the *taishang* operated. The result was that the state did not act in a unified manner. As the theory suggests, the commercial actors were able to exploit these divisions to avoid serious punishment. This strategy enabled them to fly below the radar and continue doing business with minimal actual consequences arising from their political actions.

Although there were many *taishang* actively invested in the Mainland during this phase, their size and the public nature of their activities helped the state monitor and target firms. When compared to the large numbers of small and medium sized enterprises that constituted the commercial actors of Phase 1 and the disparate fruit farmers that were the commercial actors examined in Phase 3, these large *taishang* were relatively easier for the state to monitor and target. Indeed, the evidence suggests that the problem for the state was not so much being able to identify and monitor the firms, but rather that the internal divisions within the state that served to undermine efforts to coerce the firms.

It also seems that these internal divisions are to blame for the ineffectiveness of the state's regulatory capabilities. Although the nature of the relationship between the state and the commercial actors in this case is indirect, this feature alone should not have precluded effective

local city or county government," Leng cites his interview with Liu An-kuo, a Taiwanese lamp-maker in August of 1994. Tse-Kang Leng, "The State and Taiwan's Mainland Economic Policy," Asian Affairs: An American Review 23, no. 1 (Spring, 1996), p. 26.

government action. The regulatory environment had been largely decentralized and was resting mainly on local enforcement efforts. Since local officials diverged from the central government's objectives, the disunity of the state undermined the power of the state to leverage whatever authority it may have been able to wield via the *Reporting Relationship IV*. This undermined the effectiveness of state enforcement—a necessary tool for a coercive strategy.

From the perspective of the *Relative Resources IV*, the *taishang* had a good deal of local operating knowledge on the Mainland. Since the state was divided along center-local tensions, the distribution of the state's enforcement capabilities also played a role. The relative resource disparity between local enforcement capabilities and the central government's more limited resources further undermined the ability of the state to control the commercial actors in this context. The local officials seem to have had more the important bureaucratic resources in terms of enforcement than the central government in Beijing was able to bring to bear in this episode.

4.2.5 Conclusion

During this phase of the cross-Strait relationship, China attempted to capitalize on what was becoming an increasingly asymmetrical relationship. China's economic statecraft strategy sought to make use of *Coercive Leverage* security externalities by targeting specific large Taiwanese firms that had significant operations in the Mainland. These firms were targeted because key leaders of these firms supported Chen Shui-bian, the DPP, or pro-independence sentiments more generally. China's efforts to prevent independence-oriented candidates from winning presidential elections on Taiwan during this phase were unsuccessful.

China's economic statecraft seems to have suffered from three shortcomings. First, China was trying to change the national preferences of Taiwan via coercive leverage. This was the wrong strategic tool for such an enormous job. The *taishang* that China targeted had very firm views regarding their political preferences, rather than recognizing this and designing an *Interest Transformation* strategy to address this, China sought to use *Coercive Leverage*—a tool suited to enforcing compliance but not altering preferences. Second, the internally divided nature of the state during this phase made enforcement difficult to execute. Even if a *Coercive Leverage* approach had been appropriate, the central government authorities were seeking outcomes that were opposed to what the local authorities sought. This friction allowed the commercial actors to find shelter under the protection of local and provincial officials. Third, China's actions against the *taishang* reinforced the belief in Taiwan that China presented a menacing threat to Taiwan. Castigating the *taishang* confirmed suspicions of a China that sought to bully a much smaller Taiwan. Moreover, receiving such pressure seemed to validate the DPP's (and its supporters') anti-authoritarian credentials. In many ways, these firms were seen as standing up to China. China's policies stoked Taiwanese nationalism and on more than one occasion resulted in an electoral lift for the anti-Mainland candidate.

4.3 Phase 1 (1979-1996): Initiating & Deepening Economic Ties

Of course before China was able to attempt to leverage Taiwan's economic dependence on the Mainland, cross-Strait ties were characterized by the Mainland's efforts to attract Taiwanese investment, expertise, and trade. During this phase, the Mainland was largely reliant on Taiwan. To the extent that economic interaction carried strategic ramifications, they were mainly of the *Bolstering* variety. It was not until Beijing's post-Tiananmen isolation had begun to thaw that China felt it could try to employ the *Coercive Leverage* strategy discussed in Phase 2 above. The remainder of the chapter lays out the foundational phase of the cross-Strait economic interaction, from the initial contact through the 1995/1996 Taiwan Straits Crisis. This section begins by briefly highlighting the background conditions that both pulled and pushed Taiwanese capital toward the Mainland.

4.3.1 Background Conditions

The origins of cross-Strait economic statecraft are rooted in three background conditions that laid the foundation for economic interaction across the Taiwan Strait. First, domestic developments in China's political economy, namely in Deng Xiaoping's policy of "Reform and Opening Up" (改革开放) created significant "pull" for economic engagement with Taiwan. China's export-oriented development strategy relied heavily on foreign capital. Perhaps more importantly than capital, China needed Taiwanese management expertise. This often accompanied foreign investment and was particularly important as China was emerging from a socialist, planned economic model. Taiwan was an excellent source for such resources. Taiwanese investment and management expertise both served to bolster the Mainland's economy during this phase.

Second, rising production costs on Taiwan helped "push" economic activity toward the Mainland. Rising standards of living meant domestic production costs in Taiwan had risen considerably making the Taiwanese operating environment less internationally competitive. As part of an effort to ferret out new low-cost production centers, Taiwanese businesses began to explore the possibility of transferring some of their production to the much lower cost Mainland. Three phenomena in particular seem to have encouraged investment in Mainland China: the rising wage and land costs in Taiwan, stricter environmental regulations (which created pressure for many of the larger, more capital intensive polluting enterprises to move their dirtier operations to the more lenient Mainland) and the surplus of "idle capital" in Taiwan.[24] As capital controls were loosened and wages began to rise concurrent with Taiwanese economic development levels, the private sector increasingly sought out lower wage labor abroad.[25] In addition, as local communities began to enjoy greater voice and representation under democratization, environmental regulations tightened. This had the effect of increasing the costs for some of the heavier polluting Taiwanese industries like petrochemical refineries and industrial manufacturing.[26] Finally, there was evidence of a surplus of foreign exchange reserves that had been built up in the late 1980s which would have found a productive home in capital hungry Mainland China of the early 1990s.[27]

These two factors (China's "Reform and Opening Up" and Taiwan's rising production costs) were catalyzed by the third background condition: the liberalization of Taiwan's domestic political economy. Taiwan was in the process of consolidating its own nascent democratization during the late 1980s and early 1990s. During Phase 1, as Taiwan democratized, the KMT loosened its dominant grip on Taiwan's government and economy. As part of the democratization process, the KMT began to divest many of its large, state owned assets. Although done as part of the larger move from an authoritarian, single party state to a democratic, competitively elected form of government, the divestiture had the effect of privatizing a large portion of Taiwan's economic activity. This privatization meant that the

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[24] Richard C. Bush, *Untying the Knot: Making Peace in the Taiwan Strait* (Washington, D.C.: Brookings Institution Press, 2005) p. 28 also highlights the appreciation of the New Taiwan Dollar in addition to the rising costs of land and labor in Taiwan, as well as growing domestic demand for stricter environmental regulations.
[25] Karen M. Sutter, "Business Dynamism Across the Taiwan Strait," Asian Survey 42, no. 3 (2002): 522 especially p. 527.
[26] For a good case study of such dynamics see Laurids S. Lauridsen's "Policies and Institutions of Industrial Deepening and Upgrading in Taiwan I –the Basic Industry Strategy in Petrochemicals" Volume 4 (Working paper no. 10—produced for the GlobAsia Research Group, International Development Studies, Roskilde University, Denmark 1999).
[27] Tse-Kang Leng, "The State and Taiwan's Mainland Economic Policy," Asian Affairs: An American Review 23, no. 1 (Spring, 1996), p. 31.

interests of Taiwan's large economic actors would no longer be closely dictated by centralized government plans. "Increased political competition enabled civil society, especially business interests, to gain greater voice relative to the state than it had during the earlier period of state-guided export-led industrialization."[28] As would be seen in even more stark relief in later years, the private sector would increasingly base its behavior on a set of incentives that did not necessarily take into consideration the goals of the government.[29] Another consequence of Taiwan's democratization was the need for the state (especially the political parties) to curry favor with business interests.[30] Incidentally, this business influence on Taiwan's politics provided pretext that would later underpin China's attempts to lean on the *taishang* as part of its *Coercive Leverage* strategy during Phase 2.

Thus, the three background factors that set conditions for the initialization of cross-Strait economic interaction are as follows. First, Taiwan's democratization led to the liberalization of its state-dominated economic model. This increased the distance between the Taiwanese government and its commercial actors. As these assets were spun off and privatized, Taiwan's commercial actors would increasingly respond to commercial incentives rather than governmental control or direction. Second, the commercial conditions on Taiwan were changing as production costs were rising. This resulted in pressure for firms to seek out new, low-cost production centers. Third, China's "Reform and Opening Up" effort created substantial demand

[28] Steve Chan, "The Politics of Economic Exchange: Carrots and Sticks in Taiwan-China-U.S. Relations," Issues & Studies 42, no. 2 (2006): p. 6.

[29] This domestic political economy development on Taiwan is an important pre-cursor to the inability of the Taiwanese State to control its commercial actors—a dynamic observed later in the 1990s & 2000s. This makes it easier for commercial actors to avoid tight control as opposed to the earlier period of tight state control of the economy. As the Taiwan state liberalized and the economy became more and more privatized, the state had less ability to maintain control over its commercial actors whose cross-Strait engagement generated strategic externalities with which Taiwan's administrations would later have to contend. In Phases 2 and 3, China would seek to take advantage of these economic ties to further its strategic objectives.

[30] Seanon S. Wong, "Economic Statecraft Across the Strait: Business Influence in Taiwan's Mainland Policy," Asian Perspective 29, no. 2 (2005): 41-72., highlights the need for the DPP to moderate its position and tack to the center, but what may be more interesting is how winning elections in Taiwan became so dependent on campaign contributions and the important role of Taiwan's large corporations as a source for these types of contributions.

for foreign capital and expertise. The confluence of these three conditions enabled the start of the cross-Strait economic relationship.

4.3.2 The Mainland's strategic logic

The strategic logic behind the Mainland's economic statecraft during this phase is straightforward. China sought to induce *Bolstering* security externalities through increased investment from Taiwan. Recall from Chapter 2, *Bolstering* security externalities result from the Ricardian gains from trade or from the natural complementarities and efficiencies resulting from the efficient allocation of capital. *Bolstering* externalities are among the most basic of security consequences that arise from economic interaction. Improvements to one's economy is often the primary benefit states seek from engaging in trade or international investment in the first place. In this instance, China's economy suffered from a capital shortage. Also, as a consequence of thirty years of inefficient state planning and disastrous crash development programs, China lacked modern managerial expertise. During this first phase of the cross-Strait economic interaction, Beijing sought to encourage the initiation of economic ties, primarily to access Taiwanese capital and managerial expertise.

Taiwan provided a uniquely "Chinese" source of both of these key inputs for the Mainland's developing economy. In addition to having recently undergone a similar transition from a state-dominated economic system to a more liberalized, dynamic economy, Taiwan's early investors brought a unique perspective to the Mainland. Moreover, Taiwanese investors were coming from a similar cultural background. Many still had familial ties in the Mainland, thus providing valuable networks and sources of partnerships. Building on these elements, the Mainland sought to encourage Taiwanese investment. The initial cross-Strait ties were driven by these dynamics. After Tiananmen, the Mainland was seriously isolated as many countries cut their economic ties to the regime. Reform efforts ground to a halt. However, China's economic development needs did not change (even though the political climate had altered considerably). As a result, during the early 1990s when China was diplomatically isolated, China was particularly desperate for foreign capital and quality managerial talent. Taiwanese entrepreneurs stepped into the breach. This led to the first major surge of Taiwanese investment in the Mainland. During this period, Mainland China came to depend on Taiwanese capital.

To pursue its goals of attracting Taiwanese capital, China engaged in a number of policy measures and actions that were designed to attract, facilitate, and reassure Taiwanese investors. At the same time that the Mainland was working to generate *Bolstering* externalities, the Taiwanese government was either acquiescent, indifferent, or unable to effectively curtail its own private sector actors from engaging ever more deeply with the Mainland. As Taiwan's economy has developed, it has become more and more dependent on the Mainland. However during this initial phase of the relationship, the asymmetry in the relationship largely favored Taiwan. As a result, China can be observed going to great lengths during this period to maintain and increase the investment flows from Taiwan. Even in the face of the missile tests in 1995-1996 as the rest of China's cross-Strait policy was getting more aggressive, China sought to reassure Taiwanese investors, demonstrating its desire to maintain economic ties even in the face of cross-Strait animosity.

4.3.3 China's *Bolstering* Economic Statecraft

During this first phase of economic interaction, Beijing sought to encourage the initiation and development of higher levels of economic interaction with Taiwan.[31] Although the specific rationale for how economic ties would serve their interests were not always precisely or consistently articulated, the Mainland Chinese leadership generally seemed to agree that it was in Beijing's interests to develop closer economic ties to Taiwan. Specifically, deeper economic ties would not only further the PRC's economic development (by providing additional capital and culturally-relevant managerial expertise); it was also hoped that deepening economic links would lay the foundation for closer political ties sometime in the future.[32]

China actively began to reach out to attract Taiwanese capital in Deng's 1979 New Year "Message to Taiwan Compatriots." Since Chiang Ching-Kuo's 1979 "Three No's Policy" (no contact, no negotiation, no compromise) in response to the PRC's New Year "Message to Taiwan Compatriots," Taiwanese investors were officially prohibited from directly engaging in economic interaction with the Mainland. Despite these prohibitions, limited economic ties began to form in the early 1980s. These nascent efforts to develop cross-strait economic relations seem to have originated with Mainland overtures directly to Taiwanese investors.[33] As part of Beijing's export-oriented development strategy, in 1983 the PRC passed the "Guidance on Taiwanese Investments in Special Economic Zones and Related Favorable Policies." These initial overtures attracted early small business entrepreneurs who exploited familial and cultural ties in localized and regional investments on the Mainland. However, the scale and scope of

[31] By the late 1970s, the Chinese Communist Party faced public alienation after four decades of failed economic policies. Under the leadership of Deng Xiaoping, the party turned to economic growth based on liberalization that required massive amounts of foreign investment. Taiwan business owners were an obvious source because they had capital and because they were culturally Chinese. Bush, *Untying the Knot*, p. 28.

[32] *Ibid.*, p. 28

[33] As early as Marshall Ye Jianying's Nine Points speech in 1981, the PRC has been taking specific steps to facilitate private sector Taiwanese investment in Mainland China. Nancy Bernkopf Tucker, *Dangerous Strait: The U.S.--Taiwan--China Crisis* (New York: Columbia University Press, 2005) p. 102; also see: Bush, *Untying the Knot*, pp. 36-38.

these activities remained fairly minimal and levels of investment continued to be generally insignificant.

As the Taiwan government began to allow Taiwan citizens to visit relatives on the Mainland in late 1987, the PRC's State Council took the opportunity to pass "Regulations for Encouraging Investment by Taiwan Compatriots," (sometimes called "The 22 Articles") in July of 1988 to clarify the incentives and provide clearer economic legality governing Taiwanese Mainland investment.[34] Less than a year later, in May of 1989, Xiamen and Fuzhou (both in Fujian Province—a province with strong historical, cultural and familial ties to Taiwan) were designated as investment zones for Taiwan firms. T. J. Cheng, in his chapter contribution to *Dangerous Strait,* offers a useful observation that Mainland government policy designed to attract Taiwanese FDI has had two components: protection of Taiwanese investment and the creation of incentives. Based on these events, it seems that the initial spark of cross-Straits economic interaction was largely motivated by changes in the Mainland investment environment. These changes were designed to attract Taiwanese investment which helped bolster the Mainland's economic development—this was the dominant strategic priority for China under Deng Xiaoping.

However, investment levels remained at fairly insignificant levels until the events of Tiananmen in June of 1989 diplomatically isolated Beijing from the rest of the world community. As part of the sanctions imposed on China in response to its crackdown on student protestors, the western-based FDI upon which much of China's future development strategy

[34] These articles contained all the special inducements offered to foreign investors, but went several steps further by allowing Taiwanese investors to sell stock in projects, rent government-owned factories, and take over and operate state enterprises by guaranteeing a certain amount of earnings to the state. See: Leng, "The State and Taiwan's Mainland Economic Policy," p. 29 and Tucker, *Dangerous Strait*, p. 102.

rested was suspended.[35] While most of the rest of the world community suspended economic ties to China, entrepreneurial Taiwanese investors leapt at the opportunity to fill the void.[36] By the end of 1989, 1,600 Taiwan enterprises had invested $1.2 billion. Indirect trade volume in 1990 would grow to $3.5 billion.[37] Taiwanese investment began to grow considerably during this period as capital hungry China took measures to encourage and facilitate Taiwanese investment even further. For instance in March of 1990, Wang Yung-ching (王永庆) CEO of Formosa Plastics signed an agreement of intention to move a multibillion dollar investment to Haichang. Deng Xiaoping ordered "green-light treatment" and priority development for this project in Haichang.[38] Although the plan eventually folded under heavy pressure from Taipei, this effort was illustrative of a notable shift that began to occur in the early 1990s. Increasingly, larger Taiwanese enterprises were looking to invest in mainland China. The huge growth in economic activity in the run up to and the aftermath of the Koo-Wang talks illustrates this point.[39] Contracted FDI levels in 1992 and 1993 show a big jump as the Taiwan and PRC governments signaled their official sanctioning of this economic interaction.[40] The lack of an established track record and the absence of and/or questionable reliability of Chinese economic

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[35] Yu-shan Wu notes that during this post-Tiananmen period, the PRC's cross-Strait economic strategic behavior was driven more out of economic necessity stemming from suspended investment flows rather than by any serious motivation to use economic interaction to unify Taiwan. See Wu, "Mainland China's Economic Policy Toward Taiwan: Economic Needs Or Unification Scheme?" Issues and Studies 30, no. 9 (September, 1994), 29-49.
[36] Weng notes that Taiwan offered only "half-hearted condemnation" of the Tiananmen crackdown. B. S. J. Weng, "The Evolution of a Divided China" in *The Chinese and their Future: Beijing, Taipei and Hong Kong*, ed. Z. Lin Thomas W.Robinson (Washington, D.C.: AEI Press, 1991), p. 373. Instead of an expected cooling of cross-straits economic activity, investment activity actually picked up steam during this period as Western capital flows dried up. The degree of China's isolation should not be too overstated, however. In addition to Taiwanese FDI, Japan was also fairly quick to re-instate much of its economic aid and loans.
[37] *Ibid.*
[38] *Ibid.*
[39] Cheng notes that Deng's South China Tour is also likely to have been responsible for attracting Taiwanese FDI during this period. See: Tucker, *Dangerous Strait*, p. 97.
[40] It should also be noted that during this time, the Taiwanese government relaxed its position on prohibited investments in Mainland China. Under this more relaxed atmosphere, a higher level of investment was officially reported to the government. Thus the unusually high levels of FDI reported in 1993 are in part due to the belated registration with the Taiwanese Investment Commission (part of the Ministry of Economic Affairs) by firms that invested surreptitiously in China previously. For more on this see Cheng in Tucker, p. 97.

infrastructure and supporting legal frameworks gave investors some pause.[41] However, by 1994, the National People's Congress enacted the "Investment Protection Law" whose further codification of private property rights cleared the way for larger, more complex and more formal investments. This effort combined with tax incentives and land provisions seem to have been effective in attracting not only small and medium Taiwanese enterprises during this period but increasingly larger Taiwanese corporations.[42] By this time, cross-strait investment began to include more and more large and medium sized companies rather than the first wave of cross-strait investors—the small, entrepreneurial ventures.

In summary, the opening phase of the development of cross-strait economic ties seems to have been driven by active Chinese government regulations and policies designed to attract Taiwanese capital. This was part of China's strategy of economic statecraft that was designed to encourage *Bolstering* security externalities. The Deng-era reforms and an increased demand for Taiwanese FDI following the events of Tiananmen made the Mainland investment climate even more attractive during this phase. At the same time, economic changes on Taiwan like rising textile wages and stricter environmental regulations seemed to add additional force to private sector assessments of whether or not to invest in Mainland China. As evidenced above, cross-Strait economic interaction began and then proceeded to rise rapidly during this period.

During the more than fifteen years that Taiwanese investments had been flowing into Mainland China, the supporting economic infrastructure had become more and more developed. Property rights became increasingly better secured and legal protection was passed to facilitate

[41] Frequently, supporting legal infrastructure was locally-based and relied on maintaining good relations with local municipal authorities. Until the Koo-Wang talks and the "Regulations for Encouraging Investment" there was little nationally-based law to govern the security of private property rights and other issues of ownership and transfer.
[42] Tax concessions included two years of corporate tax exemption and three years of 50% reduction. Land concessions filled out the offering with government-led development of industrial estates to facilitate the synergistic benefits of larger technology parks.

investment activities.[43] Toward the end of this phase, as the Mainland investment environment became less risky, larger second-mover investors became active in the Mainland. As the asymmetry in the relationship began to shift in the mid-1990s, these *taishang* would be targeted when China shifted its economic statecraft strategy from one seeking to create *Bolstering* security externalities to one that more aggressively sought to influence the elections in Taiwan by employing the *Coercive Leverage* discussed in Phase 2.

4.3.4 Evaluating China's *Bolstering* Strategy

This section examines the effects that early Taiwanese investment had on China's coastal development. Phase 1 of the cross-Strait economic interaction included the initial opening of ties that laid the foundations for future, more active forms of economic statecraft. However, the dominant security externalities that were generated during this period of the relationship are of the *Bolstering* type of security externalities. Strategies for maximizing its strategic effect are fairly passive and mainly occur as a natural result of Ricardian gains from trade (or investment).

Mainland China's strategic goal during this phase was economic development away from its rather unproductive state-planned economy. The policies that China developed during this period to attract Taiwanese investment were largely successful. Taiwanese investment contributed to the economic growth and development of China (particularly the coastal provinces like Fujian) as the economic interaction generated *Bolstering* security externalities. These effects of the Taiwanese investment often came in the form of productivity and efficiency gains.

[43] Defining and ensuring enforcement of private property rights was a key source of uncertainty and insecurity that Beijing tried to address in its development of a supporting legal and economic infrastructure in Mainland China. For more on the centrality of property rights in economic development see Douglass Cecil North and Robert Paul Thomas, *The Rise of the Western World; a New Economic History* (Cambridge, UK: Cambridge University Press, 1973); Douglass Cecil North, *Structure and Change in Economic History*, 1st ed. (New York: Norton, 1981); Oliver E. Williamson, Sidney G. Winter and R. H. Coase, *The Nature of the Firm : Origins, Evolution, and Development* (New York: Oxford University Press, 1991).

In this phase, China's economic statecraft strategy seems to have been largely successful. The form of economic interaction (namely investment capital) was large and fairly inelastic given Taiwan's unique cultural affinity, geographic proximity, level of development, and recent experience of converting from a state-dominated economic model to a more privatized one. Also the goal (economic development) that China was seeking was commensurate with the instruments employed to achieve that goal.

China was successful at getting the commercial actors (in this case Taiwanese investors) to engage in economic activity that generated the strategic externalities that China sought. In terms of the *Unity of the State IV* in this phase, both the central government in Beijing and the regional local authorities sought similar objectives, namely economic development. As a result, there were no serious divisions within the state. This alignment of goals between the center and local Chinese government authorities stands in stark contrast to the dynamics observed in the *Coercive Leverage* cases in Phase 2. Because the state was acting in a unified manner, it was more effective. Although there were many small and medium-sized enterprises that initially made up the commercial actors in question, this large number of relatively small firms did not seem to pose problems for China to effectively monitor and enforce compliance on these actors since much of the *de facto* business-government relations were effectively decentralized to local authorities. In addition, the *Goals* the commercial actors sought and what the state wanted of them were very complementary. The *Reporting Relationship* between the Chinese state and these firms was very indirect. It consisted mainly of loose regulatory relationships. The Chinese state offered several incentives and tax breaks to attract the investments but there was no direct government financing, management or ownership over these Taiwanese commercial actors. The *Relative Resources IV* independent variable did not seem to factor strongly in accounting for why the state was able to get these commercial firms to behave in a manner that was conducive to the state's pursuit of its strategic objectives.

4.3.5 Conclusion

Economics plays an important role in Mainland China's contemporary relationship with Taiwan. This chapter and the preceding one explored the evolution of that relationship. This chapter looked at the early phases of economic statecraft in the context of the cross-Strait relationship. This examination of the development of cross-Strait relations and last chapter's exploration of recent developments seem to suggest that China has undergone a process of learning and has employed a gradually more sophisticated approach to economic statecraft. In particular, these chapters focused on several specific episodes in which the Mainland sought to use economic statecraft to pursue its strategic objectives *vis a vis* Taiwan. The development of Mainland China's economic statecraft in the context of the cross-Strait relationship seems to have exhibited a pattern of gradually more sophisticated use.

There have been three phases in this learning process: in the first phase, the Mainland was primarily interested in gaining access to Taiwanese capital and management expertise as part of its reform and opening up efforts. As economic ties grew and Taiwan became increasingly dependent on the Mainland, Mainland China attempted to leverage its economic position as a coercive tool. This constitutes the second phase. This chapter examined specific attempts to use *Coercive Leverage* in which Taiwanese investors came under pressure from the Mainland authorities. In the third phase, Mainland China has become more nuanced in its employment of economic statecraft. Today, Mainland China is mainly focused on transforming the interests of Taiwan and using economic ties to deter independence. As discussed in Chapter Three, this phase includes the opposition party visits to the Mainland in early 2005 and the subsequent elimination of tariffs on Taiwanese fruit exported to China.

Today, China continues to strengthen economic ties in an attempt to alter the interests of Taiwan. The recently ratified Economic Cooperation Framework Agreement (ECFA) promises to tie Taiwan even more closely to the Mainland economy. Over the long-term, this strategy of engagement seeks to encourage Taiwan to redefine its own national interests in such a way that makes *de jure* independence counterproductive and encourages eventual reunification with the Mainland. By creating increasingly numerous and powerful vested interests in Taiwan that minimally seek continued stability (i.e. no moves toward *de jure* independence) and maximally seek reunification, China is engaged in a strategy of economic statecraft that is designed to achieve its long-term strategic goals with respect to Taiwan.

Chapter Five

China's National Oil Companies and "Going Out"

5.1 Introduction

This chapter and the next examine China's efforts to secure strategic resources. As discussed in Chapter 2, economic interaction that pertains to strategic resources often entail *Strategic Transfer* type of security externalities.[1] How does China secure the transfer of what it views as strategic raw materials? These chapters highlight the business-government dynamics that play such an important role in China's economic statecraft. The Chinese government has largely relied on a strategy that seeks to create internationally competitive corporations over which the state seeks to maintain control. This strategy seeks to reap the benefits of commercialization (e.g. efficiency, productivity, innovation, economic strength, etc.) without losing the stability and sense of security that comes from state control.[2]

To explore exactly how the state utilizes economic statecraft in the context of strategic resources, this chapter focuses on China's efforts to secure oil. State planners have identified petroleum as one of the most important (if not the most important) strategic resources that must be secured.[3] The government's efforts in this area involve the creation and subsequent "Going Out" of the Chinese national oil corporations (NOCs). These corporations were among the

[1] Bear in mind that although the *Strategic Transfer* security externality can involve any number of types of strategic resources being transferred to a country (including dual use technologies, expertise/personnel, weapons sales, etc.), this chapter will only focus on one type of *Strategic Transfer*: that concerning strategic resources. Strategic resources are the raw inputs that the state has defined as strategically significant.

[2] Mikael Mattlin, *The Chinese Government's New Approach to Ownership and Financial Control of Strategic State-Owned Enterprises* Suomen Pankki (Bank of Finland), 2007 pp. 25-26.

[3] The State Council has defined seven industries as "strategic." They are: defense, power generation and distribution, oil and petrochemicals, telecommunications, coal, aviation and shipping. See: "关于推进国有资本调整和国有企业重组的指导意见" [Guiding Opinion on Advancement of State-Owned Capital Restructuring and Reorganization of State Owned Enterprises] issued by SASAC on Dec 18, 2006 available at: www.sasac.gov.cn/gzjg/xcgz/200612180138.htm Also see: *ibid.* p. 16 especially Table 1.

earliest Chinese commercial actors to venture abroad. This chapter highlights these efforts with a particular focus on Africa—a leading destination for China's resource extractive activities.[4] When China's leaders define China's strategic interests in raw materials, Africa features prominently.[5] Exploring this area is useful for illustrating the theory since much of the empirics demonstrate how Chinese firms can get out from under the state's ability to control them. The theory provides an analytical framework for understanding what factors enable these dynamics and provides insight into the conditions under which the state can (or cannot) control the activities of its commercial actors. Finally, the examination of Chinese oil extraction in Africa also illustrates how commercial actors can generate undesirable strategic concerns for China.

5.2 China's Security and Strategic Resources

The discussion of China's grand strategy in Chapter One noted the importance of regime stability. Continued economic growth was a critical component of this regime stability. China today defines its strategic security interests in terms of maintaining the Communist Party's control of government. Keeping the regime in power is at the core of many of China's strategic interests as those are defined by the current leadership. Maintaining the Party's legitimacy

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[4] "It should be pointed out that although oil is a major and obvious source of Chinese interest in Africa, it is far from being the only one. China is actively seeking resources of every kind: copper, bauxite, uranium, aluminium, manganese and iron ore, among others, are all being sought out acquisitively by Beijing."Ian Taylor, "China's Oil Diplomacy in Africa," International Affairs 82, no. 5 (2006): 938. Although oil is the dominant raw material that China seeks from Africa, Taylor notes that "South Africa provides iron ore and platinum, while the DRC and Zambia supply copper and cobalt. Timber is sourced from Gabon, Cameroon, Congo-Brazzaville, and Liberia, while various western and central African nations supply raw cotton to Chinese textile factories." Ian Taylor, *China's New Role in Africa* (Boulder: Lynne Rienner Publishers, 2009 p. 162.

[5] For an insightful treatment of China's Africa policy in light of China's domestic development see: Wenran Jiang, "Fuelling the Dragon: China's Rise and its Energy and Resources Extraction in Africa," The China Quarterly 199, no. -1 (2009): 585. For a statement of China's official Africa strategy in English see: People's Republic of China, Ministry of Foreign Affairs, "China's African policy," 2006. Available at http://www.fmprc.gov.cn/eng/zxxx/t230615.htm.

requires continued economic growth.[6] Economic growth, in turn, needs raw inputs.[7] This is especially true for energy inputs. "...The legitimacy of the CPC's political system is based on its ability to sustain economic growth in the postmillennial era—one that is hampered by a long-term decline in domestic oil production."[8] This declining production is coupled with a monumental surge in Chinese demand for energy.[9] Much of this energy need is met with coal (which is viewed as being more reliable given China's huge domestic deposits of the fuel). But coal cannot supply all of China's energy needs. Much of the rest comes from oil and increasingly, much of this oil is imported from abroad. China's reliance on international sources of petroleum subjects the Chinese economy to price shocks.[10] At a more fundamental level, China also seems to be concerned about supply risk—its continued ability to gain access to oil.[11] Thus, China's strategic interests are intimately connected to its ability to secure raw materials.[12]

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[6] Robert G. Sutter, *Chinese Foreign Relations : Power and Policy since the Cold War* (Lanham, MD: Rowman & Littlefield, 2008).

[7] China's surging growth has also entailed significant increases in its demand for raw materials. "Though China's demand for these imports certainly will go up and down with economic cycles, from 1995 to 2003, China accounted for 68 percent of global demand growth for oil, 82 percent of steel, 100 percent of copper, 100 percent of aluminum, and 73 percent of nickel." David M. Lampton, *The Three Faces of Chinese Power : Might, Money, and Minds* (Berkeley: University of California Press, 2008) p. 91.

[8] From Taylor, *China's New Role in Africa,* p. 18 citing Taylor, "China's Oil Diplomacy in Africa."

[9] Jianhai Bi and David Zweig, "China's Global Hunt for Energy," Foreign Affairs 84, no. 5 (2005): 25.

[10] "According to official estimates in China, for every one-percent increase in international petroleum prices that lasts one year, China's GDP growth rate is likely to drop by 0.01 percentage points." Bo Kong, *China's International Petroleum Policy* (Santa Barbara, Calif.: Praeger Security International, 2010 p. 46.

[11] Many countries are concerned about price risk—that the price of oil will go up and harm their economic growth, but few today actively look to hedge against supply risk—that the nation will not be able to access oil at all. That China is concerned about supply risk when many other nations are not is an interesting point and deserves to be explored further in a separate article.

[12] Securing raw materials (including oil) is a dominant theme among China's leadership. See for instance, Premier Zhu Rongji's March 5, 2001 comments on the draft outline of the Tenth Five Year Plan: "关于国民经济和社会发展第十个五年计划纲要的报告." Available at: www.sdpc.gov.cn/fzgh/ghwb/gjjh/W020050614801666916182.pdf In that plan, China also developed its first "Energy Development Key Special Plan" (国民经济和社会发展第十个五年计划能源发展重点专项规划) as a complement to the Tenth Five Year Plan. Available at: http://www.sdpc.gov.cn/fzgh/ghwb/zdgh/t20050714_36295.htm

5.3 A Brief History of China's Oil Sector

So how has China gone about providing for its oil needs? This section briefly encapsulates the evolution of China's oil industry. The development of China's oil sector has been punctuated by three major periods. In the early days of the People's Republic, oil exploration and production were fully concentrated on China's domestic territory. China was not yet industrialized and oil production was conducted via localized, mass mobilization programs. These efforts (when successful) produced many fragmented provincial or even township-level petroleum enterprises. These integrated oil entities (called petroleum administrative bureaus) lacked economies of scale and often included exploration, drilling, and refining operations (such as they were). These localized efforts were eventually organized into a national ministry.[13] The Ministry of Petroleum Industry (MPI) owned, managed, and operated all of the petroleum production capacity of China. China's petroleum activities were conducted according to the government's economic planning. The oil sector was a fully government controlled entity and there were no significant issues concerning the state's ability to control the commercial activities in this sector. Under communism, the commercial actors *were* the state. The bigger problem was the host of economic inefficiencies, under-investment, and long-term decline of productivity that frequently plagues state economic planning efforts.[14] For example, the sector suffered from under-investment which often resulted in low yields from oil fields. Investment levels were suboptimal because oil producers had no incentive to invest since oil prices were so low. Oil

[13] The specific name and scope of the line ministry that was charged with administering China's petroleum (and often chemical) assets changed a number of times since October 1, 1949 as a result of various reorganizations. The original ministry was called the Ministry of Fuel Industry. However, what matters for the purposes of this chapter is that the assets were always managed, owned and operated by directly by the state ministry.

[14] Such pathologies include the lack of meaningful price signal, under- (or over-) planning estimates, absence of commercial incentives, shirking, and a host of other deadweight losses. The issues that frequently bedevil planned economic systems are well depicted in János Kornai, *The Socialist System : The Political Economy of Communism* (Princeton, N.J.: Princeton University Press, 1992).

prices in the plan were kept low because of fears of inflation and a general desire to stimulate economic growth.

Beginning in 1981, the Chinese oil industry began to change. In this second phase, efforts were made to liberalize China's oil sector. In 1981, China introduced a two-tiered pricing system under which the MPI was obligated to supply the central government with a specific, contracted amount of oil. Any oil that was produced in excess of this contracted amount could then be sold directly into the domestic China market at prices that were above those stipulated in the plan. Excess oil could also be sold on the international market (to buy technology, equipment, data, etc. for its operations). This was designed to create pricing incentives to increase oil production. MPI, in turn, subcontracted production agreements with local petroleum administration bureaus (these were the local, integrated petroleum operations mentioned above). Any oil that the petroleum administration bureaus produced over contract could, in turn, also be sold directly into the market at above-plan prices. Again, as was the case with MPI's obligation, the individual petroleum administration bureaus were allowed to keep the resulting revenues.

In addition to these basic pricing reforms, China's oil industry was reorganized in the 1980s. Up until that point, the Ministry of Petroleum Industry (or one of its predecessor ministries) controlled the exploration, production and refinery assets of China.[15] These government ministries were also responsible for the administration, oversight and planning of China's petroleum industry. In 1982, MPI's off-shore upstream oil assets and offshore exploration and production assets were reorganized into the China National Offshore Oil Corporation (中国海洋石油总公司 CNOOC). CNOOC continued to be wholly owned by and

[15] Virtually all of China's petroleum assets resided in the ministry. The major exception was the China National Chemicals Import and Export Corp (SinoChem) which was a state owned enterprise created in the 1950s to conduct international oil trading. Since China's economy was a closed economy, only certain entities were authorized to conduct international economic activities.

still reported into MPI. However, the new corporate structure was designed to improve the productivity of China's oil assets and to begin to split off the government's regulatory and administrative roles from its commercial activities. The reforms also allowed CNOOC to engage in cooperation with foreign oil companies as part of an effort to enhance CNOOC's offshore drilling technology. The head of CNOOC maintained his vice-ministerial rank. In 1983, the government reorganized the refining and petrochemical operations of MPI. These were combined with the chemical operations of the Ministry of Chemical Industry and the synthetic fiber manufacturing assets of the Ministry of Textile Industry to create the China Petroleum and Chemical Corporation (中国石化 Sinopec).[16] Like CNOOC, the head of Sinopec maintained his bureaucratic rank (in this case, Minister). With Sinopec focused on owning and operating China's downstream refining assets and CNOOC owning and operating China's offshore upstream production assets, MPI was left with China's natural gas and onshore, upstream oil production and exploration assets. These assets were grouped into the China National Petroleum Corporation (中国石油天然气集团公司 CNPC) in 1988. Interestingly, CNPC also inherited all of MPI's administrative functions including product quality standards and environmental regulation.[17] The head of CNPC also retained his ministerial rank. CNPC and Sinopec eventually consolidated and rolled up the numerous smaller production and refining entities that existed at the local and provincial levels to create national oil majors. When the reorganization dust had settled, China was left with CNOOC which controlled China's offshore, upstream production assets, Sinopec which was primarily focused on refining assets, and CNPC which

[16] Jin Zhang, *Catch-Up and Competitiveness in China : The Case of Large Firms in the Oil Industry* (London ; New York, N.Y.: Routledge Curzon, 2004).
[17] MPI was abolished when the CNPC was created in 1988.

encompassed the rest of China's petroleum industry (primarily onshore, upstream production assets). All three state-owned corporations reported directly to the State Council.

In 1994, the system was further liberalized and the central government did away with plan contracts. Instead, in-plan pricing was integrated with the prevailing above-plan pricing. Although the government still controlled pricing closely, this was a meaningful step toward liberalization. Also in 1994, all state-owned enterprises (including those in the oil industry) were officially permitted to keep profits. This was an important step in China's reform efforts and instituted a considerable degree of commercialization into SOE operations. By 1998, Chinese oil companies were permitted to use marker pricing. This form of pricing tied Chinese pump prices to world crude prices. This pricing reform allowed China's domestic prices to more accurately reflect world energy prices. However, the pricing still did not really connect to China's domestic market demand. Eventually, the oil companies were permitted to adjust prices within 5% then 8% bands, but the state continued to keep tight reins on petroleum pricing given its inflationary potential.

The reforms of China's oil sector mirror the larger Chinese economic reforms of the 1980s and 1990s: a pattern of gradual liberalization and reform of the Chinese economy moving it towards a more commercial orientation. Although these reforms were initially designed to improve the productivity of China's oil production efforts, they would also sow the seeds of the commercialization of China's oil industry. This commercialization would eventually make it very difficult for the state to maintain control over the behavior of its commercial actors.[18]

[18] The liberalization of China's oil sector provides a useful illustration of the "paradox of economic statecraft" presented in Chapter 2. States seeking to exercise economic power need to be able to direct that economic behavior. However, the more states try to direct the economic activities of commercial actors, the greater the distortion and eventual erosion of "economic gunpowder" that the state has at its disposal. If states seek to increase their productivity by giving commercial actors free rein, it becomes that much more difficult for a state to direct its economic might.

"Indeed, the more China liberalizes, the less easy it is to control private businesses domestically, let alone in far-off Africa."[19] As its commercial actors took on more and more active roles internationally, China would find that their activities often entailed strategic consequences for the state.

By 1998, China's oil sector had entered the third phase of its evolution. As China was increasingly becoming integrated into the global economy, it became evident that the partial liberalization of China's oil sector was not a stable equilibrium. The new oil companies lacked integrated petroleum operations. This exposed them to significant shocks from price volatility. In other words, by concentrating a company only on upstream production and exploration assets, that company would be heavily exposed to the price of oil. Such companies would have a very difficult time absorbing price volatility—when the price of oil was high, it would reap windfall profits, but when the price was low, it would suffer significant shortfalls. The same logic punished or rewarded companies focused exclusively on downstream refining, processing and distribution. If the price of oil was high, a refining operation would suffer losses. When oil was cheap, this sort of enterprise was poised to make significant profits. To help smooth out some of this instability and to prepare China's NOCs for the global competition that they would face once China entered the WTO, the State Council swapped some of CNPC's (upstream) and Sinopec's (downstream) assets with each other. This was done roughly on the basis of geography, giving CNPC assets concentrated in the North and Sinopec's in the South). This move gave both major players upstream and downstream assets in their portfolio. The State Council also gave them trading rights thus enabling the companies to engage in the international trading of petroleum and petroleum products. This wave of re-organization also took the corporations out of their

[19] Taylor, *China's New Role in Africa,* p.167 citing his interview with a Chinese trader, in Praia, Cape Verde November 5, 2007.

administrative and regulatory roles, moving that to a relatively weak State Petroleum and Chemical Industry Bureau (under the State Economic and Trade Commission).[20]

The final move toward commercialization occurred with the public listings of the crown jewel assets of each of these NOCs. The central government sought to conduct public offerings of China's NOCs in order to tap international capital markets, but also to expose these firms to market pressures, shareholder obligations, and even corporate governance as a way to improve their international competiveness. However, when these firms were listed, the government structured the offerings such that the state would be assured of retaining control of the parent company. The assets that were attractive to the markets were placed into new shell companies that would be the actual listed companies that would trade on the exchanges. For CNPC, its assets were placed in PetroChina which was listed in April 2000 (the state retained 90% ownership of the company). Sinopec was listed in October 2000 with the state retaining 77% of the ownership. CNOOC was listed in February 2001 and the state held onto 71% of the ownership. Creating these publicly-traded companies was another important step toward reform and liberalization. These moves were designed to improve the NOCs efficiency and create more effective commercial tools for China to procure oil. "Increasingly, China is relying on its oil companies to provide the means of securing energy security, linking itself to a market-base form of energy security."[21] However, this commercialization (in particular the growing gap between

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[20] From the point of view of the *Reporting Relationship* these bureaus were bureaucratically outranked by the ministerial level authority held by the heads of CNPC and Sinochem. As discussed in more detail below, this disparity added to the difficulty faced by the state regulators.
[21] Pauline Kerr, Stuart Harris, and Yaqing Qin, *China's "New" Diplomacy : Tactical Or Fundamental Change?*, 1st ed. (New York: Palgrave Macmillan, 2008) p. 220.

the state and the commercial firms) laid the groundwork for future challenges for state control that characterize the business-government relationship today.[22]

For example, the reorganization of the MPI created many of the large asymmetries that can be observed along the *Relative Resources* dimension of business-government relations in the petroleum sector. In the wake of the transition, virtually all of the government's institutional knowledge and resources related to the petroleum sector as well as the state's expert personnel and even regulatory budgets moved over to take up residence within the new oil corporations that were formed. The new companies inherited their predecessors' bureaucratic rank, administrative functions, personnel, and the institutional memory of the state ministries. This left little by way of resources in government. Regulatory agencies were under-staffed and operated under large information asymmetries that included gaps in industry knowledge, expertise, and appropriate personnel.[23]

In addition, indicators for the *Reporting Relationship* IV suggest that state control of these commercial actors would not be easy. For example, during the reorganization process, the ministerial leadership transitioned right over into the leadership posts of the new NOCs. Wang Tao (王涛) the then minister of MPI went on to become the head of CNPC. His deputy, Zhou Yongkang, (周永康) became vice-president of CNPC.[24] Chen Tonghai (陈同海) went from being the deputy director of the State Planning Commission to becoming the deputy general manager of Sinopec in the 1998 reshuffle. He would be promoted to director and vice-chairman

[22] Such frictions and state-commercial coordination challenges are fairly typical across all avenues of Chinese economic statecraft. The hybrid model of government involvement with commercial actors is what makes China such an interesting case to explore to understand exactly how states actually practice economic statecraft.
[23] "As a result, the SPCIB often deferred to the three NOCs over policy problems. Further, SPCIB suffered from an asymmetry between the amount of personnel it had and the amount of tasks it was assigned. Staffed with only 90 people, the SPCIB was responsible for planning and devising overall development strategies for the oil and petrochemical industry as well as promoting continued restructuring of the 7,500 SOEs under CNPC and Sinopec." Kong, *China's International Petroleum Policy,* p. 16.
[24] Zhou is currently a member of the Standing Committee of the Politburo. He also directs the Public Security Commission. Leadership of Chinese NOCs is considered a prestigious post for up-and-coming darlings of the CCP.

in 2000 and became chairman of Sinopec in 2006. Sheng Huaren (盛华仁) was formerly the director of the Planning Bureau of the Ministry of Chemical Industry before becoming the head of Sinopec. Qin Wencai (秦文采) was formerly vice minister of the MPI before becoming president of CNOOC. When these leaders transitioned to these new corporations they also brought over their bureaucratic ranks. Given the relatively lower-ranking supervisory and administrative bodies that later were created to oversee China's petroleum industry, the disparities in bureaucratic rank between the regulators and the regulated further complicated state efforts to control these commercial actors. Finally, although these high-powered leaders at the helm of China's NOCs made state control over the commercial actors difficult, it did provide for a certain amount of trust between them and the CCP leadership since the leaders of the state personally knew and had worked with many of the leaders of these commercial actors.

The reforms discussed in this section empowered commercial actors to take the lead in China's efforts to secure its access to petroleum. Although these reforms helped address inefficiencies in China's petroleum management system, they also set the stage for commercial actors to pursue their own interests (even if that sometimes undermined other national priorities). The issue of China's state control over its petroleum firms features prominently once these firms began taking on more active roles as international actors. Their involvement on the international stage is the subject of the next section.

5.4 China's NOCs "Go Out"

Current efforts on the part of some of China's largest and most successful corporations to expand operations internationally are part of China's *zouchuqu* (走出去) strategy.[25] Interestingly, in the oil space, forays into the international marketplace were initially led not by the state but rather by the commercial actors. The state eventually justified the strategy *ex post facto* and encouraged other strategic sectors to similarly engage in the global market as way to enhance China's international competitiveness. In the oil sector, going abroad was driven by inefficiencies at home and production declines in China's domestic petroleum resources. As outlined above, the state first created corporations from the government ministries as a way of addressing inefficiencies in China's domestic oil industry. Recognizing that China's domestic reserves would be insufficient to meet China's projected energy demand, these companies took the initiative and went abroad to secure alternative sources of petroleum. Possessing technical expertise that the state lacked (since most of the state's expertise went over to the commercial actors as discussed above), the NOCs recognized this situation before the state was focused on it. Demand from China's booming economy was going to outpace China's domestic supply forcing China to look abroad to find alternative sources of petroleum to make up the difference. As such, the impetus to go abroad was driven by the commercial actors. These moves were initially made without prior government approval.[26]

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[25] This phrase is often translated as "Going Out," "Stepping Out," or "Going Global." This policy encourages firms to move into international markets and compete in the global marketplace. It is part of the Chinese leadership's effort to improve the quality of Chinese enterprises by stimulating competitive pressure, adoption of international quality standards, diffusion of technology, and management practices through multinational competition. The goal is to create world-class, Chinese multinational corporations. For more on the "Going Out" strategy see: Zhibin Gu and Andre Gunder Frank, *China's Global Reach : Markets, Multinationals, and Globalization*, Revised and Updated ed. (Palo Alto, Calif.: Fultus Books, 2006); and E. Hong and L. Sun, "Dynamics of Internationalization and Outward Investment: Chinese Corporations' Strategies," The China Quarterly , no. 187 (2006): 610.

[26] The government did eventually give its official imprimatur to these efforts. See Xu Xiaojie, "Chinese NOCs' Overseas Strategies: Background, Comparison and Remarks," March, 2007 Paper prepared in conjunction with the James A. Baker III Institute for Public Policy, Rice University and Japan Petroleum Energy Center. Available at: http://www.rice.edu/energy/publications/docs/NOCs/Papers/NOC_ChineseNOCs_Xu.pdf. Xu Xiaojie is the director of the Institute of Overseas Investment at CNPC Research Academy of Economics and Technology in Beijing.

State enthusiasm for expanding China's access to oil grew over time. Initially, the government only officially supported the NOCs efforts to develop China's domestic Western oil fields in 1991, making this a part of the Eighth Five-Year Plan. Noticeably, the government did not a give similar endorsement to the NOCs efforts to develop *international* sources of oil until the end of 1993 when the state officially embraced the going out policy. The NOCs strategy of going out to find oil was further supported by Premier Li Peng in 1997.[27] State support built momentum when Jiang Zemin embraced China's need for oil as a matter of strategic importance in October 2000.[28] The "Going Out" strategy was endorsed and extended to other strategic sectors in the Tenth Five Year Plan. The state had shifted from passive endorsement to proactive measures to support and encourage "Going Out." By 2001, the state had established four prerequisites for obtaining government financial support for "Going Out" and China's oil companies have not looked back.[29]

Although the initial moves abroad in the oil sector were led by the CNPC, it was not until the government officially sanctioned and endorsed this strategy that China's NOCs began to move internationally in a major fashion. That the firms first moved to venture abroad is indicative of the fact that much of the human capital, talent and technical expertise of the industry resides within the NOCs. However, that these initial moves were circumscribed until the state leadership provided its full endorsement of this strategic direction reflects the fact that the strategic guidance for China's petroleum policy continues to emanate from the central government authorities. In large matters, the state still calls the shots. However, as discussed in

[27] Tai-Wei Lim, *Oil and Gas in China : The New Energy Superpower's Relations with its Region* (Singapore; Hackensack, NJ: World Scientific, 2010) p.9.
[28] For more on Jiang's remarks see: 陈淮 [Chen Huai]'s "我国石油安全战略要立足于'走出去'" 经济研究参考 2001 年第 25 期 [trans: "China's Oil Security Strategy Ought to be Based on 'Going Out'" Economic Research Review 2001, Number 25.].
[29] The four objectives of the policy are to provide markets for Chinese products, improve resource security, enable technology transfer, and promote research and development. China's oil projects overseas often meet more than one of these objectives and frequently receive state support.

more detail below, effective use of this power requires the attention of the highest echelons within the Communist Party to overcome any divisions within the state. In the absence of such centralized leadership, institutionally powerful commercial actors will take the opportunity to act on their own interests. CNPC's initial moves internationally (without state endorsement) serve to illustrate this dynamic.

CNPC's ventures abroad began rather tentatively. Beginning with an April 1991 agreement to cooperate with Alberta in exploring oil sands deposits, CNPC launched its international efforts on its own initiative. The first major oil field development rights were acquired in Thailand in March 1993 and the first equity stake was in an oil field in Alberta in July, 1993 for $5 million. In October of that year, CNPC won a $25 million bid to enhance oil recovery in Peru. These initial moves abroad were driven largely by the more attractive commercial opportunities to be found overseas as opposed to China's own aging domestic oil fields. However, these initial efforts were fairly small since CNPC was forced to jump through many layers of regulatory red tape to secure approvals for any international investment.[30] As China's energy shortfall became more apparent throughout the 1990s, government support for the NOCs international activities grew. As the state got behind the "Going Out" strategy, barriers to international investments gave way to subsidies and inducements. As NOCs sought out a larger presence overseas, they felt that much of the "low-hanging fruit" had already been claimed by the large multinational incumbents. As a result, China had little choice but to seek out untapped opportunities in countries whose petroleum resources were otherwise shunned for one reason or another.[31] " 'China confronts foreign competition,' said Chen Fengying, an expert

[30] Even relatively small investments would need to secure approvals from SAFE, MofCom, and often the State Council among other bodies.
[31] Bi and Zweig, "China's Global Hunt for Energy." This dynamic also seems to lay behind China's substantial investments in Iran, limiting its ability to cooperate with the US on other priorities.

at the China Contemporary International Relations Institute, which is based in Beijing and affiliated with the state security system. 'Chinese companies must go places for oil where American [and] European companies are not present. Sudan represents this strategy put into practice.' "[32] Such logic led Chinese NOCs to work with unsavory regimes where reserves were still available.

5.4.1 Sudan

One of the most notorious destinations to which CNPC ventured was Sudan where China's presence would result in considerable damage to China's international reputation. In the 1990s, Sudan found a willing partner in China at a time when Western governments were applying considerable pressure on the regime in Khartoum for its support of terrorism. Beginning in 1995, CNPC purchased Chevron's concession in Western Kordofan. CNPC then expanded its role in Sudan when it won an international bid in November 1996. A Canadian firm (Arakis) sold off its stake in three prospecting blocks. CNPC partnered with Malaysia's Petronnas, another Canadian firm (Talisman Energy that had taken over Arakis), and Sudan's Sudapet to create the Greater Nile Petroleum Operating Company (GNPOC) in which CNPC took a 40% stake.[33] Although it seems that China's initial involvement in Sudan was driven by CNPC's desire to secure access to international sources of oil, the Chinese government's amoral policies of non-interference in domestic affairs and its willingness to engage countries with little regard to their human rights records set up Beijing for diplomatic failure. Sinopec and CNPC

[32] Peter S. Goodman, "China Invests Heavily in Sudan's Oil Industry; Beijing Supplies Arms used on Villagers," The Washington Post, December 23 2004.
[33] Kerr, Harris, and Qin, *China's "New" Diplomacy: Tactical Or Fundamental Change?* p. 222.

have both remained actively engaged in developing Sudan's oil resources.[34] China now imports around 60% of Sudan's oil output and has invested approximately US$4 billion (as of 2008).[35] There have been allegations that these activities in Sudan provide critical support to the Sudanese government.[36]

Perhaps even more troubling has been China's complicity in providing arms and military assistance to regimes like Sudan's that engage in substantial human rights violations against their people. China has transferred helicopters, strike fighters, trucks, and small arms to Sudan.[37] "Many of the helicopter gunships in Khartoum's arsenal were obtained from China, often using projected receipts from oil extractions in the regions where fighting took place."[38] Many of these arms have made their way to Darfur, fueling the conflict there. In addition, the Sudanese government apparently used military force to clear populations from the oil fields that China was interested in exploiting:

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[34] The GNPOC "consortium's Heglig and Unity oil fields now produce 350,000 barrels per day, according to the U.S. Energy Department. Separately, CNPC owns most of a field in southern Darfur, which began trial production [in 2004], and 41 percent of a field in the Melut Basin, which is expected to produce as much as 300,000 barrels per day by the end of 2006. Another Chinese firm, Sinopec Corp., is erecting a pipeline from that complex to Port Sudan on the Red Sea, where China's Petroleum Engineering Construction Group is building a tanker terminal." Goodman, "China Invests Heavily in Sudan's Oil Industry; Beijing Supplies Arms used on Villagers."
[35] Taylor, *China's New Role in Africa,*p. 50. The precise size of China's involvement is difficult to determine. A World Bank study "recorded six confirmed oil-related projects" between 2001-2007 "amounting to some $645 million" of confirmed (although not by Chinese sources) commitments. The same study "also has information on another six unconfirmed oil projects, amounting to an additional $789 million of possible finance commitments." Vivien Foster, *Building Bridges : China's Growing Role as Infrastructure Financier for Sub-Saharan Africa* (Washington, DC: World Bank : Public-Private Infrastructure Advisory Facility, 2009) p. 50.
[36] Goodman, "China Invests Heavily in Sudan's Oil Industry; Beijing Supplies Arms used on Villagers."
[37] In particular, AVIC I transferred flight simulators for their K-8s to Sudan. Six of these training jets were delivered to the Sudanese Air Force in 2006 and another six were to follow soon thereafter. The K-8 is a trainer for fighter jets. After undergoing basic training on these jets, pilots would progress to the Chinese NAMC Q-5 (A-5 is the export version) 'Fantan.' At least three A-5 'Fantan' ground attack fighters have been photographed on runways in Darfur. See May 8, 2007 Amnesty International report entitled: "Sudan: Arms continuing to fuel serious human rights violations in Darfur," Available at: http://www.amnesty.org/en/library/info/AFR54/019/2007 Especially pp. 7-8 and 12-17. Also see: February, 2006 Amnesty International report entitled: "China: Sustaining conflict and human rights abuses – the flow of arms accelerates," Available at: http://www.amnesty.org/en/library/asset/ASA17/030/2006/en/be25c03a-d42b-11dd-8743-d305bea2b2c7/asa170302006en.pdf The Sudanese Air Force has also been supplied with "US$100 million worth of Shenyang fighter planes, including a dozen supersonic F-7 jets." Taylor, *China's New Role in Africa,* p. 120.
[38] *ibid.* p. 123.

> "The Chinese National Petroleum Corporation (CNPC) . . . is one of the main oil concession-holders in Sudan with the largest share (40%) in GNPOC, which exploited Blocks 1 and 2 (the Heglig and Unity oilfields); and a concession over the most productive field, Block 4. In July 2006 China started output from Blocks 3 and 7 (in the Melut basin, northern Upper Nile State in South Sudan), which will produce an estimated 200,820 barrels a day.
>
> The early exploitation of oil fields Block 1 and 2 in Unity State, in South Sudan, at the time that China was a member of this consortium, was accompanied by mass forced displacement and killings of the civilian population living there. Sudanese planes bombed villages and Southern militias, supported by Sudanese armed forces, attacked villages, killing people and destroying homes until the area was depopulated, in an apparent aim to clear the area of people for oil exploration and extraction. . . . CNPC also directly benefited from the "security" provided by the Sudanese army against rebel groups in the oilfields – the same forces responsible for the massive force displacements of civilians in the oilfields."[39]

China's search for oil in Sudan has entangled it in a web of ties between China's oil extraction efforts, arms, and human rights concerns. For example, "China is said to have sold the government of Sudan SCUD missiles at the end of 1996 in a deal underwritten by a $200 million Malaysian government loan against future oil extraction, according to a high-level Sudanese defector, who claimed the deal, which he said he witnessed, was arranged by Sudan's state minister for external relations, Dr. Mustafa Osman Ismail."[40] Such ties have created a caustic combination for China.

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[39] From: "Sudan / China: Appeal by Amnesty International to the Chinese Government on the Occasion of the China-Africa Summit for Development and Cooperation" Published 1 November, 2006. Available at: http://www.amnesty.org/en/library/info/AFR54/072/2006/en

[40] See: *Sudan: Global Trade, Local Impact; Arms Transfers to all Sides in the Civil War in Sudan* (Human Rights Watch: 1998) Especially Section IV entitled: "Arms Transfers to the Government of Sudan" Concerning the SCUD transfer, the report references footnote 83: "Human Rights Watch interview with Abdelaziz Ahmed Khattab, The Hague, November 15, 1997. Khattab also claimed, in a written statement, that the Malaysian national oil company was used as a cover to ship arms to Sudan: 'Arms deals agreed upon have been shipped by sea in the name of the Malaysian National Petroleum Company and that of the Chinese National Petroleum Company, under the guise of petroleum exploration equipment according to an agreement concluded between the government in Khartoum and these companies in Kuala Lumpur under which they provide weaponry and military equipment in exchange for being given concessions for oil explorations.' *Statement by the Administrative Attaché, Embassy of Sudan, Kuala Lumpur, Malaysia: To the People of the Sudan and World Public Opinion*, signed by Abdelaziz Ahmed Abdelaziz

China's provision of military aid is not limited to Sudan. China has also come under fire for providing military support to Zimbabwe and Congo. Nor is Chinese arms assistance limited to its partners in Africa. China has also been a key source of military assistance to the military junta that runs Myanmar (where China has a number of natural gas interests as well as strategic interests in using Myanmar as a possible energy transportation route to circumvent the Malacca Straits) and Nepal.

5.4.2 The Consequences of "Going Out"

The activities of China's companies have generated considerable diplomatic embarrassment for China. "Even when the Chinese leadership may want certain outcomes from China's engagement in Africa, it may not have all the leverage or control over a fast-expanding network of state and private actors who have entered these markets following the logic of globalization and profit maximization."[41] China's inability (or unwillingness) to rein in its commercial actors has brought it under significant international pressure, undermining some China's larger strategic objectives. In particular, three major criticisms have been leveled at China for its involvement in Sudan. First, international activists have pressured most international investors to divest from Sudan since such investments help fund the regime's suppressive and genocidal activities. China, however, has stood by its NOCs decisions not to withdraw from Sudan and had, for a long time, insisted on upholding its commitment to national sovereignty and non-interference in Sudan's domestic affairs. Second, human rights

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Khattab, the Netherlands, September 29, 1997. Human Rights Watch has been unable to independently confirm this allegation. The Canadian oil company Arakis Energy Corporation is known to have been involved with a number of partners in an oil-exploration and development scheme in Sudan, the Sudan Petroleum Project, since November 1996. According to news reports, two of Arakis's partners in the project, China National Petroleum Corp. and Petronas, the Malaysian state oil company, have covered start-up costs, giving credit to Arakis for its spending from 1993 until the formation of the consortium in November 1996. ..." Available at: http://www.hrw.org/legacy/reports98/sudan/Sudarm988-05.htm#P566_98312

[41] Jiang, "Fuelling the Dragon: China's Rise and its Energy and Resources Extraction in Africa", p. 608.

organizations have documented that Chinese arms help fuel the ongoing conflict. Allegations include transfer of aircraft and small arms that were used on civilian populations in Darfur.[42] Third, critics have attacked China for doing nothing to stop the genocide. Under the principle of sovereignty and non-interference, China was not only avoiding condemnation of the Khartoum regime, but China also obstructed early U.N. efforts to pass resolutions on Sudan. China actively blocked attempts by the international community to put an end to the killing in Darfur. This caused some to question China's commitment to international norms and undermined the claim that a rising China would integrate well into the international system. The ostensibly commercial activity of China's NOCs was generating negative blowback for the state. The NOCs "Going Out" strategy and the high degree of freedom that the commercial actors enjoyed combined to create a situation in which commercial actors were empowered to engage in activities that generated negative consequences for the Chinese state.[43] China's international reputation was significantly damaged by its involvement in Sudan.

To address these concerns, Beijing took a number of steps to repair its international image. First, it launched a substantial public relations campaign to improve public perceptions of Beijing's engagement with Africa. At the 2006 Forum on China-Africa Cooperation, it signed the "Beijing Declaration," that "calls for halting the illegal production, circulation, and trafficking of small arms and light weapons to Africa."[44] Beijing also shifted from its stance of initially opposing the UN peacekeeping force for Darfur that was proposed to augment the weak

[42] See May 8, 2007 Amnesty International report entitled: "Sudan: Arms continuing to fuel serious human rights violations in Darfur," Available at: http://www.amnesty.org/en/library/info/AFR54/019/2007

[43] Although China sought to have its commercial actors engage in commercial activities that would produce positive security externalities (namely securing China's access to oil), these activities, in fact, generated diplomatic backlash that increasingly caused problems for the Chinese state. The state had a difficult time coordinating its strategy across MoFA and China's energy institutional priorities.

[44] Taylor, *China's New Role in Africa,* p. 175.

African Union force.[45] China set about convincing Sudan to go along with the UN plan. In February 2007 during Hu Jintao's trip to Sudan, China pushed President Bashir to accept the hybrid AU/UN peacekeeping force. In addition, China has been pushing Sudan's government towards a more positive policy by playing a more active role in mediation and more openly criticizing the Sudanese government.[46] Finally, many observers are now highlighting that China's significant resource demand has been good for the economies of Africa.[47] Chinese demand has been a particularly important driver behind the recent surge in African exports.[48] African economies have grown considerably on the back of this international demand for raw materials. The vast majority of these exports have (not surprisingly) been oil exports.[49]

Although China seems to have made some progress on addressing the concerns stemming from its commercial actors' involvement in Sudan, China's search for oil draws it into other prickly situations as well. Indeed, Sudan was not the only place the activities of aggressive commercial actors in the oil industry have been creating strategic headaches for Beijing. The presence of Chinese NOCs in dangerous areas naturally also opened up the possibility of threats to Chinese workers being kidnapped, attacked, or killed. Darfurian rebels targeted Chinese citizens as part of a strategy to prevent CNPC and Sinopec from operating (and thus indirectly—or directly—supporting the government). Employing what seems to be a similar strategic logic, separatist rebels of the Ogaden National Liberation Front killed nine Chinese workers in Ethiopia

[45] China would eventually send 435 engineers as peacekeepers into Darfur.

[46] See: Mark Turner and Guy Dinmore, "US Defends China Over Darfur Diplomacy," Financial Times, Apr 12 2007, p. 7.; and Richard McGregor, "Beijing's Africa Envoy to Focus on Darfur," Financial Times, May 11 2007, p. 11.

[47] "China's Africa Policy Changing for the Better," The Japan Times, September 11 2008.

[48] Kevin Carey, Ulrich Jacoby, and Sanjeev Gupta, *Sub-Saharan Africa : Forging New Trade Links with Asia* (Washington, DC: International Monetary Fund, 2007).

[49] See: Harry G. Broadman and Gozde Isik, *Africa's Silk Road : China and India's New Economic Frontier* (Washington, DC: World Bank, 2007) p. 120 especially Table 2A.4 "Africa's Top 20 Exports to China: Products and Leading Exporters." For an excellent study of how China's desire for natural resources and Africa's need for infrastructure development create a very well-suited complementarity between China and Africa, see especially Section 5 of: Foster, *Building Bridges,* pp. 29-52. This source has an excellent accounting of Ex-Im Bank's projects and China's infrastructure financing techniques in Africa.

in April, 2007.[50] In January 2007, five Chinese workers were kidnapped by rebels belonging to the Movement for the Emancipation of the Niger Delta (MEND). This followed a deterioration of security in the Niger River Delta (where 90% of Nigeria's oil is produced). Following Hu Jintao's April 2006 visit and pledge to invest $4 billion in Nigeria, MEND warned Chinese companies to leave the delta or risk being targeted. Nigeria turned to China for coastal patrol boats and other military supplies to help secure the region. China obliged despite the reputation of Nigeria's armed forced for corruption, unprofessionalism, and human rights abuses. "China's reason for supplying Nigeria's military, however dysfunctional, with armament is very pragmatic: China needs Nigeria's oil."[51] Such security considerations will likely continue to surround the work of China's oil companies as they engage in unstable regions of the world.

The state has come under fire as Chinese NOCs have become more and more deeply involved with problematic regimes in places like Iran, Burma and Angola. In the early part of this decade, Angola accounted for roughly half of the Chinese crude oil that was coming from Africa.[52] Sinopec invested $3.5 billion in partnership with the Angolan national oil firm, Sonangol, to pump oil from recently auctioned off-shore blocks. In addition, Sinopec has pledged to build a $3 billion refinery in Angola.[53] It has been suspected that much of this partnership grew out of a controversial $2 billion tied aid package that China's Ex-Im Bank provided to Angola.[54] Angola had been close to signing an IMF-provided aid package that

[50] Matthew Green, Richard McGregor, and William Wallis, "Nine Chinese Oil Workers Killed in Attack at Ethiopia Exploration Site," Financial Times, Apr 25 2007, p. 1.
[51] Taylor, *China's New Role in Africa,* p. 49.
[52] Broadman and Isik, *Africa's Silk Road,*p. 82.
[53] Carey, Jacoby, and Gupta, *Sub-Saharan Africa : Forging New Trade Links with Asia,* p.4. Sinopec reportedly received a 75% share and Sonangol held a 25% of 3 offshore fields from the 2006 deal. Foster, *Building Bridges,* p. 49.
[54] The terms of this loan were very favorable to Angola: $2 billion at an annual interest rate of 1.5% payable over 17 years. Allegedly, this package convinced Angola to reject Royal Dutch Shell's intention to sell its stake in an Angolan oil field to the Oil and Natural Gas Corporation Videsh Ltd. (an Indian firm) in favor of Sinopec. Apparently, this same aid package was responsible for a separate decision to award a different stake in Angola to

would have required considerable transparency and disclosure requirements. However, once Angola discovered that it had a much more forgiving alternative source of financing in the Ex-Im Bank, it pulled out of the IMF negotiations. Angola is a very corrupt state and China's no-strings-attached engagement policies undercut Western efforts to improve governance or impose any sort of transparency on the Angolan regime. Such activities also serve to undermine Chinese claims that it is a "responsible stakeholder."

The problems that the activities of the commercial actors generate for the central government are not limited to the oil sector. They bedevil other extractive industries as well. For instance, China is actively involved in Zambia's copper mining industry. However, poor working conditions and safety concerns have resulted in anti-Chinese sentiment there. In April 2005, an explosion at the Beijing General Research Institute of Mining and Metallurgy explosives factory located near the Chambishi copper mine killed more than 50 Zambian workers.[55] The blast seems to have been the result of unsafe working conditions and Chinese management was blamed. The runner-up populist presidential candidate in Zambia's 2006 election campaigned on a platform threatening to "kick out the Chinese"[56] whom he argued were exploiting Zambia's resources in a neocolonial fashion. During Hu Jintao's 2007 trip to Africa, plans to have Hu inaugurate the Chambishi Special Economic Zone had to be cancelled because of fears of anti-Chinese protests there. In March 2008, workers building a copper smelter at the Chambishi Mine attacked Chinese management when wage negotiations stalled. Such anti-Chinese sentiment undermines larger Chinese strategic objectives. Eventually, the Chinese state

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Sinopec. See: Peter C. Evans and Erica S. Downs, "Untangling China's Quest for Oil through State-Backed Financial Deals," *Brookings Policy Brief*, no. 154 (May 2006): 3.

[55] Reuters, "Blast Kills 46 at a Copper Mine in Zambia," The New York Times, April 21 2005, sec. A; Foreign Desk, p. 5.; and Michael Wines, "World Briefing Africa: Zambia: Anger After 50 Die in Chinese Plant," The New York Times, April 22 2005, sec. A; Foreign Desk, p. 8.

[56] Joseph J. Schatz, "Zambian Hopeful Takes a Swing at China; Presidential Challenger Stirs Resentment at Asian Power's Growing Influence in Africa," The Washington Post, September 25 2006.

sought to rein in the activities of the commercial actors in an effort to limit their ability to generate counterproductive results for China.

5.4.3 Tools of State Control

Recognizing that the activities of commercial actors were creating problems for China, the Chinese authorities sought to re-establish control over the international activities of its commercial actors in the extractive resources sector. First, China strengthened bureaucratic control over the commercial actors. This was done by re-organizing the state monitoring, enforcement and compliance capabilities. With a particular focus on SASAC, the state's administrative body for oversight and supervision of SOEs, China sought to strengthen the supervision and bureaucratic control of all SOEs (including the NOCs).[57] "While most of the previous reform efforts resulted in enhanced managerial and/or local government control over enterprise management and financial decisions, several recent initiatives by SASAC specifically and central government more generally appear aimed at reestablishing central government authority over the *crème de la crème* of SOEs."[58] In addition, Chinese policy makers began to be concerned that limited oversight of commercial actors endangered China's longer-term interests in Africa. In August 2006, MofCOM re-asserted its own leadership over China's international commercial activities with a set of policy guidelines that sought "to strengthen regulations in order to avoid conflicts … in order to protect the national interest."[59] The state

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[57] See: Bonnie Glaser, "Ensuring the 'Go Abroad' Policy Serves China's Domestic Priorities," China Brief 7, no. 5 (2007): 2-5.
[58] Mattlin, *The Chinese Government's New Approach to Ownership and Financial Control of Strategic State-Owned Enterprises,* p. 44.
[59] People's Republic of China, Ministry of Commerce, "对《关于加强境外中资企业机构与人员安全保护工作的意见》的解读" [trans: "Explanation regarding 《Mechanisms for Strengthening Chinese Overseas-Invested Enterprises' and Guidelines for Worker Safety and Protection》"], 31 August 2006, Available on-line at: http://hzs.mofcom.gov.cn/aarticle/bk/200608/20060803022750.html.

also had a powerful tool at its disposal in the form of China's Communist Party. Specifically, the CCP's promotional career advancement structure provides central authorities with veto points on the careers of rising stars within the party (many of whom often spend time running one of China's prestigious SOEs on their way to the top). China's NOCs are among the elite SOEs for up-and-coming stars of the Communist Party to lead. This creates a strong incentive for the leadership of China's NOCs to toe the Party line and avoid acting against the wishes of the state. Finally, as discussed in more detail in the CDB/Chinalco case in the next chapter, the central government took on a more active role coordinating major overseas acquisitions.[60]

Second, the central authorities increased their budgetary control over the commercial actors. As "Going Out" gathered steam, state-provided financing became a new source of leverage over increasingly commercially-oriented actors. Although many of China's largest firms had undergone public offerings, the reality is that China's equity markets are still rather thin and most major corporate financing (particularly in the extractive resources sector) is done using debt issuances. Since the state still exercises a good deal of control over China's banking system, this proved to be another good source of leverage for the state to exercise control over the commercial actors. The general pattern seems to include a high level state visit (from Hu Jintao, Wen Jiabao or one of the other senior leaders in China) supported by MoFA and MofCom. Deals are struck and signed during such visits.[61] China's "deal sweeteners" often include arms and military assistance as well as high profile constructions projects (new stadiums, ports, government office buildings, transportation infrastructure, etc.).[62] This activity is often underwritten at concessionary rates by state financial institutions. These deals are then

[60] This was also designed to prevent counterproductive competition among Chinese bidders for international assets.
[61] It should be noted that China is not unique in this regard. Other states often support their firms' large, international commercial deals as well.
[62] Chris Alden, "China in Africa," Survival: Global Politics and Strategy 47, no. 3 (2005): 147.

implemented by the NDRC and specific companies that will be involved in the ongoing investment. At several points in this process the state is able to exert influence to help shape the nature and content of how China's commercial actors will engage the world.

A good example of this type of behavior can be found in China's Export-Import Bank and its influence in providing state control over Chinese corporations' engagement in Africa.[63] The basic model is to provide below-market rates on credit and loans to Chinese investment projects that have been struck with the host government. Part of the terms for these projects is that the work then needs to be awarded to Chinese firms (mainly SOE construction and engineering firms).[64] This arrangement has the added benefit for China of keeping surplus labor gainfully employed building infrastructure in Africa. Of course, this infrastructure also helps the recipient countries (particularly in their efforts to bring raw resources to market). Finally such sweetheart deals also obviously help secure Chinese NOCs favorable treatment from host governments with regard to new oil assets/deals. Such practices thus enable China's growing influence. At the same time, the state explicitly controls Ex-Im (which is legally mandated to fulfill China's political goals) and is thus able to assert control over a good deal of China's strategic investments in resource-producing states.

Another example of how the state is able to use finance to exert control over efforts to secure strategic resources is what has become known as the "Angola Model." This approach uses oil reserves (or some other valuable, generally extractive, resource) as the collateral and medium for loan repayment. In this scheme, loans are granted and repaid on the basis of future

[63] Ex-Im is also China's primary foreign aid vehicle. The dual roles of policy banks will be discussed in more detail later. Suffice it to say that policy banks like Ex-Im often blend China's commercial and political interests. Broadman and Isik, *Africa's Silk Road,* especially Box 5.12 on pp. 274-275.
[64] *ibid.* p. 272.

oil output.[65] For example, a loan would be structured to be repaid over 20 years by delivering 20,000 barrels of oil per month. Ex-Im acts as the broker facilitating this deal by providing credits to the Chinese construction company and to the Chinese refinery. Interestingly, these deals seem not to be designed to ensure against price risk, but rather against supply risk since the contracts are for *quantities* of oil (or whatever other resource is used as collateral). If prices of the underlying commodity fluctuate, the term of the loan that changes is merely the length of the payback period. The effect of this sort of structure seems to be to ensure against supply risk since price risk is effectively transposed into a potentially shorter payment time horizon.[66] With the advent of the global financial crisis in 2008, worldwide demand for oil dropped considerably as national economies slowed (and anticipated slowing further). This provided cash-rich Chinese NOCs and banks with very good opportunities to acquire natural resource assets at "fire-sale prices." As predicted, China did take advantage of the opportunity to secure additional sources of raw material (particularly oil).[67]

The third factor contributing to the Chinese state's ability to control commercial actors was a periodic unification of the state. Although China is often beset by multiple forces that create a divided Principal, when the senior leadership focuses on a particular issue area, it is able to provide very effective state unity. One indicator of such attention has been the frequent official state visits that China's Politburo has paid to Africa.[68] Such attention is necessary to

[65] See: Foster, *Building Bridges,* especially Section 6 entitled: "The Financing Perspective," pp. 52-66.
[66] This type of structure strikes me as odd, but it seems consistent with China's general obsession over supply risk in its petroleum strategy. A similarly unusual logic seems to drive China's desire to secure equity oil and ensure that Chinese oil is transported via Chinese-flagged tankers.
[67] In particular, "loans-for-oil" along the lines of the "Angola Model" have proliferated. For example, CDB (discussed in more detail in the next chapter) provided $25 billion in exchange for Russian petroleum in February, 2009. That same month, CDB loaned $10 billion to Brazil and $8 billion to Venezuela in two other massive oil-backed deals. In April, CDB invested another $1 billion in Angolan oil and Ex-Im provided $5 billion to Kazakhstan. In July, CDB once again invested $1 billion in Ecuador and another $4 billion in Venezuela.
[68] Eight of the nine members of the Politburo Standing Committee (the apex of China's leadership) have travelled to Africa in the last five years. Hu Jintao has visited 19 African countries since 2004. Source: Chinavitae.org.

overcome the various other divergent forces that serve to weaken the ability of the state to control commercial actors.[69] The presence of top-level guidance (for as long as it can be sustained) tends to overcome divisions within the Chinese state. The resulting unified state is more effectively able to issue orders, monitor compliance and enforce penalties on the commercial actors for non-compliance. As mentioned earlier, this unifying quality is limited by the finite capacity of the senior leadership—both in terms of demands on their time and level of their engagement on what can be fairly technical issue areas. Although China's government system supports such powerful, centralized authority, the reality of the dynamic complexity involved in governing modern China physically limits the volume of activity the senior leaders can engage on. Many issues never make it to the highest levels of government. In practice, other factors can easily divide the state and prevent it from effectively controlling the behavior of China's commercial actors.

5.5 Evaluating China's Efforts to Secure Strategic Materials

Have China's efforts to secure access to strategic raw materials like oil worked? Narrowly speaking, yes. Through its commercial actors, China has been able to gain access to a considerable amount of oil and other raw materials and has been able to meet increases in Chinese demand with little disruption. However, as illustrated by several cases discussed briefly above, the government's lack of control over its commercial firms has also generated strategic problems for China.

China's strategy for securing strategic resources has relied on the international investments, acquisitions and partnerships of its leading corporate actors. Although many of these firms were formally parts of government ministries or closely managed state owned

[69] See: Glaser, "Ensuring the 'Go Abroad' Policy Serves China's Domestic Priorities."

enterprises under the planned economy, China's international corporate expansion followed closely on the heels of the more general economic liberalization and reforms in China's domestic economy that took place in the 1980s and 1990s. These reforms unleashed considerable economic growth, which in turn, drove China's demand for raw materials. As China became more and more integrated into the global economy, this demand increased further. At the same time, the state increasingly relied on commercial actors (over which it held less and less control) to satisfy one of China's strategic priorities.

As these firms took on a greater commercial orientation, the state found it increasingly difficult to control their activities. "As the Chinese leadership has pursued its (admittedly uneven) post-Mao economic liberalization policies, they have encountered increasing difficulties in controlling—or even keeping abreast of—the diverse activities in which various Chinese corporations and individual merchants are engaged overseas."[70] China found it difficult to coordinate across MoFA, MofCom and the NOCs. Successful imposition of state control often required direct State Council involvement. However, at the very top of the Communist Party, elites tend to be over-tasked. Given the scarce time of China's top leaders (like national leaders in most great powers), issues only get escalated to that level when they have reached a crisis threshold.[71] For instance, Jiang Zemin only focused national attention on China's petroleum strategy once China was under pressure of a fuel shortage. Thus, in practice, institutional bureaucracies, ideological factions, patronage loyalties, center-local tensions and other dynamics often divide the state. Such divisions undermine the state's ability to effectively control its commercial actors. These divisions within the state allow commercial actors to pursue their own best interests (often without regard to larger national strategic interests). In the case of China's

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[70] Taylor, *China's New Role in Africa,* pp. 178-179.
[71] This has the effect of creating a default screening process for issues that warrant the attention of China's top leadership.

search for oil, the goals of the commercial firms mirrored those of the state with regard to securing raw materials. However, the corporate pursuit of those objectives has also frequently entailed consequences that work against China's other, non-energy strategic interests. Corporate involvement in Sudan and elsewhere has undermined Chinese efforts to demonstrate its role as a responsible stakeholder in the international system. The state has had difficulty controlling the activities of its commercial actors.[72] The next section examines what accounts for when the state has been able to control its commercial actors in the context of China's international resource extraction efforts.

5.5.1 Explaining Government Control (or lack thereof)

This examination of China's efforts to "Go Out" in search of petroleum has suggested somewhat mixed results when it comes to China's ability to control its commercial actors. There have been times when the firms seem to be leading the way and other times when the state seems to be directing the behavior of firms. This section sheds some light on the factors accounting for when the state is able to control its commercial actors and when it is less able to do so.

There seem to be three main reasons accounting for the state's inability to control the NOCs. First, the state has often been beset by bureaucratic struggles for influence among the many competing centers of power (e.g. NDRC, MofCOM, MoFA, as well as the numerous, relatively weak successor regulatory bodies for the petroleum industry). Second, the relative distribution of resources was highly skewed in favor of the commercial actors. When the MPI was converted into CNOOC, CNPC, and Sinopec, the state transitioned virtually all of its industry expertise, human capital and administrative capacity into the new NOCs. Finally, the

[72] In addition to undermining China's reputation, CNPC and Sinopec frequently competed over the same international assets, initial Chinese acquisitions seemed prone to overpaying for assets, and the government often seemed to be running to catch-up with its fast-moving NOCs.

reporting relationships between the commercial actors and the state were often complicated by the ministerial rankings held by the heads of the NOCs (or vice-ministerial ranking, in the case of CNOOC). This meant that the commercial actors often out-ranked whatever arm of the state that happened to be trying to control the commercial actor's activity (e.g. SASAC). From the theoretical point of view, these values across the *Unity of State, Relative Resources,* and *Reporting Relationship IVs* seem to account for the state's inability to control the commercial actors.

These dynamics have characterized much of the business-government relations during China's "Going Out" strategy. However, as mentioned above, the state did re-assert its power to guide its commercial actors. So when the state was successful at being to control its firms, what tools did the state use to gain greater control over its commercial actors? Three factors in particular seemed to be key in enabling the state to re-assert its control over the commercial actors in the oil industry. First was the unification of the state that occurred when China's senior leadership weighed in on a particular issue. This top-down approach was able to overcome any bureaucratic turf battles that divided the state. Second was the use of financial purse strings to coordinate a more organized "Going Out" strategy. By leveraging the state-dominated banking sector to provide commercially irresistible terms of financing, the state ensured that projects would be undertaken on its terms. Third, administrative reforms helped consolidate the reporting and approval authorities of the state over the firms.

Drawing on the theoretical framework presented in Chapter 2 helps to disaggregate the factors accounting for the (in)ability of the Chinese state to control the commercial actors in this context. In terms of the *Goals IV*, the state and firms share largely complementary goals regarding securing access to petroleum. However, the behavior of the firms and manner in which they go about their business often entails blowback for the state—frequently undermining other national strategic priorities beyond resource extraction. In many instances, the *Unity of the State IV* was divided primarily along bureaucratic lines (although when the state did exert control over the commercial actors, it was often because the state was able to act in a unified manner—generally under the leadership of senior national figures). The *Market Fragmentation IV* was highly concentrated with only three significant commercial firms controlling nearly 100% of China's oil industry. This gave these firms considerable power vis a vis the state. In addition, perhaps most significantly, the *Relative Resources IV* was highly skewed in favor of the firms. The regulatory bodies formed in the aftermath of the MPI dissolution lacked the bureaucratic resources to effectively control these firms. The vast majority of the government's expertise, industry knowledge, and administrative capabilities resided within CNPC. Because of such asymmetries, the state frequently deferred to the firms. Finally, from the perspective of the *Reporting Relationship IV,* these firms are all state-controlled enterprises with publicly listed arms. On paper, this reporting relationship would seem to facilitate state control. However, the senior stature of the NOCs within China's central government bureaucracy often afforded these firms a good deal of bureaucratic weight.

Together, these factors accounted for the business-government dynamics observed in this case. Generally speaking, the values on these variables indicate that the government would have a difficult time controlling firms in this context. When the state was able to exercise higher levels of control over the firms, it was because the state was able to alter the business-government relationship along one of these dimensions. Primarily, this seems to have occurred as a result of a unification of the state as high-level leadership occasionally intervened to settle inter-bureaucratic frictions.

5.6 Conclusion

China's use of commercial actors to secure strategic resources is one example of economic statecraft that involves the *Strategic Transfer* type of security externalities. China has identified several types of raw materials that it views as crucial to fueling its continued economic growth. Securing access to these materials is an important strategic priority for China. Petroleum is arguably among the most important of these raw materials. To secure its access to oil, China has implemented a strategy that relies on its national oil companies. For the most part, this strategy seems to have been moderately successful at meeting China's petroleum needs. Although the goals of the commercial actors are complementary to the goals of the state in this sense (broadly speaking, both wish to secure access to petroleum), in "Going Out" Chinese firms have occasionally also undermined China's national interests beyond petroleum. In some instances, the state has been able to rein in the activities of its firms and in other instances, the state seems unable to control its massive multinational resource extraction companies.

Evidence of government control in this case seems to be mixed at best. For the most part, China's NOCs have taken the lead in "Going Out." The NOCs enjoy a disproportionate share of resources compared to the state. The highly concentrated nature of the petroleum sector in China makes it fairly easy to monitor the firms operating in that space. But since there are only three very large firms that dominate the sector, market concentration provides these firms with considerable leverage *vis a vis* the state. The commercial actors examined in this case are very powerful *vis a vis* what is an often divided state. The state frequently fails to act in a unified manner to exert its control over the firms. However, the state has shown that it is not completely without an ability to unite under the CCP's central leadership and rein in the activities of the NOCs.[73]

Since the evidence from this case suggests that the state has been struggling to be able to control its commercial actors in the context of China's NOCs "Going Out," it would be useful to examine an instance in which the state exercised a fairly high degree of control over its commercial actors. An ideal case would show how the state used commercial actors to achieve a strategic objective. To provide a useful comparison to illustrate the theory, such a case of economic statecraft should also be taken from the extractive resources space. The next chapter examines just such a case in which the state played an important role in controlling and directing the behavior of its commercial actors to achieve a national strategic objective in the context of extractive resources.

[73] Although this generally only seems to happen when events have already escalated to the point that they warrant the attention of China's senior leadership.

Chapter Six

Rio Tinto and the (In)visible Hand of the State

6.1 Introduction

The last chapter focused on the petroleum sector and explored the business-government dynamics of China's "Going Out" strategy. That case highlighted the challenges facing state efforts to maintain control over its commercial actors as they searched for international supplies of oil. This chapter focuses on another case of strategic resources, iron ore, another strategic raw material vital to China's economic growth. Like petroleum, China is highly dependent on imports to meet its demand for this raw material. China imported 628 million tons of iron ore in 2009, making it the world's largest importer of iron ore. In 2010, China is expected to consume about 960 million tons of iron ore, importing 610 million tons from abroad or about 64% of its total demand.[1]

To get a better understanding of exactly how the Chinese state is able to work through commercial actors, it is instructive to drill down into a particular episode concerning one of China's largest efforts to secure a strategic resource and take a closer look at exactly how China's strategic deployment of state capital functions in practice. The uncharacteristically public attempt by Chinalco (underwritten by the China Development Bank) to acquire a large stake in Rio Tinto provides a useful window on how the state can successfully orchestrate control over commercial actors to achieve a strategic objective.

[1] From Glenys Sim and Rebecca Keenan, "China Iron Ore Imports to Near Record This Year, Shougang Says," Bloomberg Businessweek March 24, 2010 available at: http://www.businessweek.com/news/2010-03-24/china-iron-ore-imports-to-near-record-this-year-shougang-says.html

6.2 Chinalco & Rio Tinto

On July 12, 2007 the Canadian aluminum producer, Alcan—then the world's third largest aluminum producer—announced that it was entertaining a friendly takeover bid from Rio Tinto for $38.1 billion. Rio Tinto's bid was in response to an earlier hostile takeover attempt by Alcoa which valued Alcan at $27 billion. The Rio-Alcan deal was officially completed on October 25, 2007 creating the world's largest aluminum company.[2] Unfortunately for Rio Tinto, the Alcan price tag would quickly become a significant burden as the fallout from the financial crisis depressed commodity prices. Since the offer for Alcan was all-cash, Rio Tinto had financed a portion of the deal with debt. When aluminum prices fell in line with the precipitous decline in global demand (a function of the recession), it seemed that Rio had over reached. Rio's purchase of Alcan was effectively valuing Alcan using top of market prices. Rio gradually realized that market conditions were not going to improve soon enough to enable Rio to make its scheduled debt payments. Bottom of market prices would not enable Rio to adequately service its debt. Specifically, Rio was left with $19 billion in debt payments coming due in the second half of 2009 and early 2010 but no source of cash to cover them. This put Rio Tinto in play.

In November 2007, Australian mining conglomerate BHP Billiton announced an offer to merge with cash-strapped Rio Tinto and absorb Rio's debt. Because the offer was to trade three (later raised to 3.4) BHP shares for every share of Rio, the exact value of the offer fluctuated, but at one time it was as high as $170 billion. Rio Tinto's CEO, Tom Albanese, felt this undervalued Rio's assets and was not enthusiastic about the offer. Most importantly for our purposes, this proposed merger between the world's largest and third largest mining companies would create "an international commodity juggernaut" with considerable pricing power. BHP-

[2] See October 25, 2007 company press release available at: http://www.riotintoalcan.com/ENG/media/media_releases_1033.asp

Rio would have controlled a third of the world's iron ore. Another 37% would be in the hands the Brazilian mining company, Companhia Vale do Rio Doce (CVRD). Combined, the two suppliers would control more than 70% of the world's seaborne iron ore. Such a concentration was unacceptable for the buyers of iron ore. One of those major buyers of iron ore decided to do something about it.

Sometime during December, 2007 or January, 2008, the Chinese Iron and Steel Association (CISA 中国钢铁工业协会) led by its executive director, Zou Jian (邹健), approached the government authorities and made the case that the Rio Tinto-BHP deal would lock up too much of the iron ore pricing power.[3] Something needed to be done. "Concerned about the potential pricing power of a combined company, China's government hastily called meetings with several big state-owned enterprises, say people familiar with the events."[4] The NDRC apparently evaluated various options and a decision was made to try to establish a blocking stake to the BHP bid.[5] The China Development Bank (CDB) was selected as the source of funds for buying a significant minority stake on the open market via the large state-owned aluminum giant, Chinalco (中国铝业).[6] As a commercial agent, Chinalco had a recent track

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[3] The BHP-Rio merger would have combined the world's second and third largest producers of iron ore. "If Australia's BHP Billiton succeeds in ensnaring Rio Tinto, steelmakers - led by the Chinese - will find themselves trying to bargain down a miner which produces more than one-third of the world's iron ore. Add in CVRD of Brazil and the trio would account for almost three-quarters. Faced with such a prospect, it is not difficult to understand why government-owned China State Development Bank has reportedly started building a stake in Rio Tinto" "Orefull Realities," Financial Times, Nov 12, 2007, p. 14.

[4] See: Shai Oster and Rick Carew, "China Inc.'s Top Deal Maker Provokes a Backlash Abroad," Wall Street Journal. (Eastern edition). New York, N.Y.: Apr 16, 2009. pg. A.1.

[5] Glasson, "Regional Focus to Global Push: The China Syndrome," also see Oster and Carew, "China Inc.'s Top Deal Maker Provokes a Backlash Abroad." In Caijing's reporting, the Chinese Foreign Minister, Yang Jiechi, explicitly said that Chinalco's purchase was independent of government decision-making: "杨洁篪称，中铝的收购独立于政府决策。" available at: http://www.caijing.com.cn/2008-02-05/100047968.html

[6] Aluminum Corp of China (Chinalco, also known as Chalco or 中铝) was founded in 2001 as a rollup of the state owned aluminum sector. It has about 200,000 employees and 25 subsidiaries. "As a national champion with more than 40 per cent of Chinese alumina and aluminium production in 2007, Chinalco was an obvious candidate for the mission, even if lossmaking companies with a $9bn equity base don't ordinarily get $20bn loans - in this case from China Development Bank." "Chinalcrio," Financial Times, Feb 13 2009, p. 12. Chinalco had, in fact recently led a

record of successful international and domestic acquisitions experience that Baosteel and other contenders lacked.[7] Moreover, the move would satisfy both the government's desire to prevent a concentration of supply in a strategic resource and Chinalco's own goals of becoming a diversified multi-metal international conglomerate. Chinalco partnered with CDB as the main underwriter and sought advice from Lehman Brothers and China International Capital Corporation (CICC)—which was run by the son of former Premier Zhu Rongji. Chinalco also formed an acquisition vehicle with Alcoa in a politically savvy move that added a "multinational" element to what might otherwise be viewed as a wholly Chinese operation.[8]

After the markets closed on January 31, 2008, Lehman traders at the London desk bought up as many shares of Rio Tinto as they could find. Xiao Yaqing (肖亚庆), the general manager of Chinalco, was quoted as saying the events surrounding the surreptitious buy "...can be a plot for a novel."[9] Xiao apparently sat by Lehman's London trading desk as the operation unfolded. He was too nervous to eat. By the time the dust settled, Chinalco had spent $14 billion to buy 9% of Rio Tinto's total shares in the after hours market—this was China's largest overseas equity investment ever. Overnight, Chinalco had become Rio Tinto's biggest shareholder.

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number of international acquisitions (though none this large). In addition, Chinalco's goals of multi-metal diversification fit nicely with the needs of the state.

[7] Chinalco had a well-respected track record of post-acquisition success domestically in China, having been created as part of a plan to roll up the fragmented domestic aluminum producers in the early 2000s. In 2004 Chinalco outbid 10 rivals to make what was at the time, China's largest investment in Australia (a bauxite mine). In May 2007, Chinalco invested in a Saudi joint venture smelter. Chinalco also acquired 49% of Yunnan Copper Industry Group, China's third largest copper-producer and in June of that year, Chinalco completed the purchase of Canada's Peru Copper—enabling Chinalco to diversify into other metals. Baosteel, by contrast, had a reputation for acrimonious and poorly managed consolidation.

[8] Alcoa lent $1.2 billion and perhaps more importantly, its name, to the "Shining Prospect" acquisition vehicle—providing some political cover against an anti-Chinese political backlash to the deal. At the end of February, 2009, Alcoa formally pulled out of the JV vehicle and received $1.021billion in cash from Chinalco plus its pro-rata share of dividends paid by Rio while "Shining Prospect" owned the shares. Despite the considerable loss in value of the Rio shares after BHP withdrew its bid, Alcoa only had to claim a $120 million non-cash, after tax loss on the venture, given Chinalco's obligation to underwrite Alcoa's stake. That Chinalco afforded Alcoa such a degree of downside protection is indicative of the political rather than financial value that Alcoa brought to the venture.

[9] Xiao described the move as one of "unimaginable complexity" in an interview he had with Caijing three weeks later. Zhao Jianfei, "Chinalco's General Manager on the Rio Tinto Buy," Caijing March 3, 2008. Available in English at: http://english.caijing.com.cn/2008-03-03/100050605.html

Suspiciously, the official Chinese language Xinhua coverage of the incident included an entire section that dwelt on the strategic rationale of why China's central government was involved and why the government chose Chinalco instead of Baosteel or other steel industry players to conduct this operation.[10] None of this discussion made it into the edited English language version of the report.[11] This evidence corroborates interviews suggesting that the State Council played an important role in directing the Rio effort (although the Chinese government frequently seeks to minimize international awareness of its hand in such matters).[12]

Chinalco has publicly denied that its intent was to block the BHP bid, but bankers familiar with the operation have said that Chinalco sought to influence the acquisition—especially given the timing of Chinalco's buy.[13] At the time of Chinalco's "midnight ambush," BHP had about one week remaining (February 6) before it had to declare to the British regulatory authorities its intent regarding an acquisition of Rio Tinto. Despite trying to sweeten its offer for Rio by increasing its bid from 3 to 3.4 shares for every share of Rio, BHP-Billiton was not able to match Chinalco's cash offer. In November 2008, BHP formally withdrew its offer to buy Rio.

Although this was widely viewed as a victory for China, it left Chinalco with an unrealized loss of as much as $10 billion on its 9% stake at one point. In addition, Rio still had to find the cash to service the $8.9 billion of debt that was coming due in October 2009. Chinalco signaled that it was still interested in long-term cooperation with Rio and in December

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[10] See: 王恒利 (Wang Hengli)'s Xinhua news report entitled, ""中美"联手 140 亿美元入股力拓 中国最大海外投资" (cleverly, this can be translated either as: "'Chinalco & Alcoa' jointly invest US$14 billion in Rio Tinto China's largest overseas investment" or as: "*'China-US'* jointly invest..." since Chinalco's and Alcoa's Chinese names both include the characters for China and the US as their first character. Newspaper headlines often employ such abbreviations to save space. In this instance, use of the convention also seems to belie the intent of Alcoa's involvement in the first place.) Available at: http://news.xinhuanet.com/fortune/2008-02/02/content_7548886.htm

[11] See: Jiang Yuxia, "Chinalco, Alcoa buy 12% of Rio Tinto's UK-listed firm," Available at: http://news.xinhuanet.com/english/2008-02/01/content_7545423.htm

[12] Author's interviews #2008620 and #2008625a, Beijing.

[13] Oster and Carew, "China Inc.'s Top Deal Maker Provokes a Backlash Abroad."

one of Rio's executives expressed an interest in gaining access to financing from China's banks. He shared this sentiment with his neighbor in Brisbane, Wang Wenfu, the head of Chinalco's Australian subsidiary.[14] Chinalco proposed to provide a mixture of $7.2 billion in convertible bonds and a $12.3 billion asset purchase that would provide it with a joint stake in some of Rio Tinto's most valuable copper and iron mines. At the time the offer was made, the terms seemed to offer Rio Tinto a favorable way out of its debt burden and Rio's management was enthusiastic.[15] The $19.5 billion package was to be China's largest foreign investment ever—surpassing the 2005 proposed $18.5 billion CNOOC deal for Unocal.[16] In February of 2009, the Chinalco deal for Rio Tinto was announced.[17] If it went through, it would raise Chinalco's stake in Rio to 18%. In Beijing, Xiao Yaqing was heralded as a hero and awarded a position on China's State Council.[18]

However, as economic events unfolded in 2009, it grew increasingly less likely that the deal would succeed. It seemed that China's economy was recovering from the recession more quickly than originally expected, and with China's recovery came renewed global demand for commodities. This buoyed commodity asset prices and increasingly made Chinalco's offer

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[14] *Ibid.*

[15] "As a triple-B borrower, Rio has secured debt financing at a size and rate for which it would have otherwise struggled. The valuation of assets that Chinalco is buying into, meanwhile, is ahead of most analysts' estimates."*ibid.* "Rio says it could have raised $10bn from a rights issue. But that would have left it needing more, forcing it to sell prized assets at firesale prices. Chinalco's bid, it argues, is generously priced and offers access to Chinese cash and minerals," David Pilling, "Do Not Reject Chinalco's Bid for Bogus Reasons," Financial Times, Feb 26 2009, p. 9.

[16] "The deal called for Chinalco to invest $7.2 billion in Rio Tinto in the form of convertible bonds and take $12.3 billion in stakes in a group of its mining assets. It would have given Chinalco two board seats." See: Dana Cimilluca, Shai Oster and Amy Or "Rio Tinto Scuttles Its Deal With Chinalco" June 5, 2009 page B1.

[17] "Rio, flat on its back with its feet wiggling in the air, is now in the Petri dish of a giant experiment - the biggest investment China has sanctioned outside its borders. Xiao Yaqing, Chinalco chairman, is funding the deal by tapping up his old friend Chen Yuan - son of one of the Communist party's Eight Immortals - who is now governor of CDB." From: "Chinalcrio." Financial Times.

[18] See: Oster and Carew, "China Inc.'s Top Deal Maker Provokes a Backlash Abroad." Xiao is currently deputy secretary general of the State Council and an alternative member of the 17th CPC Central Committee.

appear less and less attractive to Rio Tinto's shareholders.[19] In addition, the Australian government faced mounting pressure domestically to block the "fire sale" of Australia's crown jewels—its mining assets—to China.

Finally, on June 5, 2009 Rio walked away from what had become a moribund $19.5 billion deal. On the back of renewed commodity prices, Rio had decided to issue new shares and partnered with BHP-Billiton to co-develop adjacent mines in Australia and share those costs. These combined efforts would enable Rio to service its debt obligations. Government officials in Beijing were not pleased. In July, China arrested four of Rio's negotiating team in China on allegations of spying. The Chinese government contended that they were stealing state secrets regarding the operations of China's steel producers. Among those arrested was Stern Hu, an Australian citizen. The team was negotiating prices for iron ore and the arrests were widely interpreted as an expression of China's anger at Rio Tinto's walking away from the Chinalco deal.

The case is a useful one because the size of the potential deal meant that it received a considerable amount of public coverage. It also illustrates how inter-connected the commercial interests of many of China's leading corporations are with China's national interests. For purposes of testing the theory, the case is useful because we observe the CDB being directed by the State Council to underwrite a commercial acquisition that serves China's national interests. Chinalco's own narrow goals were highly conducive to this path of action and played an important facilitating role in enabling it act as willing agent.

Essentially this case is the story of commercial actors (Chinalco, backed by CDB financing) being used to pursue a national objective of securing a strategically important

[19] Shareholders grew more and more displeased with company management and the Chinalco deal that threatened to dilute existing shareholders by not adequately providing them with an opportunity to maintain their current equity stake. See: Pilling, "Do Not Reject Chinalco's Bid for Bogus Reasons."

resource. This is a case in which China was trying to manage inputs that it views as critical to its national well being—essentially defining iron ore as a strategic resource. Like oil, this constitutes an instance of managing a *Strategic Transfer* type of security externality. In the meetings that preceded Chinalco's initial purchase of the Rio shares in London, we see a coordinated effort on the part of the state to use commercial actors to further China's strategic interests.

To the extent that the strategic consequences of China's outbound capital flows have been addressed in the public and academic debate, the discussion is often framed as a question of whether China's largest companies are scouring the globe looking to do the bidding of China's government or if these commercial actors are simply pursuing their own narrowly commercial interests. Xiao Yaqing's promotion to the State Council is illustrative of the close personal and institutional ties between China's commercial and governmental leadership that often spark such discussions.[20] "The move by aluminum czar Xiao Yaqing into politics in February raised a critical question about China's state-owned corporate giants as they step onto the global stage: Are they driven by profits, or are they pursuing a nationalist agenda for the Chinese government? A close look at the Rio Tinto deal suggests that the answer is both, as business and politics intertwine for a new breed of globally savvy Chinese executives."[21] I would agree that the answer is often complex and frequently involves a mix of commercial motives as well as national interest.

More importantly, however is that this is the wrong way to frame the question. A much better way to think about this issue is to ask: "Under what circumstances can we expect that the government will be able to pursue its strategic policy objectives by using commercial actors?" It

[20] "As if more evidence were needed that Chinalco was answering to a higher [i.e. non-commercial] cause, days after it announced the Rio deal, its chairman, Xiao Yaqing, landed a top government job." *ibid.*
[21] Oster and Carew, "China Inc.'s Top Deal Maker Provokes a Backlash Abroad."

should not be a question of "whether", since that is likely to vary from one episode to the next, but rather a question of "why." This is how I have structured this study and this approach informs the analysis that follows.

6.3 Mapping the theory onto the Chinalco Episode

The goals of Chinalco were to expand internationally, gain access to non-aluminum operations, and further enhance Chinalco's prestige within China's domestic political-economic environment. The goals of CDB were to gain additional international underwriting experience, enhance its international and domestic prestige, deploy recently infused capital from CIC & perhaps to assert its ability to act independently of its new CIC owners. The goals of the State Council were to prevent supplier market consolidation that enhance foreign controlled iron ore pricing power and would likely result in higher prices that would jeopardize future economic growth. NDRC shared similar priorities. The goals of the commercial actors and the government were highly compatible and there was not very much friction. The values on the *Goals IV* in this case would suggest state control.

Although evidence suggests that both the State Council and NDRC were involved in this case, they did not seem to work against each other. Both seemed to share a common vision to encourage actions designed to secure resources and a desire to coordinate the efforts of various commercial actors. Although there may have been more than one government principal, the evidence suggests that the state acted in a fairly unified manner. The value of the *Unity of State IV* in this case suggests state control.

Early in the deliberation process, there were several commercial actors that could have plausibly played a role in securing Rio Tinto. These included Baosteel, Shenhua Coal, and

CDB.[22] The presence of these alternative commercial agents provided an incentive to "compete" for the right to represent China's interests abroad. This type of dynamic helped ensure state control since alternative agents were available in the wings, should the chosen firm prove unreliable.

Regarding the issue of *Relative Resources*, this episode represented uncharted territory for China's international economic activity. This was to be the largest overseas deal ever conducted by China. As such, there was no true expertise resident in the commercial or governmental sectors. By virtue of its recent Peru Copper acquisition and its previous familiarity with investing in Australian assets, Chinalco did seem to have some experience that could be leveraged. In addition, CDB's recent support of Barclays effort to buy ABN Amro and its resulting 3% stake in Barclays provided some background experience for CDB to draw on.[23] Both of these seem to suggest that the commercial actors enjoyed a certain amount of resource advantage over the state, however, the unknown aspects of the endeavor more than outweighed any real knowledge advantage that might embolden the commercial actors to avoid the state's control.

Finally, the status of Chinalco as a SASAC-owned and operated SOE and CDB's position as a policy bank meant that the value of the *Reporting Relationship IV* was strongly skewed toward state control. Given these values across the five IVs in this case, one should not be surprised to find state control over the commercial actors taking place. In each instance, the causal arrows point toward state control. The state actively encouraged and supported the commercial agents to engage in activity to change the status quo. This international commercial activity was designed to facilitate the realization of the state's strategic interests, namely the

[22] *Ibid.*
[23] This episode is discussed in more detail below.

prevention of foreign supplier concentration in a strategic raw material. The Chinese leadership was interested in blocking the BHP bid to take over Rio Tinto. This was realized when BHP withdrew its offer to buy Rio in November 2008. As the situation developed, there even seemed to be the possibility not only of blocking BHP's bid, but of going one step better and taking advantage of depressed commodity prices to secure an 18% ownership stake in Rio, thus cementing future reliability of supply. Although that objective failed to materialize, the case nonetheless still stands as a useful illustration of state control. For purposes of illustrating the theory, the specific outcome of the case (whether Chinalco was successful in acquiring Rio or whether Chinalco's actions merely prevented a consolidation of iron ore supply) matters less than *how* the dynamics between the state and its commercial agents unfolded.

6.4 Other Examples of CDB's Activities

The Chinalco-Rio case is just a recent example of the CDB's financing activities, but it is by no means an isolated case of the CDB supporting the Chinese state's goals. This section briefly highlights some of the CDB's more high-profile recent activities. The 2008 financial crisis and subsequent decline in asset prices has provided long-term valuation opportunities for investment and acquisition. Concurrently, China's government has given its commercial actors the green light to diversify capital holdings that have built up on balance sheets. Expressing a recurring motif in the deployment of China's state-owned capital, Charles Tang, head of the Brazil-China Chamber of Commerce and Industry, has said, "Brazil needs the liquidity and investment, and China now has the finances to buy resources at a discount."[24] Although he was speaking in the context of CDB's loan to Petrobras, the essence of his comment applies more

[24] Antonio Regalado, "Corporate News: Beijing Considers Financing Petrobras," Wall Street Journal, Feb 20 2009, p. B.3.

broadly to China's overall extractive resources strategy. This section highlights a few of the CDB's more recent international activities.

One of the largest deals has been a $25 billion long-term loan to Russia's OAO Rosneft (oil producer) and OAO Transneft (pipeline operator).[25] The loan will enable Rosneft to recapitalize its relatively undeveloped East Siberian oil fields and build a pipeline to deliver oil to Chinese refineries. The CDB will supply the loan in exchange for 15 million metric tons of crude oil a year (about 300,000 barrels a day—10% of China's current volume of oil imports) for 20 years.[26] "In 2008, Russia exported 11.64 million tons of crude to China, equivalent to 233,000 barrels a day, down nearly 20% from the previous year."[27] So CDB's deal enables China to more than double the oil it receives from Russia. This sort of diversifying away from Middle Eastern sources of petroleum (and the concomitant "Malacca Dilemma") is seen as an important national energy goal.

Another recent, large deal designed to diversify China's energy supply was the $10 billion financing package that CDB provided to Brazil's state-run oil giant, Petroleo Brasileiro SA (Petrobras) to explore deep-water oil reserves. Petrobras had been receiving pressure from the Brazilian government to increase its counter-cyclical spending and CDB was happy to finance its expanded oil exploration.[28] In an ostensibly separate agreement, Petrobras agreed "to sell to China Petroleum and Chemical Corp. 60,000 to 100,000 barrels of heavy crude oil a day,

[25] "China reached a long-term deal to lend $25 billion to two Russian energy companies in exchange for an expanded supply of Russian oil, highlighting how the world's No. 3 economy is using its financial muscle to lock up access to natural resources." David Winning, Shai Oster, and Alex Wilson, "World News: China, Russia Strike $25 Billion Oil Pact --- in Third Deal in a Week, Beijing Moves to Lock Up Natural Resources at Bargain Prices to Fuel its Growth," Wall Street Journal, Feb 18 2009, p. A.8.
[26] China imports about half of the oil it uses. See: Winning, Oster, and Wilson, "China, Russia Strike $25 Billion Oil Pact," This proportion is slated to grow.
[27] *Ibid.*
[28] "Brazil's government has pressed the oil giant, the country's largest company, to increase spending ahead of elections in 2010 and as a tonic against the economic crisis. ...it will spend $28 billion through 2013 exploring and drilling in the deep-water fields." From: Regalado, "Corporate News: Beijing Considers Financing Petrobras."

or as much as 5% of total Petrobras production, starting immediately."[29] These announcements at a recent signing ceremony between Chinese Vice President Xi Jinping and Brazilian President Luiz Inacio Lula da Silva also alluded to a possible memorandum of understanding between Petrobras and CNPC to sell China another 60,000 barrels per day. Replicating a tried and true strategy, China sought to leverage the synergies between closer economic cooperation on energy and minerals and improved diplomatic relations.

As evidenced by the Chinalco/Rio case and these other recent big-ticket deals, the Chinese state has used state financing as an effective lever of control to guide, encourage, and influence the international activities of its commercial actors. In the lead-up to Chinalco's investment in Rio Tinto, the Chinese state brought together potential commercial actors, vetted them and matched the winning Chinalco with state-sponsored financing to complete its "Midnight Ambush." By underwriting these types of major transactions, the state is able to shape the behavior of firms. To better understand exactly how this mechanism of state power is used, the next few sections examine the CDB—specifically its goals, reporting relationships, and financing activities. This entity has been responsible for financing a good deal of China's recent "Going Out" efforts. Such operational details provide insight into exactly *how* the Chinese state is able to exercise effective economic statecraft to achieve national strategic objectives.

6.5 The China Development Bank[30] (国家开发银行): Origins & Mandate

In 1994 China established three policy banks as part of the plan to transition the "Big 4" national banks to a more commercial footing by hiving off their non-commercial work and

[29] *Ibid.*
[30] "国家开发银行" is more accurately translated as "Nation Development Bank" but I have adopted the common naming convention of "China Development Bank" or "CDB" that more often appears in English language sources.

moving that over to the policy banks.[31] This gradual commercialization of the banking sector was part of the larger economic reform effort designed to modernize China's economic system. These three policy banks were the China Development Bank (CDB), the Export-Import Bank (Ex-Im) and the Agricultural Development Bank of China (ADBC). The mandates of each was slightly different: the CDB was designed to finance key domestic infrastructure construction projects and coordinate what was a fairly scattered national investment loan effort; the Ex-Im Bank was designed to promote the development of foreign trade by providing trade financing; and the Agricultural Development Bank of China was to provide for capital needs of the government development plans for the rural areas and agricultural sectors.[32]

From the start, CDB was saddled with a considerable portfolio of nonperforming loans and a legacy of loose lending practices. These were the product of government directed lending to otherwise insolvent state owned enterprises (SOEs). In addition to the expected rent-seeking behavior of such large political institutions, the Party had a strong incentive to maintain these SOEs on life support since the SOEs substituted for China's under-developed social welfare net. Under the centrally-planned economy, SOEs often provided healthcare, pension, education and other public welfare benefits. Suddenly subjecting these largely inefficient enterprises to market competition would drive many of them out of business and with them would go provision of important public goods. This had the potential to set off considerable popular discontent and generate social instability. As a result, the NDRC and its predecessor planning bureaucracy directed credits and loans be extended to keep the SOEs afloat. While this kept the SOEs

[31] The Big 4 are: ICBC (which was primarily engaged in providing industrial and commercial credit), Agricultural Bank of China (which provided credit primarily to rural areas), Bank of China (which handled foreign currencies) and China Construction Bank (which specialized in medium to long-term domestic infrastructure project finance). With the 1994 reforms, these fiscal policy activities began to be transitioned to the policy banks, and the Big 4 were made ready for public stock listings as commercial-oriented banks.

[32] Rick Carew in Hong Kong and James T. Areddy in Shanghai, "Moving the Market: China Fund to Aid State Bank; Sovereign Investor Uses Cash at Home as Well; A $20 Billion Infusion," Wall Street Journal, Jan 2 2008, p. C.2.

running, it left much of China's banking sector with a growing portfolio of non-performing loans. As a policy bank carved out of what would become the commercial banks, the CDB was left with a considerable amount of commercially unsustainable loans. In addition, the CDB continued to operate under the legal mandate of a policy bank, meaning it could expect additional non-commercial tasking in the future.

In the last few years, CDB has aggressively moved away from just underwriting large domestic Chinese infrastructure and development project financing. Although still supportive of state goals, the CDB now engages in international activities on a large scale. For example, the previously mentioned Russian and Brazilian oil development deals helped secure long-term supply agreements for China. The CDB has also expanded its scope to underwrite international development financing and international corporate expansion and acquisitions on the part of China's leading SOEs. A case in point was the September 9, 2009 announcement that CDB has provided a $30 billion loan to CNPC to finance CNPC's planned international acquisitions. As part of the state's "Going Out" mandate, CDB has supported a number of activities closely tied to both commercial and foreign policy goals. [33]

6.5.1 The China Development Bank: Structure, Financing Sources, and Uses

The CDB is fully owned by the state. While the state may still hold a controlling interest in China's "commercial banks," these entities at least have some portion of their equity publicly-traded on market exchanges in Shanghai and/or Hong Kong—providing some externally-driven commercial motivation, governance, and public oversight. The CDB is not yet listed on any stock exchanges and has only recently begun issuing public disclosures. Yet, the CDB is today

[33] Carew and Areddy, "Moving the Market."

one of the most significant forces in international finance: it has more assets than the World Bank and the Asian Development Bank combined.[34]

"At present, CDB functions much like a domestic version of the World Bank, raising money through bond sales and lending to projects favoured by Communist Party policy."[35] The CDB is financed not by deposits, but rather by bond issuances.[36] These bonds are auctioned off to raise capital which the CDB then uses to underwrite loans and lines of credit to various entities (often at favorable, below market terms). Over the course of its existence, the CDB has issued more than $275 billion of bonds—more than a quarter of all the debt securities outstanding in China's financial markets. CDB has issued more bonds internationally than any other Chinese institution.[37] As part of the recapitalization and re-organization of China's domestic banking sector, CDB was placed in Central Huijin—a holding vehicle directly under the Ministry of Finance. When the CIC was created, the assets of Central Huijin were transferred to CIC.[38] Thus, today the CDB is now technically a holding of the Ministry of Finance and CIC via the Central Huijin vehicle. At the end of 2007, CIC injected $20 billion into CDB in part to help it prepare for an eventual public listing.[39]

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[34] In 2008 the CDB had assets of $540 billion. The World Bank had approximately $58.8 billion in 2009 (38.2 in 2008) while the Asian Development Bank had only about $52 billion. See: http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:22233771~pagePK:34370~piPK:34424~theSitePK:4607,00.html and http://www.adb.org/Documents/Others/Financial_Profile/default.asp?p=orgfrs respectively.

[35] Jamil Anderlini, "Illegal Lending Scandal Hits China Development Bank," Financial Times, Aug 30 2008, p. 9.

[36] Carew and Areddy, "Moving the Market."

[37] *Ibid.*

[38] See Chapter Eight for more on CIC's origins.

[39] CDB was re-capitalized at $20 billion. See: Brad Setser, "The Implications of Sovereign Wealth Fund Investments for National Security," Testimony before the US-China Economic and Security Review Commission February 7, 2007 p.9.; Xin Zhiming, "Huijin to Inject $20b into China Development Bank," China Daily, December 31, 2007. On December 11, 2008 the CDB officially changed its organizational structure to a corporate stockholding structure similar to the sort the "Big 4" commercial banks have used to go public. As part of this reorganization, Central Huijin provided RMB 146.1 billion and the Ministry of Finance provided a RMB 153.9 billion registered capital injection—again similar to the efforts to shore up commercial banks balance sheets before public listing. As a result, the CDB's 2008 Annual Report lists Central Huijin as owning 48.7% of CDB while MoF holds the remaining 51.3%.

Most recently, the CDB appears to have become a favored investment financing vehicle for Chinese SOEs looking to make acquisitions abroad.[40] In 2008, CDB reported that it had $64.5 billion in foreign currency loans outstanding—2/3 of which were directly issued to underwrite Chinese corporate efforts to "Go Out" (走出去).[41] Typically, Chinese multinational firms will partner with a state-backed financial entity to underwrite major foreign investments and acquisitions. Sometimes these activities are instigated by the firm and sometimes by the state.[42] In almost every case, such international economic interaction is now closely coordinated by the state (although in the early days of the "going out" policy, SOEs were acting much more independently). The state's re-assertion of control over its commercial actors has deftly relied on centralized provision of inexpensive capital. Generally, this domestic coordination process begins early so as to ensure that attractively-priced funds and state support exist before the Chinese firm moves forward with negotiating deals internationally.[43]

One final aspect of the CDB's operations that differs from some of China's other state-directed financing vehicles is that it often underwrites specific loans or provides direct financing to Chinese companies for particular purposes. This method of debt financing is different from the investments made by NSSF, CIC, and SAFE which generally take the form of equity ownership and provide stakes in specific companies or industries.[44] Of the two means of

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[40] "[The CIC's] subsidiary, the China Development Bank, has become the bank of choice for financing outward investments. This is not by accident. The bank, along with China's Exim Bank, were created precisely for the purpose of supporting Chinese companies' push into overseas markets, with the aim of becoming truly global players in a commercially competitive way." Paul Glasson, "Regional Focus to Global Push: The China Syndrome," The Australian March 4, 2009, p. 22.

[41] CDB's 2008 Annual Report available in English at: http://www.cdb.com.cn/English/Column.asp?ColumnId=91

[42] "The State Council has become more active in communicating its wishes to key departments and companies of late. . . In some instances, the State Council has itself been the driver of investments abroad." Paul Glasson, "Regional Focus to Global Push: The China Syndrome," The Australian March 4, 2009, p. 22.

[43] "Ordinarily, a Chinese SOE will seek approval early in its negotiations with a foreign party, to ensure that the funds it needs will become available." Paul Glasson, "Regional Focus to Global Push: The China Syndrome," The Australian, March 4 2009, sec. Finance, p. 22.

[44] These will be discussed in more detail in Part III.

financing, it would seem that CDB's project-specific approach provides the financier with more direct tactical discretion as it can approve or reject activities on a project-by-project basis. *Ceteris paribus*, project-specific debt financing should provide the lender with more precise leverage than a minority equity stake. Direct equity stakes delegate more of the decision-making to a firm's professional managers. That said, the influence of large equity stakeholders (particularly on matters of high level, strategic guidance) should not be underestimated.

6.5.2 The China Development Bank: Analyzing the CDB's Activities

CDB is in the process of transitioning from a "policy lender" to a commercial operator. There still seems to be support for such a transition (despite the onset of the current financial crisis, which has seen liberalization and reform efforts fall out of favor among senior Chinese elites). If such a transition were to take place, it would have the effect of shifting the CDB's operations to a more commercially-driven footing and away from today's policy-driven dynamics.

Up to this point, however, most of the CDB's activities have exhibited significant non-commercial dimensions. During China's domestic lending spree in response to the global financial crisis, the CDB enthusiastically embraced government priorities in doling out its support.[45] The CDB's international projects have also been in support of the stated policy goals

[45] "China's State Council, the country's cabinet, also announced measures yesterday to stimulate lending and mitigate the impact of the global slowdown on China's slowing economy. The council said it would work to ensure there was sufficient liquidity in the banking system and would allow the country's three "policy" banks - China Development Bank, China Export and Import Bank and China Agricultural Development Bank - to make a further Rmb100bn ($14.5bn, EUR11.5bn, pound(s)9.9bn) of loans." Jamil Anderlini, Geoff Dyer, and Raphael Minder, "Western Banks Face Snub from China Fund," Financial Times, Dec 4 2008, p. 3. "China Development Bank (CDB), a joint-stock commercial lender reformed from policy one, relied on its project reserve advantage to further expand credit in 2008, in line with the domestic demand expansion policy. 83.3% of its loan was provided for the nation's coal, electricity, and oil supply, agriculture, forestry, animal husbandry and fishery, telecommunications, and public infrastructure fields, as well as central, west, and northeast China enjoyed 64.5% of the total money loaned by CDB. In addition, the Beijing-located bank aggregately lent CNY 83.3 billion to the domestic

of promoting an outward expansion of China's leading industries. The strategic goals of the state in encouraging these efforts have been to improve the general efficiency of China's largest enterprises (and by extension the efficiency of China's economy) largely by gaining access to the latest technologies and state of the art management practices. This is an example of the *Bolstering* type of security externality. The Chinese government has also stated that it views securing access to reliable supplies of strategic resources to be in the national interest. It has defined inputs like iron ore, petroleum, copper, etc. to be vital to China's well being, making the continued security of supply of such materials a key national interest. This logic is reflective of the *Strategic Transfer* security externality discussed earlier.

The CDB seems to conduct its financing operations using three general models. The first is direct investments into companies or projects. This is a pretty straightforward capital infusion and the CDB becomes the purchaser of the equity. Examples of such activities include the Citibank deal (which seems to have been stopped by the State Council) and the Barclays equity stake. In a bold move abroad, CDB paid close to $3 billion to buy a 3.1% stake in Barclays Bank.[46] The British bank, Barclays, was looking to raise capital to fund its attempted acquisition of the Dutch bank, ABN Amro. CDB seized the opportunity to partner with Barclays as a part of an effort to move into international finance and learn from the leading players.[47] CDB hoped to learn more about commodities trading and commodities risk hedging—presumably since these

environment protection, energy saving, and emission reduction projects, and around CNY 17 billion was loaned to disaster areas attacked by the 8.0-magnitude earthquake on May 12, 2008." From: "China Development Bank Expanded Credit in 08," SinoCast China Business Daily News, Jan 12 2009.

46 "...Barclays strengthened its bidding power for ABN Amro by raising Euros 3.6bn from China Development Bank and Singapore's Temasek, in return for stakes of 3.1 and 2.1 per cent respectively." From: John Willman, "Yesterday's Bad Guys Ride to the Rescue," Financial Times, Jan 23 2008, p. 4. CDB invested approximately $2.9 billion.

47 "Earlier this year, state-owned China Development Bank bought a 3.1% stake in Britain's Barclay's Bank. CDB hopes to tap Barclay's banking expertise while Barclay's hoped to use the cash to bolster its ultimately unsuccessful bid for ABN Amro." From: "Chinese Bear Hug," Wall Street Journal, Oct 24 2007, p. A.20. See also: Carew and Areddy, "Moving the Market."

were areas in which CDB anticipated continuing involvement.[48] CDB also has the ability to appoint directors to the board of Barclays.[49] Perhaps most significantly, the stake provided CDB with a potential opportunity to invest in a much larger position had Barclays succeeded in acquiring ABN Amro. CDB was prepared to fund a considerable portion of the acquisition in exchange for a sizeable part of the equity of the combined company. This would have catapulted CDB to the forefront of international banking and would have gone a long way in meeting the government's desire to place its financial industry on a more globally-competitive footing. In the end, Barclays did not succeed and CDB's stake in Barclays was limited to 3%. Despite losing a considerable sum in this investment, CDB has elected to maintain its 3% position by exercising its right to purchase additional shares in subsequent rights offerings.[50]

Although the CDB seems to be a willing supporter of state goals when they align closely with its own commercial goals, the state is also able to exercise control over the CDB when the commercial goals conflict with state preferences. For example, in early January of 2008 Citigroup was looking for a capital infusion to shore up its balance sheet. CDB had planned to provide $5 billion for a stake in the wounded company. However, China's senior leadership was having second thoughts about the severity of the credit crunch. Although generally supportive of the efforts of Chinese companies snapping up assets abroad when their prices are down, the

[48] "Barclays will train CDB commodities traders and bankers and will become the Chinese bank's preferred provider of commodity market risk hedging. . . . The bank also said it will help CDB develop commodity products, focusing initially on corporate clients rather than investors, trading capabilities and commodities risk management infrastructure . . . Gao Jian, deputy governor of CDB, said Barclays was the right long-term partner for the bank. The agreement, which runs to 2012 and could be extended for another five-year period, is part of the banks' alliance started in July when CDB become one of Barclays' largest shareholders." From: Javier Blas, "Barclays to Form Alliance with CDB," Financial Times, Oct 10 2007, p. 17.
[49] "But Temasek and China Development Bank have the right to appoint directors to the board of Barclays under their own deal." From: Peter Thal Larsen, "Sovereign Wealth Funds Bag Big Stakes in Banks," Financial Times, Sep 26 2007, p. 21.
[50] "China Development Bank (CDB), one of the three policy banks in the nation, has finished buying more shares in Barclays Bank, one of the largest commercial banks in the UK, said Barclays Bank spokesman Robin Tozer on July 24. . . Mr. Robin did not disclose how many shares the Chinese bank bought in the UK bank but added that the policy bank is expected to keep an about 3% stake in Barclays Bank after the deal." From: "CDB Said to Finish Buying More Barclays Bank Shares," SinoCast China Business Daily News, Jul 25 2008.

government had decided that financial companies had become too unstable and China's previous experience with strategic stakes in Blackstone, Barclays, Morgan Stanley and Fortis did not provide reassurance.[51] As a result, the State Council tried to stop the CDB from investing up to $5 billion in Citigroup.[52] In response, dutiful CDB rebuffed Citigroup's offer. Although the commercial actor, CDB, seemed to want to partner with Citibank, when the state principal indicated that it was not in favor of such action, the deal was halted.[53] The CDB was forced to forgo its narrow interests of acquiring international banking skills and building up its international partnerships which would have made it more commercially competitive in favor of conforming with state preferences to avoid further exposure to the international financial sector. This episode demonstrates the state's ability to control the CDB even when commercial forces pulled against state preferences.

The second general mode of CDB's investment activities is one in which CDB plays a secondary, enabling role for other companies' activities. In this type, the CDB provides a line of credit, financing or other financial assistance to another (almost always Chinese) corporation in order to allow that entity to undertake some project or conduct some activity that the state supports. Based on my research, this seems to be the CDB's most common type of operation. Recent examples include the CDB's provision of $30 billion in financing to CNPC to underwrite

[51] "The decision to stop CDB from investing up to $5bn in Citi was made in large part because of the perceived failure of the Barclays investment . . . China Investment Corp's stake in US private equity firm Blackstone, CIC's stake in Morgan Stanley and Ping An Insurance's investment in Fortis. From: Jamil Anderlini, "Beijing Leadership Will Need Persuading," FT.Com (2008).
[52] "A CDB plan to participate in Citigroup's giant capital-raising in January was halted by intervention from Wen Jiabao, China's premier . . ." *ibid.*
[53] "Losses from the Barclays investment are believed to have led to the intervention of Wen Jiabao, China's premier, which stopped CDB from investing up to $5bn in Citigroup." From: Anderlini, "Illegal Lending Scandal Hits China Development Bank."

CNPC's international acquisitions and CDB's funding of a 10 year debt facility to underwrite Huawei's upgrading of a Polish telecom system.[54]

The third type of operation involves setting up investment funds with specific mandates or missions. These are often considerably smaller and frequently have a regional or sectoral focus. The CDB infuses this sort of fund with capital and the fund then looks to invest that capital according to its mandate. Examples of such funds that the CDB has set up include the Sino-Swiss Partnership Fund, China-Belgium Direct Equity Investment Fund, ASEAN China Investment Fund L.P., Sino-Israel Investment Fund, and the China-Africa Development Fund.[55]

Most of the CDB's large-scale international investments have fallen into one of three sectors: finance, extractive industries (like petroleum, gas, minerals, and metal ores), and infrastructure.[56] CDB's involvement in infrastructure projects is not difficult to understand. The roots of CDB were in infrastructure projects domestically in China. Building on this institutional expertise was a logical way to extend CDB's operations internationally. Activities in the financial sector are largely driven by a desire to modernize CDB's own banking operations and risk management practices.[57] Strategic partnerships with international banking entities provides CDB with access to best practices, technology transfer, and financial product innovation. Another benefit of investment operations in finance are the networking and personal relationship

[54] "The Euro 640m ($992m), 10-year debt facility to fund an upgrade at Play, Poland's fourth largest mobile operator, will mostly benefit Huawei, the Chinese telecoms equipment giant with the contract to do the upgrade, and fits well into the bank's mandate of helping Chinese champions expand abroad." Jamil Anderlini, Paul Betts, and Andrew Hill, "Politics could Force Silence on China Development Bank," Financial Times, Jun 19 2008, p. 16.

[55] "China Development Bank to Launch a Sino-Israel Fund," SinoCast China Business Daily News, Jan 11 2008, p. 1.

[56] Since this case is about international deployment of China's state capital, the empirical evidence will focus on CDB's international activities.

[57] "Chinese institutions have been looking at opportunities to take stakes in foreign financial institutions to diversify their revenue sources. In the case of Western investments, they also hope to gain an inside look at how more-mature banks tick." From: Rick Carew,Edward Taylor and Dana Cimilluca, "China Bank Seeks Western Investments," Wall Street Journal, Aug 6 2008, p. C.3.

cultivation that are so important for doing successful business in China.[58] China's involvement in extractive industries is largely fueled by its projected needs and a desire to hedge price and supply risk. As discussed earlier, the government has been explicitly encouraging large Chinese companies to venture abroad as a way of improving their competitiveness while securing access to raw materials. Extractive sectors also tend to be least reliant on skilled mergers and acquisitions management and execution expertise since most commodities are fairly easy to value. Extractive companies often retain the "hard value" of their underlying assets, regardless of acquisition skill, unlike tertiary industries which are often reliant on human capital or brand value that might be destroyed by poor merger execution. Finally, because of the "hard value" nature of their assets, extractive sectors tend be less reliant on intellectual property or other political-legal supporting infrastructure—making such industries particularly resilient in otherwise unstable conditions.

6.5.3 Assessing Evidence from China Development Bank (CDB)

The Chinalco deal indicates that the State Council was able to "encourage" CDB participation. Evidence from the Chinalco case seems to suggest that as a policy bank, CDB is subject to control by the state.[59] This high degree of control is the result of values on the IVs that make CDB a particularly useful agent for achieving state foreign policy goals. As a policy bank, CDB is in a rather unique position as a commercial actor whose interests are statutorily constructed to mirror those of the government. This case represents an extreme value on the *Goals Compatibility IV*. As expected, state control is strong.

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[58] Apparently, one of factors that enabled CDB to be tapped to finance the Chinalco-Rio deal was CDB's relationship with international bankers.

[59] CDB's structure as a policy bank entails a statutory obligation to implement state policy rather than operate on purely commercial terms.

In many instances, there is often more than one commercial actor available to finance a given international investment. For instance, several entities could have financed the Chinalco deal. China Ex-Im is another policy bank with an explicit international mandate that could provide an alternative source of financing for state-sanctioned international investment activities. To the degree that alternative agents exist for the state to select from, the *Market Fragmentation IV* dynamic suggests that the CDB will be more pliable and accommodating to the state's interests.[60] Since there are only three policy banks, the monitoring burden on the part of the state is tolerable. The CDB/Chinalco case represents a case of oligopolistic market fragmentation and as hypothesized, results in significant state Control.

From the *Unity of State IV* perspective, the CDB's major projects (including the Chinalco case) also result in state control. The State Council exercises supervisory jurisdiction on China's most significant, high visibility international investment projects. As was the case with state supervision of Chinese oil companies, such high level attention provides an effective degree of unified state supervision. This unified state element was reflected in the involvement of China's state leadership in aspects of the Chinalco, Petrobras, and Rosneft episodes (all CDB financed deals).

With regard to the *Relative Resource IV*, the CDB does occasionally seem to enjoy some latitude in its activities stemming from its financial expertise (e.g. its considerable experience issuing bonds, structuring large scale project finance, risk management, etc.) and unique foreign partnership relationships that afford it a relative resource advantage. That said, the empirical evidence suggests that any independent agency that the CDB might enjoy from this asymmetry is generally offset by the confluence of goals and the extreme values on the other IVs that favor

[60] "But to say there is state involvement is not the same as imagining a monolithic apparatus planning world domination. … Chinese companies, even state-owned ones, are as likely to be engaged in cut-throat competition as in cosy cartels or state-sponsored carve-ups." From: Pilling, "Do Not Reject Chinalco's Bid for Bogus Reasons."

state control. Interestingly, the high profile nature of several of these cases meant that it would have been difficult for the CDB to directly undermine the wishes of the State Council. The public nature of some of these cases seems to have provided the state with additional monitoring capability.

With respect to the *Reporting Relationship IV*, almost every dimension indicates that the state is clearly in charge of the CDB. CDB is a wholly-owned government entity, financed by the Ministry of Finance and the China Investment Corporation (which as argued in the next chapter is, itself, largely beholden to the Ministry of Finance). The CDB's management must answer to the State Council. It was created explicitly to implement government policy priorities and its legal mandate reflects this mission. Again, the value on this IV is extreme and state control results as the theory would predict.

6.6 Conclusion

This chapter and the last chapter examined China's efforts to secure raw materials. The last chapter highlighted the government's inability to control commercial actors while this chapter used the Rio Tinto case and CDB to illustrate state control. Specifically, these chapters have examined how China secures strategic resources in the form of both petroleum and iron.[61] The Chinese state often seeks to work through commercial actors to accomplish its objectives with regard to securing raw materials it views as strategic. In different times and across different contexts, the state enjoys varying degrees of control over these commercial actors. Rather than arguing that the state is categorically "weak" or "strong," it is more helpful to use a theoretical

[61] Large transactions often signal important data points for the study of economic statecraft in these sectors. Such case evidence also generally involves relatively high levels of public visibility providing instructive transparency in what can otherwise be fairly murky terrain.

framework for understanding the elements of a state's successful use of commercial actors to realize its strategic objectives.

The five factors presented in Chapter Two account for when the state is able to control its commercial actors. In the case of China's NOCs, the state was often divided by internal bureaucratic coordination difficulties which undermined the *Unity of the State.* The senior bureaucratic ranking of the NOCs also meant that the *Reporting Relationship* between the state and the commercial actors further limited state control. In addition, the *Relative Resources* were highly skewed in favor of the commercial actors. As a result, the Chinese state often had a difficult time controlling these commercial actors. In contrast, the CDB/Chinalco case provided evidence that the state was able to very effectively control the behavior of its commercial actors. In particular, the extreme values across almost all of the independent variables in this case were skewed in favor of the state. In particular, the complementarity of the state's *Goals* and the goals of the commercial actors facilitated state objectives. Also, the *Reporting Relationship* was clearly in favor of the state. The CDB/Chinalco case provides a useful illustration of how the Chinese state may use commercial actors to pursue its strategic objectives. The evidence shows the CDB being directed by the State Council to underwrite a commercial acquisition that serves China's national interests. Essentially this case is the story of commercial actors (Chinalco, backed by CDB financing) being used to pursue a national objective of securing a strategically important resource. The case is one in which China was trying to manage inputs that it views as critical to its national well being—defining iron ore as a strategic resource. This constitutes an instance of managing a *Strategic Transfer* type of security externality. In the meetings that preceded Chinalco's initial purchase of the Rio shares in London, there was a coordinated effort on the part of the state to use commercial actors to further China's strategic interests.

Particularly striking from this evaluation of China's efforts in both the petroleum and iron sectors is the prominent role that financing seems to have played. In the Chinalco case, the CDB acted as a critical element of state coordination. To the extent that the Chinese state was able to re-assert its control over the "Going Out" activities of the NOCs, state-backed financing also seems to have provided an important lever of control over major international investments. As China continues down the path of increasing commercialization of its corporate actors and the state is removed from day-to-day management of firms, finance is emerging as a key lever of continuing state control. This is primarily the result of two factors. First, the state still maintains very close control over China's banking and finance sector, providing the state with ready institutional mechanisms for enforcing its policy preferences. Second, despite the high-profile nature of Chinese IPOs, the vast majority of Chinese corporate finance continues to rely on bonds and bank loans rather than public equity.[62] As a result, state-controlled finance holds out the prospect for continued state control over Chinese firms even as corporations move toward formal commercialization. Barring further maturation of China's capital markets, firms are unlikely to be able to finance their international expansion without relying on China's banking system. Thus, the next chapter will turn to examine China's national financing infrastructure. If control over the purse strings can provide the state with the ability to practice effective economic statecraft, then one ought to consider if, how, and when such control might be possible. The most likely pools of capital that the state would be able to direct for strategic purposes are those that the state most directly owns and administers: its sovereign wealth funds.

These funds have been a recent cause for concern given the significant role of the state in managing and directing such large pools of capital. To better understand the strategic

[62] Chinese equity markets are rather thinly capitalized and volume movements are often the product of momentum rather than company fundamentals.

implications of China's sovereign wealth funds, the next chapter will apply of the theory to analyzing the structure, funding, and activities of these commercial actors. The theory provides helpful analytical leverage for understanding the conditions under which one might be concerned that these financial entities may be used for purposes of economic statecraft.

Chapter Seven

What Right Looks Like: SAFE and the NSSF

7. 1 Introduction

As evidenced in the last chapter, China's global resource extraction activities often involve substantial state-backed investments. In this chapter and the next, I examine China's sovereign wealth funds—namely the government financial entities charged with investing funds on behalf of the state. Given the unusually high levels of retained earnings on Chinese corporate balance sheets, its exchange rate regime, and the large amount of national savings more generally, it seems likely that Chinese outward bound investment is likely to grow.[1] According to China's Ministry of Commerce, by 2020 China will be the largest overseas investor in the world.[2] This growth in outward investment activity has been a source of concern to many policy makers, given the potential or actual security externalities that result from the activities of commercial actors. Specifically, it seems to be the strategic implications of large flows of government-directed investment capital that raise the fear of this particular form of economic interaction being used to further politically-motivated, strategic goals.[3] Of particular concern, given the prominent role played by the state, are the financial activities of the sovereign wealth

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[1] "In the year 2007, China entered into 108 bilateral investment agreements with foreign countries all over the world and China's foreign investment amounted to USD 20 billion. Most of the money went into the developing countries in Asia and Latin America." From: "China Foreign Investment Spree to Continue," SinoCast China Business Daily News, Apr 9 2008. Compare this with the growth in 2008 and 2009, when CDB (in September 2009) just announced (in a single instance!) a $30 billion loan to CNPC for financing acquisitions abroad.

[2] Paul Glasson, "Regional Focus to Global Push: The China Syndrome," The Australian March 4, 2009, p. 22.

[3] Angel Gurria, secretary general of the Organization for Economic Cooperation and Development, in his March 27, 2008 address to the organization's Global Forum on International Investment stated that "The size of these funds, and the fact that they are owned by governments have raised many questions regarding their operation and purpose. Potential host countries fear that SWF investment decisions could be motivated more by political objectives than by profit considerations, and that the funds could target security-sensitive and other 'strategic' assets." Remarks available at: http://www.oecd.org/document/13/0,3343,en_2649_34863_40336589_1_1_1_1,00.html

funds and the state-owned banks. To the extent that these state investment decisions are used to support foreign policy goals, such behavior is an example of the financial form of economic statecraft. The empirics of this chapter illustrate how these types of economic statecraft do or do not play out in practice.

An accurate assessment of these potential tools of economic statecraft ought to consider the full range of entities that are charged with allocating capital internationally on behalf of the state. To this end, this chapter and the next examine not only China's official sovereign wealth fund, the China Investment Corporation (中国投资有限责任公司), but also the National Social Security Fund Council (全国社会保障基金理事会), and the State Administration of Foreign Exchange (国家外汇管理局). [4] Although each of these entities are responsible for investing government funds, they differ from each other in important ways. For example, the goals and missions of these actors vary, as does the degree to which their activities support China's foreign policy objectives. All share the unifying quality of being non-private, state-owned, managed and/or funded commercial actors, thus making them a good testing ground for comparatively analyzing the differences among them to determine how those differences may account for observed outcomes. To varying degrees, their activities are influenced both by commercial and strategic foreign policy objectives. Understanding the factors that explain these differences

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[4] Brief profiles of all six of China's sovereign wealth funds discussed here can be found in Appendix B. The other commercial actors that are similarly tasked with investing state capital are: two of China's three "policy banks"[4] (namely, the China Export-Import Bank—中国进出口银行, and the China Development Bank—国家开发银行[4]), and the China-Africa Development Fund (中非发展基金有限公司). Although the China Investment Corporation (the CIC) is widely considered to be China's official sovereign wealth fund, each of these government entities is charged with investing a portion of the state's wealth. Although the US Treasury officially only recognizes the CIC as China's sovereign wealth fund, from an analytical point of view, there is a strong case to be made for expanding the analysis to cover the full range of entities that function as sovereign wealth funds. The Treasury's classification carries certain obligations and legal stipulations that, for political reasons, may wish to be avoided. Ted Truman (widely recognized authority on global sovereign wealth funds) suggests a more inclusive definition along the lines of the one I am using. See: Edwin M. Truman, "Rise of Sovereign Wealth Funds: Impacts on US Foreign Policy and Economic Interests," Testimony before the Committee on Foreign Affairs, US House of Representatives, May 21, 2008. Available at: http://peterson-institute.org/publications/papers/truman0508.pdf

provides us with a better understanding of how the state is able (or not able) to effectively control the deployment of investment capital to achieve its foreign policy objectives.

Specifically, this chapter examines two Chinese sovereign wealth funds in detail: the State Administration of Foreign Exchange (SAFE) and the National Social Security Fund Council (NSSF). These two cases are useful from a theory-building perspective in their ability to illustrate extreme values.[5] The time period covered by these cases runs from China's WTO entry to the onset of the current financial crisis. China's massive build up of foreign exchange reserves really begins its dramatic growth when China enters the WTO in 2001. The build-up is a result of China's trade surplus and its non-convertible currency policy. During this period, China has built up its "economic gunpowder" to the point that it can now afford the luxury of using economics to pursue its foreign policy objectives (as opposed to primarily using its foreign policy to ensure that its economic objectives are met).[6] Understanding the limits of that economic power and how it gets mobilized involves a closer examination of the particular interface of the Chinese government and its commercial actors. In this chapter, I focus on how this interaction takes place in the realm of the investment of state capital. In the case of NSSF, we observe an unambiguously commercial agent with little potential for economic statecraft while SAFE presents evidence of a commercial actor being used to achieve China's foreign policy objectives. First, this chapter examines the case of SAFE—an entity that has recently demonstrated its utility as an instrument of Chinese economic statecraft.

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[5] Selecting cases that exhibit extreme values on the IVs offers an opportunity to observe how such values cause outcomes in the DV. Such process tracing enables tests of internal validity—an important basis for theory building.

[6] I am indebted to Barry Naughton, Charles Freeman, and Tony Lake for pointing out this distinction in our conversations. During much of the 1990s and early 2000s, it can be said that China's foreign policy mainly served its economic interests. There is still some of that going on today, but the growth and progress China has made economically (and seems likely to continue to make) has sparked concern that China will be able to leverage its economic power to pursue an expanding set of foreign policy preferences. For more on how expanding capabilities tend to lead to expanding national aims see: Arnold Wolfers, *Discord and Collaboration; Essays on International Politics* (Baltimore: Johns Hopkins Press, 1962) pp. 89-91.

7.2 The State Administration of Foreign Exchange (SAFE)

SAFE primarily serves to manage China's foreign exchange reserves. SAFE has had investment operations dating at least to 1997 when its Hong Kong office was established to conduct open market operations to defend China's currency peg in the face of the East Asian Financial Crisis. Today, SAFE still maintains the RMB's peg range. Its primary duties also include allocating foreign exchange for clearing China's foreign trade and managing China's capital account liquidity. The history of SAFE's institutional development is really the story of China's evolution on foreign exchange policy—a gradual and experimental liberalization of its capital account.[7]

Although specific information regarding SAFE's internal reporting structure is not widely available, it seems that SAFE is "a bureau with vice-ministerial rank under the PBoC."[8] It functioned as an independent entity until 1998 when it was rolled up under PBoC as part of the larger reorganization of China's financial sector. Even once it reported to PBoC, there seems to have been a division of labor between SAFE and PBoC that saw SAFE enjoy a substantial degree of autonomy in its management of China's foreign exchange reserves while the PBoC focused on domestic macroeconomic management, building up its central bank functions, and steering China's monetary policy. This functional division of labor and SAFE's history as a previously autonomous entity partly account for why SAFE may have been accustomed to operating relatively autonomously under the PBoC.[9]

[7] Annex Table A.I.11 of the UN World Investment Report 2008, p. 216. Available at: http://www.unctad.org/en/docs/wir2008p3_en.pdf
[8] Author interview 091001b, Washington, D.C.
[9] With the introduction of CIC, however, SAFE seems to have become more attuned to the wishes of the state. As mentioned below, this is largely a result of the competitive dynamic that the presence of CIC has introduced.

SAFE has traditionally been very secretive about its investment activity. This disposition has valid commercial reasoning: because of SAFE's size, knowledge of its capital allocations could move markets. Unfortunately, such a shroud of secrecy also makes it easier for the state to direct such institutions to conduct non-commercial (often political) activities out of the public's eye. Despite SAFE's secrecy, there is recent evidence that SAFE has begun diversifying away from US Treasuries—its default investment asset. By 2007, these treasuries had been producing negative real returns given the anticipated RMB appreciation and China's domestic inflation. As a result, it seems that SAFE has been diversifying away from USD-denominated assets. These efforts are directing SAFE's investments both into other currencies and into alternative asset classes with greater risk/reward profiles (e.g. equities as opposed to fixed income government bonds). As discussed in more detail in the next chapter, CIC seems to have been created in part because MOF was critical of PBoC's (and thus SAFE's) foreign exchange management and investment of what, by 2007, had amounted to a good deal of China's store of its national wealth.

According to available estimates, SAFE apparently manages an investment portfolio of $311.6 billion—mainly in US Treasuries and Bonds.[10] Details of SAFE's portfolio are not available. However, we do know that it is big; very big. China ended 2009 with approximately $2 trillion in foreign exchange reserves and by mid-2010, these had grown to $2.5 trillion.[11] Because Chinese banks must clear their foreign exchange and convert all foreign currency to RMB exclusively through SAFE, SAFE is left holding a very large stockpile of foreign currency. Generally speaking, most trading countries tend to hold enough foreign exchange reserves to

[10] See: Section C of Chapter 1, "FDI by Sovereign Wealth Funds" in the UN World Investment Report 2008. Available at: http://www.unctad.org/en/docs/wir2008p1_en.pdf The report was updated in September of 2009, however the new 2009 edition makes no mention of the size of SAFE. For the relevant section see: Subsection 2 of Section C of Chapter 1, entitled: "FDI by Sovereign Wealth Funds on the Rise Despite the Crisis" in the UN World Investment Report 2009. Available at: http://www.unctad.org/en/docs/wir2009_en.pdf.

[11] Anonymous, "China's ForEx Reserves Growth Slows in Q2, Total Reaching $2.45 Trillion," July 11, 2010 Xinhua News. Available in English on-line at: http://news.xinhuanet.com/english2010/business/2010-07/11/c_13394250.htm

cover about three to four month's worth of trade.[12] Beginning in 2004 or early 2005, China found itself with "excess reserves"—an economic condition in which reserves exceed the amount of foreign currency needed to underwrite and clear about one quarter's worth of trade (plus some cushion for investments, direct conversion, and capital flows). This fairly quickly seems to have led to a consensus domestically in China that SAFE now had more reserves on hand than was needed to underwrite China's international trade and defend its currency peg—even under very conservative assumptions. This naturally prompted discussions over what China ought to do with its excess reserves.[13] Eventually, it was decided that a portion of the reserves would be used to recapitalize China's banking sector which, since the late 1990s, had become weighed down by bad debts.[14] SAFE also faced increasing pressure to generate a higher return on its asset base.[15] As a result, China decided to create the CIC.

The creation of CIC was a direct bureaucratic encroachment into SAFE's traditional arena that prompted SAFE to alter its behavior. Part of SAFE's response was to demonstrate that it, too, could provide higher returns by moving a portion of its holdings out of low-yielding treasuries.[16] One of the consequences of this more aggressive investment stance appears to have been a series of ill-timed, clandestine stock purchases made on the London exchange in the latter portion of 2007 and the first half of 2008.[17] Shortly after SAFE made these purchases, the

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[12] This would be about $400-500 billion. Wang Xiangwei, "Fed's 'Printing Presses' Give Wen a Headache," South China Morning Post, March 23 2009 China Briefing, p. 04.
[13] Effectively, these excess reserves constitute a form of national savings.
[14] This process will be discussed in greater detail in the next chapter.
[15] Moreover, since foreign exchange conversion is mandatory, SAFE has a very low cost of capital. "Beijing Bulls," Financial Times, Aug 7 2008, p. 12.
[16] "SAFE once aimed to have as much as 5% of its portfolio in equities. That would be $90US billion, the amount of CIC's initial capital that it plans to invest abroad in equity and fixed income or more than the equity holdings of the Swiss National bank, the Hong Kong Monetary Authority, many pension funds, and probably the Saudi Arabian Monetary Agency." From: Rachel Ziemba, "My Say, Where are the SWFs?" The Edge Singapore, September 22, 2008.
[17] "The State Administration of Foreign Exchange is believed to have moved 15 per cent of its US $1.8 trillion reserves into riskier assets in July last year, just when stock markets were beginning to fall."Grace Ng and China Correspondent, "Shifting Dynamic of US- China Relations," The Straits Times (Singapore), March 18 2009.

market experienced a precipitous decline. Analysts have estimated that SAFE lost approximately $80 billion by buying in at the top of the market.[18] Although SAFE does not disclose its investments, some of its holdings have publicly reported having SAFE as a major stockholder. Among these are the French petroleum company, Total, some European private equity funds, and several large cap UK companies including British Petroleum. SAFE has also been identified as a shareholder in the US private equity group, TPG.[19] Apparently, SAFE often uses intermediaries to conduct its purchases to help conceal SAFE's involvement in the transactions. For instance, SAFE allegedly used its Hong Kong office which, in turn, directed a third party manager to conduct many of these transactions on the open market in London.[20] Such a predilection for secrecy, a lack of public accountability and an absence of transparency make SAFE well-suited to be used to pursue non-commercial activities. At the same time, the competitive dynamic introduced by the creation of CIC, seems to have prompted SAFE to become a more pliable agent for the state—willing to pursue national goals that may not be strictly commercial in nature. To get a better sense of exactly how such economic statecraft works in practice, the next few sections examine one such episode regarding China's use of SAFE to pursue China's strategic objectives.

7.2.1 SAFE's purchase of Costa Rica's Bonds

On June 1, 2007 Costa Rica formally ceased to recognize the Republic of China and announced that it would now recognize the People's Republic of China.[21] This represented the

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[18] Wang, "Fed's 'Printing Presses' Give Wen a Headache."
[19] "Beijing Bulls" Financial Times.
[20] SAFE seems to have conducted most of its equity investing via its Hong Kong branch office (SAFE Investments Inc.). Wang Xiangwei, "Fed's 'Printing Presses' Give Wen a Headache," South China Morning Post, March 23 2009, China Briefing, p. 04.
[21] Costa Rica established diplomatic relations with the People's Republic of China on June 1, 2007, after more than six decades of ties with Taiwan. "World Briefing Asia: Taiwan Loses another Friend to China," New York Times,

culmination of considerable diplomatic efforts on the part of the PRC. The State Administration of Foreign Exchange (SAFE) played a key role in financing the eventual deal in the form of a two-stage purchase of $300 million dollars worth of US dollar-denominated Cost Rican government bonds.[22] The first purchase occurred in January, 2008 for $150 million worth.[23] The second purchase seems to have occurred in January, 2009 for another $150 million. The bonds were 12-year notes with a "way below market" interest rate of 2 percent.[24] The terms of these bonds are significant. Such non-commercial terms provide evidence that this episode was a "hard test" for government control in which SAFE had to engage in commercially unattractive behavior to achieve the state's foreign policy objectives.[25] In addition to the bond purchase, China promised $130 million of aid.

The terms of the switch in recognition were apparently made an explicit part of the agreement that Yang Jiechi, China's foreign minister, and Bruno Stagno Ugarte, foreign minister of Costa Rica, signed on June 1, 2007.[26] Although the deal was intended to remain secret (apparently against the wishes of the Costa Rican diplomats),[27] documents detailing the agreement have been subsequently made public as a result of a FOIA-style inquiry by a Costa Rican journalist. "SAFE doesn't publicly discuss its investments and took steps to ensure this

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Jun 7 2007, p. A.17., Daniel Zueras, "Central America: Costa Rica Discusses Free Trade with China," Global Information Network (2008): 1. and Kathrin Hille, "Island Sees Allies Dwindle," Financial Times, Jun 8 2007, p. 12.

[22] "China secretly agreed to use its foreign-exchange reserves to buy $300 million in bonds from Costa Rica as part of a deal that enticed the Latin American nation to switch diplomatic recognition to Beijing from Taiwan, newly published government documents show."Andrew Batson, "The Buzz: China used Reserves to Sway Costa Rica," Wall Street Journal, Sep 13 2008, p. B.3.

[23] *ibid.*

[24] Stephen Fidler and Adam Thomson, "Fierce Battle for Diplomatic Supremacy," Financial Times, Sep 12 2008, p. 4; and Batson, "The Buzz: China used Reserves to Sway Costa Rica."

[25] A "hard test" for government control occurs when the state is able to direct the commercial actor(s) to engage in some activity to help further the state's strategic objectives but doing so runs counter to the commercial actor's economic self-interests. Generally speaking, evidence that commercial actors are engaging in economically disadvantageous behavior provides a good indicator that something unusual (like economic statecraft) may be occurring.

[26] Anderlini, "Beijing Uses Reserves Fund to Persuade Costa Rica Over Taipei."

[27] "Costa Rican diplomats advised against keeping the terms secret, but the Chinese insisted, said people familiar with the matter." Anderlini, "Beijing Uses Reserves Fund to Persuade Costa Rica Over Taipei."

deal would also be secret. In an English-language letter dated Jan. 2, 2008, a SAFE official named Fang Shangpu wrote to the Costa Rican finance ministry setting out terms of the bond deal, including a request that Costa Rica 'shall take necessary measures to prevent the disclosure of the financial terms of this operation and of SAFE as a purchaser of the bonds.' On Jan. 7, finance minister Guillermo Zuniga replied in a letter saying 'It is a pleasure for me to confirm that these suggestions are acceptable to us.'"[28] Although the documents have since been removed, for a time, the Costa Rican Foreign Ministry had posted copies of the June 1, 2007 agreement between the PRC and Costa Rica on its website.[29] In addition to the agreement, the Foreign Ministry posted "several subsequent letters" that laid out the terms of the deal (e.g. an additional $130 million of direct foreign aid). The Chinese Ministry of Foreign Affairs did not contest the validity of these documents.[30]

These revelations are significant in two ways. First, as Stephen Van Evera likes to emphasize, secret government documents that later become public can often provide very good source material and make for particularly compelling case evidence. Since the contents were not originally intended to be made public, policy makers are generally more free to reveal true intentions without regard to public or political costs. Second, the attempt to keep such activities out of the public eye suggests that similar episodes may be occurring secretly (although secrecy also implies that "smoking gun" evidence of such activity will generally be thin).

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[28] "Costa Rica also published a letter by foreign ministry official Edgar Ugalde, confirming that SAFE's first investment of $150 million took place on Jan. 23, [2008]." Batson, "The Buzz: China used Reserves to Sway Costa Rica."

[29] Batson, "The Buzz: China used Reserves to Sway Costa Rica."

[30] " In a statement Friday, China's foreign ministry did not contest the validity of the Costa Rican documents. 'China provides assistance to the Costa Rican government within its means. The goal is to help Costa Rica's economic and social development,' the statement said." From: Batson, "The Buzz: China used Reserves to Sway Costa Rica."

Changing recognition in exchange for economic benefits should not be viewed as a particularly notable event.[31] Costa Rica's switch was simply the most recent chapter of what has been called "checkbook diplomacy" —a strategy through which Beijing and Taipei vie for international support by providing economic concessions to other nations in exchange for recipient nations' formal diplomatic recognition. This phenomenon is not new.[32] Since the origins of the Chinese Civil War, both sides have sought international legitimization from third parties. The significance of the Costa Rican episode lies in the fact that there is clear evidence that the PRC successfully used SAFE to pursue its foreign policy objectives. This episode demonstrates a particular situation in which the central government was able to direct the behavior of the state investment entity to support its foreign policy objectives.[33] In this case, the state mobilized monetary assets—not fiscal assets—to achieve its foreign policy goals. This case is important because it represents a clear case of the state's allocation of monetary assets being used for foreign policy goals[34]. The evidence shows that SAFE was directly used as an agent of

[31] Recipients of economic benefits have often changed their formal diplomatic recognition in what has been termed "checkbook diplomacy." For instance, in October of 2003 Liberia ceased recognizing Taiwan and Dominica changed its recognition to the PRC in March of 2004. In late 2004, Vanuatu switched recognition from the PRC to the ROC before the prime minister was ousted and Vanuatu switched back. In January of 2005, Grenada changed its formal diplomatic recognition from ROC to PRC. In May of 2005, Nauru restored its relations with the ROC following its 2002 decision to suspend relations (it recognized the PRC in the interim). In October of 2005, Senegal changed its recognition from the ROC to the PRC and in August of 2006, Chad established relations with the PRC and Taiwan ended relations with Chad. In April of 2007, Saint Lucia restored relations with the ROC. In January of 2008, Malawi switched diplomatic recognition from the ROC to the PRC.

[32] "China and Taiwan have for years used aid payments, infrastructure projects and the like as incentives for small countries like Costa Rica to take their side. But SAFE's international profile is relatively new. In the past year, it has used a Hong Kong subsidiary to buy small stakes in publicly listed companies including BP, Total of France and at least three Australian banks."Jamil Anderlini, "Beijing Uses Reserves Fund to Persuade Costa Rica Over Taipei," Financial Times, Sep 12 2008, p. 1.

[33] "Purchase of US-denominated Costa Rican government bonds by China's State Administration of Foreign Exchange (Safe) is the clearest proof yet that Beijing regards its $1,800bn in foreign reserves - the world's biggest - as a tool to advance foreign policy, as well as a potential source of income. . . . 'This is the first smoking gun that proves China uses its foreign exchange reserves for political purposes,' said Kerry Brown, senior fellow with the Asia programme at Chatham House in London." *ibid.*

[34] The distinction between "fiscal" assets and "monetary" assets is helpful here. Fiscal assets are those assets that *belong* to the state—usually gained as a result of taxes that have been paid to the government. States are generally free to spend their fiscal assets in a political manner (e.g. foreign aid, domestic welfare, etc.). Monetary assets are those for which the state is merely acting as *custodian*—generally held by an independent central bank or trust.

the Chinese government to pursue its foreign policy objective vis a vis Costa Rica (and indirectly vis a vis Taiwan).

In this case, SAFE's goals were to ensure that it maintained a continued monopoly over China's foreign exchange management. In order to do this, it needed to isolate, marginalize, and if possible, eliminate the CIC. One of the best ways to accomplish this was to demonstrate how useful SAFE could be to China's leadership. In this instance, SAFE demonstrated its usefulness by providing an important element of economic inducement to Costa Rica. In addition, there does not seem to be a good deal of conflict between the goals of SAFE and the goals of the State Council. Unlike more transparent, commercially-oriented sovereign wealth funds, SAFE does not seem to be particularly concerned with appearing to be politically motivated in its allocation of investment capital. On the contrary, it seems particularly motivated to demonstrate its usefulness in the face of the creation of an alternative rival institution (CIC) that was challenging its bureaucratic turf. As a result, there does not seem to be any substantial conflict between the goals of the state and the goals of the commercial actor in this episode.

So what were the goals of the state in this instance? China sought to limit the number of countries that provide diplomatic recognition to Taiwan. Limiting Taiwan's diplomatic space has been a long-standing objective of the PRC's foreign policy. One of the ways that the PRC pursues this objective is to use economic inducements to woo Taiwan's allies away. Often, there are multiple avenues of economic engagement (trade, investments, aid, etc.). In the lead up to the SAFE purchase, Chinese economic ties with Costa Rica had been growing rapidly. Costa Rica is one of the few countries to run a trade surplus with China. Trade with China in 2007 was

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Strictly speaking, when a country has an independent central bank, these assets are not the government's to spend. Rather, the central bank is statutorily made independent of the political leadership. This arrangement allows the central bank to manage the macroeconomic levers of the economy—relatively insulated from political pressure. In the case of China, what we observe is that the government is able to effectively direct the allocation of these foreign exchange reserves to pursue political objectives.

up more than 25% while exports were up more than 30% over a year earlier making China Costa Rica's second largest trading partner. Costa Rica was also China's second biggest trading partner in Central America.[35] China often takes advantage of such deepening economic ties to improve diplomatic relations. It is important to view the SAFE deal in the larger context of China's growing economic relationship with Costa Rica. Although economic interaction is important in its own right, China also leverages its economic relations for strategic ends. In this case, China sought to convince Costa Rica to switch its official diplomatic recognition from Taiwan to the PRC.[36] SAFE, China's official custodian of its foreign exchange reserves, secretly used a portion of those reserves to pursue one of China's core strategic interests. The result was successful economic statecraft.

7.2.2 Beyond SAFE: Other aspects of the Costa Rica Deal:

The SAFE bond purchase was part of a larger pattern of economic inducements collectively designed to bring about a change in Costa Rica's foreign policy—namely

[35] "Now, China is Costa Rica's strategic partner, and trade between them has climbed from $630 million in 2004 to $1.7 billion in 2006."Ral Gutirrez, "Central America: Taiwan's President Seeks to Strengthen Ties," Global Information Network (2007): 1. This figure grew again to $2.87 billion in 2007. For more on Costa Rica's growing trade ties see: Zueras, "Central America: Costa Rica Discusses Free Trade with China,"; "Costa Rica, China Launch Free Trade Talks," World Trade 22, no. 2 (2009): 14; and Vanessa I. Garnica, "China Proves Tough Negotiator for Costa Rica," McClatchy - Tribune Business News (2009).

[36] "Analysts say this region of the Americas has become a chessboard for the two Asian countries, which are battling for something more than trade partners: Diplomatic support and recognition is the ultimate aim." Gutirrez, "Central America: Taiwan's President Seeks to Strengthen Ties." Although both sides generally try to deny their use of economics to further their diplomatic goals, evidence seems to suggest that both sides make economic benefits contingent on diplomatic recognition. Wang Baodong (spokesman for China's embassy in Washington) was quoted as saying, "There are still a few countries that have not established diplomatic relations with China. Even though the Chinese people and government hold friendly feelings toward these countries, the Taiwan question constitutes the main obstacle to the development of our relationships." Larry Luxner, "Two Chinas Battle for Influence," LatinFinance (2007): 1. For more on "checkbook diplomacy," Taiwan's response and its efforts to shore up support among other Latin American allies, see: "China/Taiwan: Costa Rica Switches Allegiance to PRC, More may Follow," Asialaw (2007): 1; and Fidler and Thomson, "Fierce Battle for Diplomatic Supremacy."

strengthening its ties to the PRC while severing its connection to Taiwan.[37] As is common in such episodes of Chinese use of economics to strengthen its diplomatic ties, China also financed the construction of a new, 40,000 seat national sports stadium for San Jose. Estimates of the cost for the stadium range from $25-83 million.[38] China also promised a new science and technology park.[39]

As discussed in Chapter Five on China's natural resource extraction-based engagement strategy, China's economic interaction with would-be partners frequently entails an energy resource development component. It seems that the Costa Rica deal also involved natural resource development and exploration. Hu Jintao signed a contract to modernize and expand Costa Rica's Moin refinery's capacity from 25,000 barrels per day to 60,000 b/d.[40] The financing of this $1 billion project is illustrative of the inter-connectedness of many of the commercial actors discussed in this dissertation. CNPC and Costa Rica's state-owned refinery, Recope, will each contribute $150 million to capitalize a $300 million, mixed capital joint venture entity. The remaining $700 million will be provided to CNPC in the form of credits

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[37] "Encouraging the handful of countries that still recognise Taipei as the legitimate representative of the Chinese people to switch allegiance is an important foreign policy goal for Beijing, which regards Taiwan as a renegade province." Anderlini, "Beijing Uses Reserves Fund to Persuade Costa Rica Over Taipei."

[38] When asked to elaborate on the details of the donation, Marco Vinicio (Costa Rica's foreign trade minister) was only willing to say "It is part of the co-operation." See: Fidler and Thomson, "Fierce Battle for Diplomatic Supremacy," also see: Patrick Fitzgerald, "China to Invest in New Technology Park in Costa Rica," McClatchy - Tribune Business News (2009).

[39] Estimated costs for the science and technology park are approximately $65 million, although the Costa Rican foreign trade minister is reported to have said that "We don't have an exact cost yet because (the project) will be divided into five phases," he said. "This first (phase) will have a cost of $20 million, and includes biotechnology, nanotechnology, information technology and mechatronics." *ibid.*

[40] The state in this case was fairly unified as exhibited by the presence of Hu, himself, and the foreign policy coordination under MOFA. "The modernisation of Recope will involve the establishment of a partnership between the refinery and the China National Petroleum Corp (CNPC), with the aim of enlarging Costa Rica's oil-refining capacity and possibly building a new refinery for exporting end products to other Central American countries. Expansion of Recope's oil-refining capacity to a target of 60,000 barrels of oil per day--48,000 for domestic use and the remainder for exporting to the rest of the region--will cost an estimated US$1bn." "Costa Rica Politics: Co-Operating with China," EIU ViewsWire (2008). Also see: E. Watkins, "Costa Rica Nixes Exploration; Wants Chinese Refinery," Oil & Gas Journal 107, no. 18 (2009): 32.

"from a bank in China."[41] Large Chinese policy banks have often been required to extend such credits to finance government-designated projects. In this way, the Chinese government is able to exercise a good deal of control over its ability to effectively direct economic activity (like project finance) to facilitate foreign policy objectives. Additionally, China National Petroleum Corp. (CNPC) and Costa Rica's state-owned refinery, Recope, are planning to establish a $6 billion refinery that is to have a daily processing capacity of 200,000 barrels.[42] It also appears that a subsidiary of CNPC is engaged in negotiations to conduct oil exploration in Costa Rica's territorial waters.[43]

Such government-backed economic activity is not limited to extractive industries. Huawei Technologies Co., Ltd. (Huawei) was chosen over Ericsson to deploy Costa Rica's first 3G network.[44] The $235 million contract was awarded by Costa Rica's Electricity Institute (ICE) which is a Costa Rican state-run electrical company. Generally, China's economic engagement also entails a cultural component as well. Such activities are intended to foster deeper understanding and closer cultural ties between China and its foreign partners. In the case of Costa Rica, such activities have included the founding of the Confucius Institute for Chinese language studies at the University of Costa Rica as well as an invitation to participate in the Shanghai Expo in 2010.[45] It seems that large-ticket capital projects and high profile public

[41] "Costa Rica Politics: Co-Operating with China," EIU. The bank in question may be the China Development Bank, although this could not be confirmed.
[42] J. McTague, "China Makes a Mark in Trade," Barron's 88, no. 47 (2008): 26; and Watkins, "Costa Rica Nixes Exploration; Wants Chinese Refinery."
[43] In January 2008, Environment and Energy Minister Roberto Dobles announced plans by China National Oil & Gas Exploration & Development Corp. [now known as China Southern Petroleum Exploration & Development Corp., based in Guangzhou and a subsidiary of China National Petroleum Corp.] to explore Costa Rican territorial waters. Watkins, "Costa Rica Nixes Exploration; Wants Chinese Refinery."
[44] "Huawei Chosen to Build First 3G Network in Costa Rica," SinoCast China Business Daily News, Jan 12 2009.
[45] "Costa Rica Politics: Co-Operating with China," EIU.

works are also often combined with personal benefits for key decision-makers.[46] Such activities skate dangerously close to bribery and corruption, often exacerbating already problematic governance conditions in smaller, developing economies.

Another aspect of China's use of economic statecraft that is particularly pronounced in its interactions with small states is the asymmetry between the size of China's economy and market in comparison with other states. These relative asymmetries often lay the foundations for smaller economies to develop a dependence on China's much larger, dynamic economy. Overtime, such dependence can generate *Coercive Leverage* externalities.

This case of Costa Rica is just one example of a larger trend in which China seeks to use its economic engagement to improve ties with countries. China gradually seeks to build on these economic links to foster greater diplomatic cooperation.[47] Over time, as economic ties grow and deepen, they generate *Interest Transformation* security externalities which China often seeks to capitalize on to further its longer term strategic goals. China's use of economics to achieve its foreign policy objectives is not limited to economic support. China's strategic engagement also includes diplomatic and political support as well.[48]

7.2.3 Evaluating the SAFE Case

The reporting structure for this case, like all of China's sovereign wealth funds, is direct. SAFE is a wholly government-owned, managed, financed and operated state investment entity. This extreme value on the *Reporting Relationship IV* reinforces the government's ability to direct

[46] In the Costa Rica episode, there have been suggestions that "people close to the president may have benefited from the deal." Fidler and Thomson, "Fierce Battle for Diplomatic Supremacy."
[47] For more on this pattern see: William Norris, "China's 'Other' Southeast Asia Relations," paper presented at ISA, March 2007.
[48] The Costa Rican vice president noted that China promised support for Costa Rica in international forums like the UN. From: Batson, "The Buzz: China used Reserves to Sway Costa Rica." China has also been "sending high-ranking military delegations to many countries in Latin America." See: Luxner, "Two Chinas Battle for Influence."

SAFE's activities. SAFE is run by managers who serve at the pleasure of the CCP. The senior management team is approved by the central Communist Party Organization Department (中国共产党中央组织部).[49] SAFE nominally reports to the PBoC, and while it is able to enjoy some degree of discretion in its investment decision making,[50] it seems to have only limited independent agency and, as discussed above, no real incentive in this case to resist State Council directives (given the bureaucratic incentive to please senior leadership as part of its effort to re-capture its exclusive position as sole asset manager of China's state capital reserves).

The *Relative Resources* seem to have been fairly evenly distributed between the central government and SAFE in this episode. Since the engagement with Costa Rica was at its core a foreign policy issue, the State Council in conjunction with the Ministry of Foreign Affairs were the natural government entities leading the coordination efforts. However, in terms of the purchasing, pricing and structuring of the actual deal to buy Costa Rica's bonds, the government would likely have relied on SAFE's expertise. There does not seem to have been any obvious resource asymmetry in this episode.

That said, SAFE has traditionally enjoyed a good deal of unique financial expertise, given its history managing China's foreign exchange reserves. Prior to the existence of CIC, SAFE enjoyed an unchallenged monopoly over the administration and investment of China's foreign exchange reserves. This was coupled with SAFE's institutionally concentrated financial expertise that provided SAFE with power vis a vis the less knowledgeable state. For a considerable portion of its existence, this relative resource asymmetry coupled with an absence of institutions competing for SAFE's mission provided SAFE with some degree of autonomy vis

[49] This body also conducts the most senior appointments of 50 some managers of SASAC's largest corporations.
[50] While SAFE is nominally a direct report to the PBoC, it has a reputation for operating largely independently of much oversight. Author Interview 080623, Beijing.

a vis the state. With the introduction of CIC, SAFE lost a good deal of this agency. The recent emergence of CIC significantly undermined SAFE's relative resource asymmetry and predictably increased the state's control over SAFE. SAFE's poorly timed equity investments are an example of the competitive dynamics brought about by the creation of CIC. With the Costa Rica episode, SAFE wanted to show its superiors that it could act as a useful policy arm for the senior decision makers. These data points seem to suggest that, with the creation of CIC, SAFE ha been playing institutional defense against the encroachment on its traditional sphere of influence—namely investing the State's hard currency assets.[51] The existence of CIC created direct competition for SAFE and as a result, SAFE may have been more willing to act as a dutiful agent of the state. This change partly explains why SAFE became more willing to do the State's political bidding (as in the case of Costa Rica).

These dynamics suggest that SAFE is more likely to listen to the wishes of the principal now that it knows that there is a real alternative for investing state foreign exchange reserves located in CIC. The most conducive situation for state control is one in which there are a small number of commercial agents who can be pitted against one another—effectively jockeying for the good graces of the state.[52] In this case, a change in the value of the *Market Fragmentation IV* (shifting from a monopoly to an oligopoly) contributed to SAFE's willingness to act as an agent to achieve China's strategic objectives vis a vis Costa Rica.

The state in this episode does not seem to have been very divided on the strategy nor the particular instruments used to engage Costa Rica. The timing and announcement of various

[51] Bear in mind that these events were unfolding in the midst of the discussions about the creation of the CIC in early-mid 2007.

[52] For a very good study of such competitive dynamics "with Chinese characteristics" see Lin Yi-min Lin, *Between Politics and Markets : Firms, Competition, and Institutional Change in Post-Mao China* (Cambridge ; New York: Cambridge University Press, 2001). Alternative entities that could have served the purposes of the State Council may have been the China Development Bank or any of the state-owned banks (including ICBC, Bank of China, etc.) or possibly the Ex-Im Bank or the National Social Security Fund.

aspects of the strategy indicate a good deal of senior level coordination. For instance, trade and investment deals were often coordinated with a senior official's state visit. It seems that the foreign ministry took the lead in ensuring smooth coordination across various functional lines. There does not seem to be any evidence of cross-cutting local or provincial vested interests that stood in opposition to closer ties with Costa Rica. Likewise, there do not seem to have been any obvious factional politics or apparent bureaucratic turf battles over Costa Rica's recognition policy. As a result the state exhibited a good deal of *Unity* in this episode.

In conclusion, this episode provides a clear case of the state using economic tools to achieve a foreign policy goal. SAFE became an instrument of Chinese foreign policy when it used monetary assets to purchase Costa Rican bonds on commercially unattractive terms. Hard tests for economic statecraft include those instances when the state is able to exert enough control over commercial actors to direct them to pursue strategic objectives even if that activity runs against the commercial actor's own commercial interests.[53] How did the state do this? The state was able to provide an incentive structure to generate the desired behavior. This incentive structure can be usefully conceptualized using the factors presented in Chapter Two. This is a case in which every IV points to likely state control. This case provides a useful illustration of extreme values on the IVs. As expected, we observe state control happening. Extreme value cases are very helpful for testing internal validity of the theory. Although it is difficult to accurately determine which of the five IVs played the most dominant role, the state ownership and management in conjunction with the competitive threat presented by the creation of CIC offer compelling reasons for why SAFE was able to be used so effectively to pursue China's

[53] The SAFE-Costa Rica case provides a good example of such behavior. Unfortunately, in many episodes in Chinese foreign policy, the commercial and political aspects are often intertwined, making a pure test of such dynamics difficult. Politically expedient activities may often carry some commercial merit. Likewise, commercially attractive behavior may often bolster political goals. Nonetheless, it is useful to specify the ideal types even if complex realities rarely accommodate neat, clean experimental testing of theoretical abstractions.

strategic objectives. This episode also involved a lack of transparency which seems to be a condition that is conducive to having non-commercial factors play a larger role in influencing the behavior of the agent. The case also indicates efforts to keep the state manipulation of commercial activity secret (implying that other cases may not exhibit such obvious "smoking guns").

Taken together, the values on the independent variables indicate factors that suggest a high likelihood that the commercial actor would do what the state would like it to do in this case. It should not come as a surprise then that the outcome in this episode is that the state was able to control SAFE. In this episode, we can clearly observe that SAFE was directed to purchase $300 million of Costa Rican bonds at below-market rates as part of China's effort to entice Costa Rica to switch diplomatic recognition away from Taiwan. This purchase by SAFE was part of a larger series of diplomatic visits and economic inducements which were designed to achieve the foreign policy goal of Costa Rica's de-recognition of Taiwan and its switch of diplomatic recognition to the PRC. As indicated above, the empirics of this episode provide evidence of state control. In this instance, China was able to use a state investment entity as a strategic tool to effectively achieve a foreign policy objective.

7.3 The National Social Security Fund (NSSF)

If the SAFE-Costa Rica episode illustrates how these sovereign wealth funds can be used to pursue Chinese strategic interests, the NSSF case demonstrates the opposite extreme of a relatively commercially-driven state investment entity. In contrast to the SAFE case, this case explores the factors that make the NSSF unlikely to be a source of strategic concern.

The National Council for the Social Security Fund was established in November 2000 to oversee a special supplementary fund (the National Social Security Fund—the NSSF) used by the central government to help ensure adequate funds to cover its social security needs. It was originally intended to backstop liabilities and potential investment losses of municipal and province-level social security funds which had been investing the pension assets that workers had paid into SOEs. In many ways, the NSSF was a pioneer for China. It was China's first explicit sovereign wealth fund and the NSSF was the first to use third party asset managers. It was originally set up to both act as a national resource to bailout potentially failed local and provincial pension funds and to provide a nationally-sanctioned model of pension investment upon which other local funds around China could pattern their management, fiduciary responsibilities, governance, and investment operations. The management of the national social security fund is based on the State Council's "Provisional Rules of Management for the National Social Security Fund." The annual report that the NSSF publishes as part of its statutory duties clearly specifies the high degree of convergence between the goals of the state, namely to provide adequate funds to cover future social security liabilities, and the goals of the fund, which exhibits a strongly commercial orientation in its desire to maximize investment returns while protecting the initial capital investment. As a result, the fund operates with a good deal of professionalism and conducts commercially-motivated investment activity. Of the entities that invest capital on behalf of the state, the NSSF represents a case in which the agent seems to be the least motivated by non-commercial goals.[54]

[54] For this reason, the NSSF case makes an interesting juxtaposition with the SAFE case just examined—the two cases lie at opposite ends of the spectrum, thus providing useful illustrations of the theory.

The government set up the NSSF to provide funding for the projected social security obligations that the government faced in the near future.[55] As a result, there was a strong incentive to focus the NSSF on generating respectable returns while protecting the initial capital which was entrusted to it.[56] The goals of the state (namely to ensure adequate funding for future social security obligations) depend on the goals of the commercial actor (namely to pursue investment returns while preserving the capital base entrusted to NSSF). Complementary goals result in the state being able to effectively control the activities of the NSSF. However, the NSSF's activities are oriented around largely commercial goals—thus substantially mitigating the likelihood that the NSSF's activities will be used to generate security externalities.

The NSSF is run by a board of directors that reports to the State Council. The State Council can appoint and dismiss the NSSF's chairman, vice-chairman and any of the 13 directors on the board. As a "governmental agency at the ministerial level", the NSSF institutionally reports directly to the State Council. At the same time, the Ministry of Finance and the Ministry of Labor and Social Security are mandated to "supervise the investment operations and custody" of the NSSF. In practice MOF personnel seem to occupy the key operational positions while the MoLSS is able to voice its preferences or concerns regarding particular investments, portfolio allocation or practices. Although these reporting relationships evidence a significant role for the state in monitoring and enforcing compliance with national goals, the multiple institutional interests that have a voice in the administration of NSSF suggest the potential for a lack of state unity.

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[55] NSSF 2008 Annual Report (Published on May 9, 2009) available on their website www.ssf.gov.cn (in Chinese only).
[56] See Stuart Leckie & Ning Pan, "A Review of the National Social Security Fund in China," Pensions Vol. 12, number 2, 2006, pp. 88-97.

7.3.1 The National Social Security Fund (NSSF): Financing Sources

The NSSF has grown to about RMB 776.5 billion (or about US $113.7 billion) in assets under management at the end of 2009. The source of these funds has largely been "fiscal surpluses" that have been allocated to NSSF from the central government. Its other important sources of funds are shares of publicly listed SOEs, individual worker contributions, and investment returns. The annual funding comes from the central budget (hence an important source of MoF's influence). The NSSF also often receives proceeds and/or stock in SOEs just before their IPOs.[57] This has generally been seen as a government vote of confidence and support as well as acting as a stabilizing influence for the IPOs since the NSSF traditionally does not sell its (normally around 10% of the total number of) shares right away. The third source of funds for the NSSF comes directly from individual worker contributions. Finally, the NSSF retains and reinvests its returns that it has earned on previous NSSF investments.

Over time, the relative importance of these sources has shifted. Initially, almost 100% of the NSSF's funding came from state budget allocations. However, as more and more SOEs went public in the early to mid 2000s, a greater and greater share of the NSSF's annual funding was coming from proceeds from these IPOs.[58] Today, investment income usually accounts for most of the annual increase in NSSF's assets. In addition, the NSSF seems to have gotten increasingly more and more independent and self-sustaining over time. Its purview of permitted investments has also expanded, growing to include private equity and alternative investment classes as well as now being able to invest a portion of its capital internationally. The NSSF operates with a

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[57] See: Stuart Leckie & Ning Pan, "A Review of the National Social Security Fund in China," Pensions Vol. 12, number 2, 2006, pp. 88-97 and Michael McCormack, "Chinese Sovereign Wealth Funds: 2008-2010 Opportunities for Foreign Asset Managers." (Shanghai: Z-Ben Advisors, 2008) pp. 21-43.

[58] According to Leckie and Pan, government outlays accounted for 100% of the increase in funds in 2000, by 2005, this source had dropped to only 25% of the increase in funds as investment returns grew.

long term investment horizon—about 15-20 years.[59] This enables it to take advantage of short-term price fluctuations and act as a market stabilizing force.

7.3.2 The National Social Security Fund (NSSF): Financing Uses

The gradual evolution of NSSF's asset allocation provides evidence for a sustained pattern of commercially-driven diversification and investment activities. The NSSF was launched in 2000 with RMB 20 billion (US $2.9 billion). In its early days, the NSSF's returns were primarily driven by the interest paid on its bank deposits. But that was soon to change. It first ventured away from short-term, fixed income investments with a RMB 1.27 billion pre-IPO equity investment in Sinopec and Yangtze Power when those companies listed domestically in 2001.[60] Since these early investments, the NSSF has shown a desire to move out of fixed income and into more equities. In 2002 a statute was passed which stipulated that SOEs would contribute 10% of their IPO proceeds to NSSF (generally in the form of direct equity stakes). The government's objective in having the NSSF take these stakes was mainly to provide a stable government owner that would not sell the newly listed shares right away. It also allowed the NSSF to scale up its assets under management and partake in the monetization of the state's crown jewels. In June 2004, NSSF used RMB 10 billion to buy pre-IPO shares of Bank of Communications just before it went public on the Hong Kong exchange.[61] During 2005, NSSF also bought US $2.6 billion of ICBC's pre-IPO stock and US $ 1.4 billion of BOC's stock before

[59] See: "[NSSF's] Investment Concept" (投资理念) Available at: http://www.ssf.gov.cn/tzln/.
[60] Michael McCormack, "Chinese Sovereign Wealth Funds: 2008-2010 Opportunities for Foreign Asset Managers." (Shanghai: Z-Ben Advisors, 2008) p. 21.
[61] "One of the earliest investments of this kind occurred in June 2004, when the Bank of Communications (BoCom), one of China's smaller yet more profitable state-owned banks, restructured in preparation for a Hong Kong listing. The NSSF invested RMB10bn (US $ 1.2bn) in BoCom as a strategic investor, and became the third largest owner of BoCom after the MoF and HSBC. In July 2005, BoCom shares were listed in Hong Kong at a price 42 per cent higher than that paid by the NSSF, netting it with a handsome (although unrealised) return of over RMB4.2bn (US $ 0.5bn)." Leckie and Pan, "A Review of the National Social Security Fund in China," p. 93. Leckie and Pan reference Bank of Communications IPO prospectus and IPO Allotment Result June, 2005.

each of their Hong Kong listings. Buying in at this time (usually at or close to book market value—i.e. undervalued) just before the public listing allows the NSSF to ensure relatively safe, high returns on its investments. In addition, the NSSF was receiving 10% of the shares of SOEs that were listing in Hong Kong. As a result of the 10% pre-IPO "tax," during this time period, NSSF acquired a portfolio of small stakes in 21 recently IPO'd SOEs. Eventually, this "IPO tax" was limited to SOEs that were listing on foreign exchanges since it was thought that the "IPO tax" was contributing to the cooling of China's domestic stock market in the mid-2000s.

The NSSF was also an early innovator of using third party asset managers—another important factor favoring commercial, arms length investment strategies in which the government has a fairly limited voice (thus further restricting its ability to use the investment activities to realize strategic foreign policy objectives). The NSSF has continued to expand this practice and seems poised to have third party asset managers control the majority of its assets in the next few years. After its first two years of operation, the NSSF displayed a preference for incrementally ramping up and expanding its use of third party asset managers. In 2003, the NSSF first sought out local fund managers to manage assets on its behalf. It hired six Chinese third-party asset managers to manage funds split 1:2 (stocks : bonds).[62] These mandates managed about RMB 32 billion or approximately 24% of NSSF's total assets at the end of the year. During 2004, NSSF also increased its number of third party asset managers to 10 and increased their share of assets under management to 36%.[63] By the end of 2005, the third party asset managers were in charge of RMB 73 billion (~ US $ 9 billion, or 34% of the NSSF's total assets). Between 2005 and 2007, NSSF also added one securities company and three fund

[62] "The managers included Boshi (now re-named Bosera), Changsheng, Huaxia, Harvest, Penghua and Southern, all considered among the best in the Chinese fund management industry." Stuart Leckie & Ning Pan, "A Review of the National Social Security Fund in China," Pensions Vol. 12, number 2, 2006, p. 92.
[63] NCSSF's 2004 annual report

managers to its original 10 third party asset managers. With the State Council's passage of the "Interim Measures on Overseas Investment by Social Security Fund" in the late spring of 2006, the NSSF was authorized to begin investing abroad. Although this move into international investing greatly enhanced the NSSF's potential to generate strategic security externalities, the NSSF mitigated concerns by appointing ten foreign third-party professional fund managers in late 2006. By 2007, the NSSF was investing internationally under very commercial conditions.

As the NSSF has ramped up its assets under management, it seems to be looking to continue this commercially-driven strategy. At the end of 2008, the NSSF had about RMB 513 billion or about $74 billion in net assets. (according to its 2008 annual report). This consists of about RMB 562 billion of assets (of this about RMB 305 billion was directly invested by the NSSF while the other 257 billion was sourced to third party asset managers) and about RMB 49 billion in liabilities.[64] In 2008, the fund had a negative return of 6.79% although since inception, the NSSF has averaged an 8.98% annual return. Chasing returns rather than scoring diplomatic points provides a strong incentive for the agent to pursue purely commercial (rather than political) objectives.

The NSSF is primarily invested in domestic Chinese assets. This domestic distribution of the NSSF's investments further mitigates the likelihood that the NSSF will be used to pursue strategic foreign policy goals.[65] At the end of 2008, NSSF held about RMB 61 billion in bank deposits. Another RMB 133 billion was held as short term (mainly government) debt and RMB 25 billion was long term debt. The largest category of assets was "current portion of long term debt" which stood at RMB 260 billion at year end. The value of the NSSF's largely third-party-

[64] Figures come from "2008 Fund Annual Report" (基金年度报告 2008 年度) Available in Chinese at: http://www.ssf.gov.cn/xxgk/tzycb/cwbg/200905/t20090507_918.html

[65] From the point of view of security externalities, domestic investment flows are much less likely to generate international security concerns than cross-border investments *ceteris paribus*.

managed equity investments fell from RMB 125 billion at the beginning of the year to RMB 69 billion by year's end—reflecting the general decline in the value of equities in 2008. There seems to be fairly little evidence of significantly sized direct foreign investments, acquisitions or controlling interest stakes that were purchased or managed directly by the NSSF. Avoiding such concentrated investments also reduces the potential for security externalities to result.

The NSSF's pioneering use of investment mandates issued to third-party domestic asset managers was an important source of professionalism for the NSSF. This practice significantly lowered the possibility that the NSSF would be used as a strategic tool for realizing China's foreign policy objectives. By relying on third party mandates, the NSSF essentially was able to remove a significant potential source of politicization from its investment process. Effectively, the use of third party asset managers introduced another layer of state-commercial actor relations into the situation. Now, the state would have to not only manage the NSSF if it wished to use the NSSF to support non-commercial goals, but the NSSF would then also need to direct or control these third party asset managers to get *them* to support non-commercial goals. Such layers of agency seem to provide a considerable fire-break against any sort of non-commercial behavior. Importantly, the NSSF's practice also seems to have become the template for CIC's use of third party asset managers. To the extent that China is looking to reassure recipient nations who may be concerned about the non-commercial orientation of China's outwardly-bound investment flows, it may wish to consider using professional, transparent, third-party asset managers that provide a convincing element of *commercial* rather than political or strategic motivation.

7.3.3 The National Social Security Fund (NSSF): Mandate & Activities

The NSSF seeks to achieve "capital appreciation of assets on the basis of protecting capital [principal]."[66] The inherently commercial nature of this primary mission provides NSSF with a solid commercial footing. Despite the absence of independent directors on the board, it seems that the NSSF has been able to remain relatively free from the politicization of its investments. This seems to be due largely to the intrinsic goal compatibility between the government and NSSF around its explicit function: to focus on earning safe, reliable returns while protecting its capital base as part of the state's effort to meet its outstanding social security, retirement and pension obligations.

The net effect of the NSSF's commercial orientation is to significantly reduce the possibility of the NSSF's investment activity being used to further China's foreign policy objectives. There are several rationales for this. First, the NSSF seems suffused with a strong conservative bias to protect its investment capital. This motivation also serves to reassure investment targets of NSSF's position as a conservative long-term investor. This helps to allay fears of the NSSF posing a destabilizing investment influence. By minimizing the NSSF's capacity or proclivity for destabilizing recipients of its funds, this investment strategy also reduces the possibility of using the NSSF as an instrument of *Coercive Leverage*, thus helping to limit potential security externalities. Second, the NSSF is deliberately seeking to outsource the majority of its tactical investment decision-making (acting like a "fund of funds"). This is especially true in the area of international (non-Chinese) investments. Relying on private-sector, third-party international asset managers introduces another layer of principal-agent coordination challenges that the state would need to overcome if it were to effectively wield the NSSF as a strategic instrument of economic statecraft.

[66] See NSSF website: http://www.ssf.gov.cn "According to the NSSF website, 'the NSSF aims to be a solution to the problem of ageing and serves as a strategic reserve fund accumulated by central government to support future social security needs'." From Leckie and Pan, "A Review of the National Social Security Fund in China," p. 95.

Finally, it seems that the NSSF has been able to avoid efforts to exert non-commercial pressure by claiming that the NSSF must operate on a strictly commercial basis to achieve its mission to fund the pension system against China's demographic projections.[67] This primary tasking for the NSSF enjoys considerable political buy-in among China's elite leadership. The compatibility of goals between the state and the NSSF enables the NSSF to pursue commercial objectives and conduct its business on commercial grounds. Although this goal compatibility makes state control more likely, the commercial nature of these mutual goals limits the security concerns stemming from the NSSF's activity.

7.3.4 Evaluating the NSSF case

With respect to the *Goals IV*, the state and the NSSF are in agreement regarding the NSSF's commercially-oriented objectives since both the state and the commercial actor seek to maximize risk-adjusted return on the NSSF's investments. The NSSF seems to exhibit considerable evidence of commercially-oriented goals. It does not seem to be a source of significant security externalities as a large portion of its assets are invested domestically in China. What foreign investment it does conduct is done through professional, third party asset managers (like JP Morgan Chase, Invesco, LaSalle, PIMCO, Fidelity, T. Rowe Price, etc.). Such reliance on arms-length asset managers decreases the likelihood that they will be used to support specific foreign or strategic policy objectives.[68]

[67] The most likely source of political pressure would arise in the event that the NSSF needs to be tapped to bailout a failing provincial pension fund. Such crisis circumstances calling for intervention would be likely to provoke the sort of politicization that has been relatively absent up to this point in NSSF's history. It should be noted that even this non-commercial activity would be limited in its strategic security ramifications since it would be a domestically-focused effort.

[68] "The international fund managers have in general been impressed (and perhaps somewhat surprised) by the level of professionalism demonstrated in the selection process. Many commented that the process appeared fair *and without political interference.* It seems that the NSSF, in its selection of overseas managers, has set a new higher

Of course, if the NSSF's investment mandates were to constitute a significant portion of these third-party manager's portfolio of assets, it would not be unreasonable to ask whether these third-party managers might become beholden to the NSSF. Indeed, to the extent that a firm is largely reliant on NSSF (or any other entity's) funding, we might expect it to defer to the preferences of the large investor. To date, there does not seem to be any specific instances of this having occurred. I suspect that is because most investment mandates that have been placed with third party managers are relatively small amounts in comparison to the total assets under management at these large, multinational investment houses. However, as placements grow in size and as sources of capital tighten (perhaps as a result of a credit crunch) we can expect the influence of China's outward bound capital to grow.[69]

The NSSF is governed by a Board of Directors whose chairman and vice-chairman are appointed by the State Council. The state in this case is fairly divided under the State Council, with MOF and the MoLSS providing input and guidance in their respective contexts. Although the Ministry of Civil Affairs and the Ministry of Human Resources and Social Security play an advisory role, the Ministry of Finance seems to be the key supervisory entity. For day-to-day operations, the Ministry of Finance and the Ministry of Labor and Social Security also have a voice at the table. As the oldest of China's sovereign wealth funds (dating back to 2000), the NSSF has had a relatively long period to resolve matters of bureaucratic influence and establish clear lines of authority. That said, the presence of so many interests in NSSF governance seems to suggest that *State Unity* may be very fragile. These wide-ranging bureaucratic interests represented at the NSSF would make it hard for any one interest to hijack the NSSF and direct its

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standard of governance for other Chinese government agencies and for China's fund management industry generally." [my italics]. From Leckie and Pan, "A Review of the National Social Security Fund in China," p. 94.

[69] In particular, it may be instructive to watch private equity placements like CIC's placement of US $3.2 billion with J.C. Flowers. The placement reportedly constitutes 80% of the new fund. It would be instructive to assess the degree to which the firm coordinates with CIC on its investment activities.

investments for narrow political goals. Thus, commercially-motivated goals provide consensus objectives that further reinforce NSSF's commercial proclivity.

The NSSF is the only national social security fund. In this sense it operates in a concentrated market. Of course there are other Chinese sovereign wealth funds, but only one NSSF with a clear commercial and fiduciary mandate.[70] Therefore, the NSSF lacks the competitive dynamic observed in the SAFE case that compelled the commercial actor in that case to engage in non-commercially-motivated activities to please the state. Moreover, the state has clearly signaled that it does not seek anything but commercial returns from the NSSF. Accepting such strategic direction is made even more complicated by the NSSF's use of third party professional asset managers. These add another layer of insulation between political forces and the investment of state assets. The *Reporting Relationship IV* indicates that it would be hard for the state to direct the NSSF to achieve strategic objectives. Being the oldest of China's sovereign wealth funds, the NSSF has considerable institutional knowledge which also tilts the *Relative Resources IV* in its favor. At CIC and NSSF, the familiarity with international investment banking operations and world-class asset management skills endow these agents with a significant resource advantage over the state.[71] Moreover, these entities have attracted a significant share of the CCP's financial management talent. Both of these factors suggest that these commercial actors will enjoy a degree of expertise asymmetry that would be likely to result in the state deferring to the preferences of the agent. Interestingly, it seems that both of these

[70] The National Social Security Fund is the only organization bureaucratically tasked in its mission, however, it does face something of a commercial pressure to generate returns on its portfolio as its performance is often compared to other long-term liability-oriented investors (e.g. life insurance companies). In addition, the NSSF was created against an implicit comparison with provincial and municipal social security funds. In the sense that its performance and activities can be compared against those of peers, the NSSF operates in a "Competitive" market structure. This provides the state with some degree of supervisory benchmarking and thus leverage for controlling the NSSF but the NSSF faces little genuine competition for its mission.
[71] This dynamic is similar to what was observed among oil companies and their expertise vis a vis the state in Chapter Five.

entities have worked hard to place their organizations on as commercially-oriented footing as possible. Such a disposition would play to their technical expertise and provide the commercial actor with even greater autonomy, free from political interference.

To summarize, the NSSF's efforts to provide public transparency, regular reporting and disclosure as well as its clear, commercially-driven goals all seem to suggest that the security consequences of NSSF's activities will likely be minimal. The diverse interests of the state represented in the NSSF's governance structure make it difficult to direct the NSSF to pursue any one constituency's narrow political agenda. As a result, maintaining NSSF's commercial orientation seems to provide a consensus mission on which all parts of the state can agree. In addition, the NSSF enjoys an information and expertise asymmetry *vis a vis* the state in matters of financial expertise. This and the lack of any alternative bureaucratic rivals strengthen the NSSF *vis a vis* any state attempts to control its activities. Lastly, the extensive use of third-party asset managers makes it much more difficult for the state to direct or even influence NSSF's investment activities. This facet of the reporting relationship makes the use of NSSF funds to pursue strategic state security objectives unlikely. Although the NSSF case displays some state control (largely due to convergent goals), in this case, the goals of the state seem to be largely commercial with very little effective pressure for anything other than commercial objectives. As such, NSSF's commercial orientation provides a good baseline for comparison. The NSSF stands out as an extreme case. Just as SAFE represented a set of extreme values resulting in its effective use as an instrument of Chinese economic statecraft, so too does the NSSF case study also stand out as a case illustrative of a commercially-oriented Chinese sovereign wealth investment fund.

7.4 Conclusion

These two case studies are useful from a theory building perspective in that they resulted in extreme opposite outcomes: economic statecraft is illustrated in the case of SAFE (a result that is explained largely by state control that is attributed to values on the *Market Fragmentation IV*, *Reporting Relationship IV*, and *Unity of State IV*) and only limited state control with very little potential for economic statecraft in the case of NSSF. Its strong commercial orientation suggests it is significantly less likely to be used as an effective tool of economic statecraft.

In terms of the dissertation's theory, SAFE and NSSF provide useful case studies with extreme values across the IVs. Such extreme cases facilitate checks of internal validity—in other words, does the theory work as we would expect it to given the extreme value on the IVs? As we observe, the extreme values in the case of SAFE suggest that the state would be able to direct the behavior of the agent in a way that is conducive to realizing the state's foreign policy interest.[72] Although perfect experiments are rarely possible in international relations, it seems that the theory's causality does play out as expected in the case of SAFE. In the case of the NSSF, the values are also extreme, but in the opposite direction. The NSSF case suggests that the state would have a difficult time trying to use the NSSF as a tool of effective statecraft. These specific cases of China's state investment offer an in-depth examination of how the state can (or cannot) achieve state control. In both the cases of NSSF and SAFE, the theory operates as we would expect it would.

[72] Of course, the size of the economic interaction seems large enough to matter given China is Costa Rica's second largest trading partner. The economic interaction was also fairly inelastic given the generous, non-commercial 2% cost of capital extended to Costa Rica—something that was not widely available in the marketplace for sovereign debt. Finally, the goals that China had for this episode of economic statecraft seem to have been commensurate with the tools being used. Taiwanese diplomatic recognition did not seem to be particularly important to Costa Rica's overall strategic interests.

Chapter Eight

The China Investment Corporation

8.1 Introduction

The last chapter examined SAFE and NSSF, two sovereign wealth funds whose extreme values on the IVs served to illustrate the theory in the empirical context of China's state finance. SAFE was directed to use foreign exchange reserves as part of an integrated economic foreign policy designed to achieve China's strategic interests whereas the NSSF was an exclusively commercially-oriented sovereign wealth fund. This chapter examines the China Investment Corporation—another Chinese sovereign wealth fund whose empirics suggest it lies somewhere between the two extremes of SAFE and NSSF.

This final empirical chapter draws on the theory to address a specific contemporary concern about Chinese economic statecraft: namely whether China's official sovereign wealth fund will be used in a non-commercial way to advanced Chinese strategic interests. The continuing growth of China's foreign exchange reserves raises a host of concerns. Although China will certainly maintain some of these holdings as traditional central bank foreign exchange reserves, some portion of this capital will be re-allocated into China's sovereign wealth funds. The size and activities of these sovereign wealth funds spark a number of strategic concerns. In fact, much of the recent U.S. domestic political debate surrounding China's foreign exchange-supported sovereign wealth fund involves concerns about the security externalities that its activities may generate.[1] As demonstrated by the case study of SAFE in the last chapter, such

[1] Such worries run the gamut from strategic resources transfer as a result of equity stakes in mineral deposits and sensitive technology transfer as a result of joint ownership in dual-use technologies to fears of coercive leverage stemming from dependence on Chinese sources of capital and the longer term transformation of interests that results from international investment flows. For instance, in its January 22, 2008 report to Congress on China's sovereign

concerns are not without merit. At the same time, it would be a mistake to implement irrationally protectionist policies that unduly restrict the international flow of capital. What is missing from the contemporary discussion is an analytical framework for dispassionately evaluating when such concerns are warranted. The theory of economic statecraft presented in Chapter Two provides this sort of framework. This chapter applies the theory to determine whether the CIC presents cause for strategic concern.

The chapter begins by briefly examining the origins, structure and leadership of the CIC. This is followed by a detailed review of the sources and uses of CIC's financing. The final portion of the chapter applies the theory to better understand the CIC case.

8.2 Origins of the CIC

The CIC, itself, came about as an institutional response to mounting criticism that the PBoC (via SAFE) was not maximizing the returns on China's growing foreign exchange reserves. The macroeconomic structural imbalances seemed to suggest that China would continue to build up foreign exchange reserves for the foreseeable future. This problem of managing China's foreign exchange reserves was not going to go away and critics of the PBoC argued that China needed to proactively address how best to use its excessive reserves. Of course, one can imagine how many institutional interests come out of the woodwork to lay claim

wealth fund (the CIC), the Congressional Research Service provided at least seven areas of concern that map directly onto the typology: "There is concern that China may use the CIC to secure energy resources or purchase strategic assets for geopolitical purposes. There are also market apprehensions that the CIC could seek to increase its market share in important industries via targeted acquisitions or takeovers. Others are concerned that CIC might make investments in particular companies in order to obtain access to sensitive technology or information. . . There are also apprehensions about the potential for abuse or corruption created by the greater proximity SWFs create between governments and the private sector. As the existing investments of the CIC reveal, there is a growing network of interlinked investments between banks and other financial firms within China and overseas. . . These potential economic risks are seen as including financial market instability, undesirable foreign control or influence over key industries or companies, access to sensitive technology, and other forms of unfair competitive advantages." Michael F. Martin, "China's Sovereign Wealth Fund," CRS Report for Congress, January 22, 2008 pp. 17-19 *inter alia*. All of these concerns can be usefully conceptualized as security externalities that stem from the behavior of these commercial entities.

to excess national resources! Eventually, China's leadership determined that it would set up a sovereign wealth fund primarily modeled on Singapore.[2] Thus, the idea of CIC was born.

The China Investment Corporation (中国投资有限责任公司) formally commenced operations on September 29, 2007. However, the intention to create a sovereign wealth fund was first publicly announced as early as March, 2007.[3] Apparently, there were some delays in getting the organization stood up initially.[4] In fact, the first official sovereign wealth investment occurred in May, 2007 when China Jianyin Investment Limited (a government holding company that was charged with managing any asset purchases until the sovereign wealth fund was stood up) purchased a 9.9% non-voting stake in the Blackstone Group for US $3 billion. China Jianyin (along with its Blackstone stake and other assets) would eventually be rolled into the CIC.

At the time of the Blackstone purchase, the evidence strongly suggests that there was little central government control over the behavior of the commercial actor. The commercial actor enjoyed considerable independence. This stemmed from a lack of a clear reporting structure to the senior leadership of the CCP. At that time, Jianyin was part of the Ministry of Finance (MOF). As a bureaucratic entity, MOF was actively engaged in critiquing the PBoC for its paltry returns on China's increasing foreign exchange reserves.[5] This was part of an effort to wrest greater control over the management of China's foreign exchange reserves from the PBoC that dates back at least four or five years prior to the launch of CIC. By mid-2007, the state was clearly divided along bureaucratic lines. This division provided the commercial actor with

[2] Li Yang, Director of the Finance Research Institute of the Chinese Academy of Social Sciences, traveled to Singapore on a fact-finding trip to study Temasek and the GIC (Singapore's two sovereign wealth funds) as part of the preparation to create the CIC. Apparently Korea's sovereign wealth fund was also studied although my research was not able to confirm this.
[3] Xin Zhiming, "$200 Billion Investment Firm Starts Operation," China Daily, October, 1, 2007.
[4] According to a senior analyst, there was a contest between competing bureaucratic interests over the structure, organization, and control of the CIC. Author's interview 080620, Beijing.
[5] Zhang Ming and Sarah Eaton "Dragon on a Short Leash: an Inside-out Analysis of China Investment Corporation," Working Paper No. 0821, CASS: Beijing, November 26, 2008.

considerable room to maneuver. This condition was exacerbated by the relative absence of financial expertise among senior Party leadership.[6] As such, the state had little choice but to rely on the professional judgment of the few senior leaders in the CCP that had established financial credentials. The result was that Jianyin bought a 9.9% stake in Blackstone Group for $3 billion as part of Blackstone's IPO. This action would later come under fire for its lack of due diligence and proper vetting.

So what was China Jianyin? How did it come to enjoy so much autonomy in the months leading up to the creation of the CIC? China Jianyin Investment Limited (中国建银投资有限责任公司) was created out of China Construction Bank (CCB) on September 17, 2004. Its creation was part of the CCB's re-organization in preparation for its public listing as a joint-stock company. Because of legal limitations on what the CCB could own once it was reorganized, it was required to spin-off its ownership of China International Capital Corporation (CICC).[7] China Jianyin Investment Limited was created to own 43.35% of CICC.[8] Since the CCB was wholly owned by Central Huijin at this time, China Jianyin also became a subsidiary of Central Huijin. China Jianyin later would become the primary recapitalization and restructuring vehicle for the government to recapitalize and restructure China's domestic stock brokerages following the 2004-2005 collapse in that sector.[9] As a result, China Jianyin would eventually come to serve as a holding company for several Chinese financial companies (mainly brokerages). These

[6] "...most of these investment arms are staffed by government people, largely party cadres. Both their lack of experience and their independence are open to question." Henny Sender, "China Turns Risk Averse as Capital Outflows Rise," Financial Times, Jan 18 2008, p. 21.

[7] CICC was the first Chinese joint-venture investment bank. CICC was a joint venture between Morgan Stanley and CCB. Because of its early entry into the China market, CICC was well-positioned to dominate the early IPO business of China. CICC took several of the initial big Chinese SOEs public.

[8] Morgan Stanley retained 34.3%, China National Investment & Garanty Company owns 7.65%, Government of Singapore Investment Corporation owns 7.35% and Mingly Corporation owns 7.35%.

[9] "During the spring and summer [of 2005], China Jianyin bailed out several of the country's largest securities firms, including Galaxy Securities, China Southern Securities, Shenyin & Wanguo and Guotai Junan." Jamil Anderlini, "Firm hand steers vehicle of financial reform; Banker who has handed out $60USb is the force behind restructuring," South China Morning Post February 6, 2006.

assets eventually came under CIC when CIC initially acquired Central Huijin. Indeed, the CIC can trace its roots to the early recapitalization efforts of Central Huijin and China Jianyin.

To complete the picture of CIC's roots, we must go back to 2003 when the People's Bank of China (PBoC)—China's central bank—acting through its subsidiary, the State Administration of Foreign Exchange (SAFE), dedicated US $45 billion of China's foreign exchange reserves to create the Central Huijin Investment Company (中央汇金投资有限责任公司). This vehicle was designed to recapitalize China's largest domestic banks.[10] The move was a controversial one at the time since valuable foreign currency was being used to prop up bad assets on the books of China's domestic banks. Moreover, the move signaled a bureaucratic power shift away from the Ministry of Finance (who had previously been the dominant government bureaucracy with respect to China's banking entities) to the People's Bank of China (the central bank—which managed China's foreign currency reserves). On January 6, 2004 the PBoC announced that earlier in December 2003 it had used $45 billion of US government bonds and other foreign currency denominated assets in its coffers (taken from what would have otherwise been an even higher $403.3 billion foreign exchange reserve reported at year end 2003) to take an equity stake in Central Huijin Investment Company. The newly-created Central Huijin then turned around and made subordinated loans to the Bank of China (BOC) and China Construction Bank (CCB) so that these banks could count the value of these loans as their own assets (equity capital) on their 2003 year-end books. The purpose of this shell game was to help clean up the balance sheets of these banks (i.e. lower their non-performing loans ratio) to enable them to have successful IPOs. This operation was done in December, 2003 with a view to eventually retiring

[10] The "Big Four" banks had accumulated significant amounts of bad debt as a result of loans made to failing state-owned enterprises in the 1990s. The "Big Four" banks are all state-controlled and largely state-owned with some publicly listed shares. They are: Industrial and Commercial Bank of China (ICBC), Bank of China (BOC), Agricultural Bank of China (ABC) and China Construction Bank (CCB).

the Central Huijin loans via an exchange for stock when the banks went public in two or three years time. A similar maneuver was used to recapitalize ICBC. [11]

The move enabled the relatively weak commercial banks to use China's official dollar denominated assets to support their balance sheets, thus permitting the PBoC to help them without requiring the PBoC to issue any additional RMB-denominated bonds (i.e. "real money" domestically in China). Issuing the banks more RMB would likely have added to the domestic inflationary pressure, while re-allocating foreign reserves would help relieve pressure for letting the RMB appreciate—thus making the maneuver a win-win proposition. Of course, the only catch was that these assets could not really be spent in China (since the banks would have first needed to convert them to RMB—which the PBoC was not going to let them do). However, these assets *could* be used on dollar-denominated investments. Over next few years, Central Huijin would come to develop some limited expertise in assisting the banks with placing some of their capital in overseas, dollar-denominated investments (since these sorts of investments did not require conversion to RMB).

The December 2003 operation ought to be understood in the context of the broader effort to reform China's domestic banking sector. Previously, in 1998, the PBoC had injected RMB 270 billion (~$32.6 billion) into "The Big Four" banks to help stave off collapse. Again in 2000 and 2001, it allowed them to essentially write off RMB 1.4 trillion of bad loans by transferring these non-performing loans to asset management companies that were designed to recover as much of the bad debt as possible. By using the foreign exchange reserves to set up Central Huijin, the PBoC was able to use these assets to achieve an important domestic reform priority at

[11] Although by the time of the ICBC recap, the MOF and Communist Party Organization Department had agitated against the PBoC's growing bureaucratic "empire" and the ICBC recapitalization was limited to $15 billion in exchange for 50% of the equity (MOF retained the other 50%). In contrast, Central Huijin received 85% of CCB's equity and 100% of BOC's equity. Jamil Anderlini, "Firm hand steers vehicle of financial reform; Banker who has handed out $60USb is the force behind restructuring," South China Morning Post February 6, 2006.

a time when low interest rates in the US meant that the opportunity cost of using these foreign exchange reserves was not very high.

I begin the CIC case with this brief discussion of the CIC's roots in China's domestic bank recapitalization in order to provide context for the domestic bureaucratic competition between the MOF and the PBoC which would color the CIC's early experience. Under the planned economy, the MOF directed China's banks to provide credits as dictated by the plan. As such, China's banks were national instruments of economic planning. With the advent of the bailouts of non-performing loans, the PBoC took on a larger role in the ownership and management of the banking sector. As the PBoC played a larger role, MOF ceded bureaucratic territory. Frictions between MOF and PBoC have characterized a significant portion of China's recent macroeconomic reforms.[12] The CIC grew out of a series of moves to mobilize foreign exchange reserves to achieve the domestic political goals of recapitalizing China's banks. Although, the CIC today seems to be trying to move toward a purely commercial footing, this has certainly not always been the case. To understand whether the CIC can be used as an effective instrument for furthering China's foreign policy objectives, it is important to identify the factors that enable the state to control the activities of the CIC. To answer this, let us take a closer look at the leadership, structure and activities of today's CIC.

8.3 The China Investment Corporation (CIC): Structure and Leadership

To understand the dynamics driving the values on the *Unity of State IV* and the *Reporting Relationship IV* for this case requires examining the organizational architecture and leadership of

[12] See Victor C. Shih, *Factions and Finance in China* (Cambridge: Cambridge University Press 2008).

the CIC.[13] At the top of the organization is the CIC's Board of Directors. "The CIC Board of Directors is mandated and authorized to oversee the company's operation and overall performance."[14] Essentially, the Board of Directors serves as the senior leadership organization for the CIC. As needed, the Board may notify the State Council of "major issues." These are usually investment decisions over US $1 billion.[15] The CIC's Articles of Association stipulate the composition of this eleven person Board of Directors. The Chairman (Lou Jiwei 楼继伟) and Vice Chairman (Gao Xiqing 高西庆) are both appointed directly by the State Council of the PRC. The third and final executive director is Zhang Hongli (张弘力), who is also the Executive Vice President and COO of CIC. The five non-executive directors (directors who do not also concurrently hold a senior operational management position in the company) must be comprised of one individual nominated by each of the following ministries: the National Development and Reform Commission, The Ministry of Finance, the Ministry of Commerce, the People's Bank of China, and the State Administration of Foreign Exchange. The State Council must approve their nominations. There are also two independent directors who cannot have any ties to the CIC "that may influence his or her independent objective judgment." The final member is the "Employee Director" that is supposed to "represent the employees" on the board.

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[13] The CIC has recently made limited efforts to improve its transparency. These include a disclosure of the management team and CIC's internal reporting structure. In particular, its involvement in the Santiago Protocols for sovereign wealth fund operating and reporting standards as well as its recently-launched website are both positive steps in this direction.

[14] CIC website: http://www.china-inv.cn/cicen/governance/governing_bod.html

[15] Traditionally, the State Council has had to approve all SOE investments abroad that are over $200 million.Paul Glasson, "Regional Focus to Global Push - The China Syndrone," The Australian, March 4 2009, sec. Finance, p. 22. However, it seems that the CIC enjoys a bit more latitude in its approval process. According to CIC sources and analysts, decisions over $100 million up to $1 billion will go to the CIC Investment Committee for approval, while those over $1 billion would need to have State Council approval. Decisions below $10 million were reported to be discretionary. Presumably, investments between $10 and $100 million are handled in the normal course of internal reporting operations. See Author Interview 080620, Beijing; Author Interview 080621, Beijing; Author Interview 080623, Beijing.

The Board composition reflects the diverse range of institutional interests that have a stake in the CIC, but the overall impression of the CIC's leadership is that 1.) this is clearly a government entity with direct lines of authority to senior state leadership and 2.) former Ministry of Finance officials occupy most of the top executive posts. The five non-director positions are quota-allocated to the ministries that are directly concerned with the CIC to ensure that each stakeholder gets a voice at the table. However, both the Chairman and the Vice Chairman are appointed by the State Council (headed by Premier Wen Jiabao). Lou Jiwei, and Zhang Hongli both came out of the Ministry of Finance and are considered to be loyal to Wen Jiabao. In addition, the company management and the Executive Committee—responsible for the day to day operations of the CIC—are both dominated by the Ministry of Finance. Jin Liqun (金立群) (Chairman of the Board of Supervisors—the auditing and oversight portion of the management) also came out of the Ministry of Finance.

While the Ministry of Finance may have strong representation at the CIC, it is certainly not the only voice at the table. Almost every other major government institutional stakeholder in the world of Chinese finance is represented at CIC. For example, the Chief Investment Officer, Gao Xiqing is a graduate of Duke Law School and came to the CIC from the National Council for the Social Security Fund.[16] The former president of Central Huijin, Xie Ping (谢平)—a reformer from the PBoC, is also a member of the executive committee as is the Chief Risk Officer, Wang Jianxi (汪建熙)—former Chairman of China Jianyin.[17] This diversity of institutional allegiances throughout the governance structure of the CIC is an important factor in light of the *Unity of State IV*.

[16] See: Anonymous, "China's trillion-dollar kitty is ready," Asia Times Oct 2, 2007.
[17] See: Xinhua, "China's forex investment company to debut next Friday: report" Xinhua News Agency Septemeber 19, 2007.

Particularly in the early days of the CIC, there seemed to be a considerable bureaucratic struggle between the MoF, PBoC and NDRC over CIC's mandate and how it should deploy its capital.[18] At the core of this debate was a difference over the degree to which the CIC ought to use its resources to support national policy versus using its resources to maximize its risk-adjusted return on investment. While this struggle was taking place, it seems that CIC's precursor entities (China Jianyin and Central Huijin) were actively seeking out investment opportunities abroad (Blackstone and Morgan Stanley). These investments were characterized by their chummy characteristics and have since come under fire for their lack of due diligence and subsequent losses. The details of the investments seem to suggest that the commercial actor was taking the initiative and acting relatively independently of the state. Later efforts to consolidate power over CIC were partly based on arguments claiming that this loosely-supervised CIC of the early period needed to be reigned in with proper investment review processes and risk management procedures. Without such mechanisms of more centralized control, it was argued, the CIC would continue to engage in poorly timed investments that lose half of their value in a few years.

Although the data seems to suggest that diverse institutional interests are represented at CIC (indicative of a divided state—especially in the early, formative days of the CIC), there is also strong evidence that the MOF has begun to consolidate its dominance of the organization, paving the way for tighter state control today and in the future. In particular, leaders with significant MOF experience seem to outnumber individuals from other organizational

[18] These inter-bureaucratic struggles pre-dated the CIC. Central Huijin's recapitalization of ICBC was a considerably smaller $15 billion and entitled Central Huijin to only 50% of the equity (as opposed to the $45 billion that had been splashed out for BOC and CCB). "…[T]he smaller stake was a result of high-level opposition from competing regulatory agencies, which criticised the 'empire-building' of the People's Bank of China (PBOC) and its reformist governor, Zhou Xiaochuan, to whom Mr Xie and Huijin officials report." Jamil Anderlini, "Firm hand steers vehicle of financial reform; Banker who has handed out $60USb is the force behind restructuring," South China Morning Post February 6, 2006.

backgrounds. Moreover, recent personnel changes in some of the top positions at CIC seem to suggest that the MOF has been consolidating its grasp.[19]

As a result, we observe less state control (relatively unsupervised deals like Blackstone and Morgan Stanley) during the CIC's initial formative period when the government was more divided. To the extent that the state has become more unified, we can expect additional control in the future.[20] Although, the organization chart and the backgrounds of senior leadership might provide important information on the values for the *Reporting Relationship IV* and the *Unity of State IV*, these are only some of the factors that must be considered when determining what drives the outcomes observed in the CIC case. Understanding the CIC case more fully requires examining its funding sources since these play an important role in shaping CIC's commercial interests.

8.4 The China Investment Corporation (CIC): Financing Sources

The CIC was capitalized with $200 billion using three tranches of fixed-coupon special treasury bonds denominated in RMB. The first tranche (10 year, paying a 4.3% coupon) was worth 600 billion yuan (about $77 billion) and was sold to the PBoC on August 28, 2007.[21] The

[19] For instance, Hu Huaibang (胡怀邦) has been replaced as Chairman of the Board of Supervisors by Jin Liqun. Hu was formerly Secretary of the Disciplinary Board at the CBRC and a member of the Communist Party Discipline and Inspection Committee. He was an anti-corruption, Communist Party representative on the board. Jin was a vice president of operations at the Asian Development Bank. Prior to that position he was Vice Minister of Finance, Director General of the World Bank Department at MOF.

[20] Additional evidence of MOF ascendancy within CIC's leadership includes the valuation and sale of Central Huijin (discussed below)—by valuing it at near book value, the MOF received a good price while the PBoC was not given full compensation for its valuable asset.This conforms with reports of an intense struggle between the MOF and PBoC over the PBoC's rapidly growing influence over the banking sector—an arena that MOF had traditionally dominated. The creation of the CIC can be interpreted as MOF's institutional effort to wrest back control over the banking sector.

[21] It ought to be noted that the PBoC cannot directly buy bonds from the Ministry of Finance, so this transaction was conducted using the PBoC-owned Agricultural Bank of China (ABC) as an intermediary. For further details on the CIC's financing see Rachel Ziemba's helpful post from December 5, 2007 and the update on December 14, 2007 on *RGE Analysts' Economonitor* entitled, "How is China Funding the China Investment Corporation (CIC)?" available

second tranche was actually a series of six "public" offerings of 10 and 15 year bonds with coupon rates in the range of 4.41-4.68%. Most of these were (semi-forced) purchases by commercial banks for a total of about 199 billion yuan (about $26 billion) between mid-September and mid-December, 2007.[22] The third tranche (15 year, paying a 4.45% coupon) was worth 750 billion yuan (about $97 billion) and was sold to the PBoC (again via the ABC intermediary) on December 10, 2007.[23]

This financing structure has three implications. First, the investment returns that the CIC must generate to make its scheduled interest payments are considerable. Not only does it face fixed debt payments regardless of the performance of its investment portfolio, but it is expected to invest in international assets while its debt payments must be made in the appreciating RMB currency.[24] Even though the interest on this debt is only around 4.5% (considerably less than a 6% domestic inflation rate) by its own estimate, the CIC needs to generate aggregate returns of about $14.6 billion per year or about 7.3% on its $200 billion asset base just to break even.[25]

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at: http://www.rgemonitor.com/economonitor-monitor/230764/how_is_china_funding_the_chinese_investment_corporation_cic. Last accessed on April 15, 2009.

[22] "The interest payments on all these bonds are below those of comparable bonds- and current inflation. The main (only) audience for these bonds is thought to be the commercial banks who are already the major purchasers of the frequently issued sterilization bills and longer term bonds." *Ibid.*

[23] *Ibid.*

[24] "In addition, China's accumulation of U.S. debt in 2007 was not very profitable given the appreciation of the renminbi (RMB) against the U.S. dollar. The yield on 10-year U.S. treasury bills fluctuated between 4.5% and 5.0% throughout the year. However, since the beginning of 2007, the RMB has appreciated 6.0% relative to the U.S. dollar. As a result, the effective rate of return on U.S. treasury bills valued in Chinese currency was negative in 2007. For example, on January 1, 2007, the exchange rate was 1 yuan of RMB = 12.82 cents of U.S. dollars. If China had invested 100 billion yuan in one-year U.S. treasury bills on January 2, 2007, it would have been offered a return of 5.0%. After conversion into U.S. dollars, China would have invested $12.82 billion. At the end of the year, China would have been paid $13.461 billion by the U.S. Treasury for its investment. However, the exchange rate at the end of 2007 was 1 yuan = 13.59 cents. So, after converting the U.S. dollars back into RMB, China would have received the equivalent of 99.051 billion yuan for its investment — a loss of 949 million yuan, or a -0.9% return on its investment. When evaluated in its domestic currency, China lost money on its investments in U.S. government debt in 2007." From: Michael F. Martin, "China's Sovereign Wealth Fund," Congressional Research Service Report for Congress, January 22, 2008, p. 16.

[25] According to Lou, the interest cost on the outstanding bonds is about 300 million yuan (more than $40 million) per day. See: "China's Sovereign Wealth Fund Seeks to be a Stabilizing Presence in Global Markets," *Xinhua*, November 30, 2007. Assuming a minimum return of $40 million per day, the CIC will need to earn at least $14.6 billion per year in profits (at least 7.3% return on its total capital base of $200 billion). Moreover, hopes of access to

This financing structure suggests that the CIC has been provided with a strong commercial incentive to focus on generating investment returns to meet its financial obligations. Second, by seeding the CIC in this way, the PBoC was able to soak up perceived excess liquidity from the system.[26] "'Our purpose [at CIC] is to reduce the liquidity in China,' says one senior CIC staffer."[27] This seems to suggest that to the extent that the CIC will be used as an instrument for the state to pursue policy preferences, those priorities will be largely domestically-oriented macroeconomic priorities as opposed to expansive, foreign policy goals. Third, the PBoC seems to have been forced to bear the brunt of the currency risk, since the Ministry of Finance (MOF) could hold the RMB proceeds from the bonds for a period of time and collect the risk-free returns resulting from the RMB appreciation. As the counterparty to the transaction, this financing arrangement forces the PBoC to hold the relatively devalued foreign exchange.[28] This provides another data point indicating that MOF is in the bureaucratic driver's seat.

This examination of the financing and management structure both seem to suggest that MOF has gained control of CIC after an initial period during which time the state was divided across bureaucratic lines. Another implication of this data is that the CIC has been constituted in

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additional foreign exchange reserves will depend on the CIC performance. Lou stated: "If I am making losses every day, how can I face asking the government for more money?" See: "China Wealth Fund Aims for Stability, Openness," *China Daily*, October 16, 2007. It is also important to note that the annual dividends from CIC's bank ownership have been estimated to be US $7.8 billion. This would help satisfy more than half of CIC's interest obligation. See: Katherine Ng, "CIC Dispels Fund Concerns," The Standard March 10, 2008 available online at: http://www.thestandard.com.hk/news_detail.asp?sid=17984607&art_id=62790&con_type=1&pp_cat=1

[26] In Chinese central banking such forced savings is a common method of directly adjusting the money supply since interest rate mechanisms (commonly used as the primary monetary tool in the West) are not really permitted to operate effectively. "Most of the newly-issued bonds ended up in the hands of the PBoC, effectively soaking up some of the perceived excess liquidity in China's money markets." From: Michael F. Martin, "China's Sovereign Wealth Fund," Congressional Research Service Report for Congress, January 22, 2008, p. 7.

[27] Henny Sender, "China Turns Risk Averse as Capital Outflows Rise."

[28] "The RMB raised from these bond sales are not converted into foreign currency immediately. It seems like the 600b RMB bond was converted into foreign exchange in q3 [2007], the 200b RMB from the small bond issues in q4 [2007] and the last bond issue will be converted into foreign exchange in q1 2008. . . Given the RMB's ongoing appreciation, the Ministry of Finance has every incentive to only buy foreign exchange when it actually needs the money." From: Brad Setser, "What to do with over a half a trillion a year? Understanding the changes in the management of China's foreign assets," Council on Foreign Relations Working Paper January 15, 2008, p. 13. This sentiment was re-iterated in subsequent conversations with the author.

such a way that it faces a number of incentives to perform as a commercially-viable investment entity going forward. The holdings of CIC provide another important source of information about the behavior and intentions of the CIC. Let us now turn to a more detailed look at the CIC's investment activities.

8.5 The China Investment Corporation (CIC): Financing Uses and Activities

So how has this USD$200 billion capital base been put to use? By far, the majority of the CIC's investments have been in the finance sector. Specifically, the capital raised by the bond issuances discussed above was put to use in three ways. These allocations serve as costly signals that reveal CIC's goals and priorities and as such, make for excellent empirical material for analyzing whether the CIC will be used as an instrument of China's economic statecraft. The largest allocation was used to acquire Central Huijin from the PBoC. Another large allocation was used to continue the recapitalization of the domestic banks (in this case, Agricultural Bank of China and China Development Bank). The final portion of the capital is designated to be used for investing abroad. Although it seems that the CIC would have preferred to have a purely internationally-oriented commercial investment mandate, the central government directed the CIC to take on the mission of recapitalizing the banking sector. As the CIC began to coalesce, the government showed more signs of asserting its control.

In November, 2007 the newly-created CIC purchased Central Huijin from the PBoC for US $67 billion.[29] This valuation of Central Huijin was approximately at book value indicating a relative bargain for the Ministry of Finance and another bureaucratic set-back for the PBoC. With the acquisition of Central Huijin, CIC had utilized about 1/3 of its $200 billion of investment capital and picked up a considerable portfolio of China's domestic banking assets.

[29] Keith Bradsher, "$200 Billion to Invest, But in China," The New York Times, 29 November 2007.

Central Huijin's holdings at the time included a 35.33% stake of the Industrial and Commercial Bank of China (ICBC) and a 70.69% stake (this includes the 9.21% owned by China Jianyin) of the China Construction Bank (CCB).[30]

How did Central Huijin come to hold such a large stake in China's largest banks? Throughout the 1980s and early 1990s, China's state-owned banks underwrote many of China's inefficient and failing state-owned enterprises. By providing favorable loans and extending credit to these otherwise unsustainable enterprises, the banks eventually accumulated considerable portfolios of non-performing loans (NPLs) on their balance sheets. As these NPLs built up on the banks' balance sheets, fears of systemic banking collapse grew. With the 1998 post-East Asian Financial Crisis creation of the CCP's Central Financial Work Commission, the PBoC embarked on a plan to reduce the NPLs and gradually commercialize the banks. Doing this involved a complicated (and often non-transparent) re-allocation of central bank assets and off-balance sheet recapitalization vehicles. It seems that CIC has now inherited at least a majority (if not the entirety) of this function. This domestic banking sector recapitalization mission is reflected in the CIC's second large transactional allocation of its capital, to which we now turn.

In addition to the acquisition of Central Huijin's and China Jianyin's assets, the CIC was tasked to provide future capital injections to banks preparing to list their stock publicly as part of the ongoing recapitalization of China's banking system.[31] Also in November 2007, CIC announced that it would provide US $67 billion to two of China's state-owned banks: The

[30] Ownership figures are as of April, 2009 from the company websites.

[31] "There are indications that the State Council, the PBoC and the NDRC insisted that the CIC provide help in the restructuring of these two state-owned banks as a condition of the CIC's establishment." See: Michael F. Martin, "China's Sovereign Wealth Fund," Congressional Research Service Report for Congress, January 22, 2008, p. 10. The CRS text references Prof. Michael Pettis of Beijing University. He confirmed this sentiment in my conversations with him.

Agricultural Bank of China and the China Development Bank.[32] In December of 2008, CIC (via Central Huijin) injected US $19 billion into the Agricultural Bank of China in preparation for its anticipated 2010 public listing. This resulted in ownership of ABC being split 50-50 between the Ministry of Finance and the CIC.

Unlike ABC, which is the last of China's "Big Four" commercial banks to be readied for partial public listing, China Development Bank is a "policy bank" (政策银行) meaning that it functions as a legally-mandated, explicit policy arm of the central government (rather than operate on a commercial basis).[33] At the end of 2007, Central Huijin provided US $20 billion capital to shore up CDB's balance sheet.[34] Central Huijin provided an additional $21 billion at the end of 2008 as part of CDB's reorganization into a joint stock company (i.e. no longer a policy bank). Today, Central Huijin owns 48.7% of the CDB with the other 51.3% residing at the Ministry of Finance.

The acquisition of Central Huijin and the recapitalization of ABC and CDB account for approximately $135 billion of CIC's initial $200 billion capitalization. This implies that only approximately $65-70 billion remains for CIC use as foreign investment capital.[35] The likelihood of this much smaller figure having a significant, sustained foreign policy effect

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[32] The $67 billion figure was reported in the press at the time, but in subsequent research, I have only been able to confirm $19 billion that was used in ABC and $20 billion at CDB. "China Investment Co to Invest a Third of Its 200 Bln USD 'Cautiously' — Official," AFX News Limited, November 7, 2007. At the end of 2008, CIC provided another RMB 146.1 billion (~$21 billion) to capitalize the newly-formed joint stock company holding vehicle for CDB. At the same time, there were reports that the CIC now had additional funds that had originally been reserved for recapitalizing ABC and CDB but were no longer needed. These approximately $7 billion of newly-freed up capital were to be added to CIC's funds earmarked for foreign investment (primarily to be placed with third party mandates).

[33] For more detail on the CDB see Chapter Six, especially Section 6.3 relating to CDB.

[34] See: CDB's 2007 Annual Report section entitled: "Financial Review" available at: http://www.cdb.com.cn/english/Column.asp?ColumnId=91 "ABC and CDB are the two largest banks still in the process of this restructuring, which involves government recapitalisation - CDB received $20bn at the end of last year [2007] and ABC expects even more - and eventual stock market listings." From: Anderlini, "Illegal Lending Scandal Hits China Development Bank."

[35] This figure has since been revised as less capital was needed that originally thought to recapitalize CDB and ABC. It is now thought that CIC has between $80-90 billion earmarked for foreign investment. See the more detailed discussion of the revision below.

decreases considerably. Although CIC's $200 billion top-line figure and billing as "China's Sovereign Wealth Fund" conjure up frightening possibilities of large waves of government-directed foreign investment, the $65-70 billion figure represents considerably less international economic gunpowder that may be used to gain influence.

So what exactly does the CIC now own and how are these assets structured? Although China Jianyin's purchase of US $3 billion of Blackstone during Blackstone's IPO and CIC's acquisition of $5 billion of Morgan Stanley both attracted considerable public attention, these holdings represent a comparatively small fraction of CIC's investments. The majority of CIC's holdings are concentrated in China's state-owned banks.[36] These fall into two groups: "commercial banks" and "policy banks." The commercial banks are the "Big Four." As of the December 31, 2008, CIC (via Central Huijin) now owns: 67.5% of the Bank of China, 35.4% of ICBC (the other 35.4% is with MOF), 48.2% of China Construction Bank, and 50% of ABC (pending public listing).[37] These, in addition its 48.7% ownership of China Development Bank, comprise the majority of CIC's assets. Exactly how much of CIC's asset base they make up is more difficult to determine. These assets are difficult to value since much of the equity is locked up in non-tradable shares, however, based on the $67 billion Central Huijin acquisition, plus the roughly $60 billion of publicly announced capital that has been invested into the ABC and CDB recapitalizations, these assets account for between ½ to 2/3 of CIC's assets and clearly indicate a

[36] Drawing the line between CIC and state banks is not easy. See Brad Setser, "The Implications of Sovereign Wealth Fund Investments for National Security," Testimony before the US-China Economic and Security Review Commission February 7, 2007 p.9.

[37] Share ownership is sometimes difficult to keep up to date given the multiple reorganizations and historic lack of transparency with regard to government ownership. These figures are based on company reports of the publicly-listed firms. The government generally holds its ownership stake in the holding company, a subsidiary of which is the publicly-listed firm. The figures have also recently been confirmed by the CIC's own 2008 Annual Report; specifically, "Exhibit 7: Top Five portfolio holdings of Central Huijin" p. 35 available at: http://www.china-inv.cn/cicen/include/resources/CIC_2008_annualreport_en.pdf The only significant point of disparity was in CIC's share of China Construction Bank: Initially, it was reported that CIC controlled 57%, but CIC's annual report listed its ownership as 48.2%. The difference, I assume, can be explained by the dilution stemming from CCB's stock offering.

domestic, banking reform focus.[38] This portion of CIC's work seems unlikely to generate serious security concerns since this capital is simply not involved in international activities.

The remaining third of CIC's assets are those assets that *have* been earmarked for foreign investment. The investment of these assets seems to be the root cause of much of the trepidation surrounding the activities of the CIC. Based on my original calculations, the total amount of capital that CIC would be looking to deploy internationally would be between $45-70 billion.[39] However, CIC President Gao Xiqing, has since announced that "CIC will invest between $80 billion and $90 billion outside China, up from its original target of deploying $66 billion overseas." Apparently, the additional funds stem from capital that had been ear-marked for recapitalizing state-owned banks, but which has now been determined to no longer be necessary.[40] In addition, the higher figure most likely includes some portion of the CIC's early investment profits. Analysts have predicted that this amount will likely grow as CIC demonstrates its ability to generate returns and it is given further allocations of state capital to manage.[41]

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[38] Central Huijin also apparently recapitalized the much smaller China Everbright Bank for about $2.7 billion in preparation for its IPO. See: "China Everbright Agrees to Capital Injection Plan," China Daily, November 28, 2007. Also see: "SAFE Investments to Offer Bailouts to State-Owned Banks," SinoCast China Business Daily News, Dec 26 2007, p. 1.

[39] In early 2010, there have been rumors that CIC is slated to receive an additional capital injection of another $200 billion. I intend to explore the details (timing, allocation, financing structure, etc.) of this tranche of funding when I return to China for follow-up interviews in the late winter of 2010.

[40] "World News: China Fund Plans to Steer More of its Money Overseas," Wall Street Journal, Apr 24 2008, p. A.8. Although, according to my calculations (based on publicly available information), this $80-90 billion figure still does not add up. Even if the ABC and CDB recapitalizations only required $60 billion instead of the originally projected $67 billion that only frees up an additional $7 billion which added to the original projection of $66 billion for foreign investment, only gets you to $73 billion. I suspect that Gao's announced figure may include some additional capital infusion to CIC that has not been publicly announced (perhaps from CIC's bank dividends or other return on investment in excess of its interest payments).

[41] "The initial Dollars 200bn was basically the first batch and if CIC gets their investment framework right and shows it is capable of earning decent returns there is no question they will be allowed to invest more," said Qu Hongbin, chief China economist for HSBC." From: Jamil Anderlini, "CIC Gears Up for Dollars 30bn Drive," Financial Times, Feb 11 2008, p. 24. See also: Henny Sender, "China Turns Risk Averse as Capital Outflows Rise"

Thus far, only a very small portion of this internationally-designated capital has been publicly committed. According the CIC's 2008 annual report (which was made public in August, 2009), the CIC holds 87.4% of its "Global Investment Portfolio" (those funds not used for Central Huijin) in cash or cash equivalents.[42] The largest investment stake seems to have been the $5 billion purchase of 9.9% of Morgan Stanley on December 19, 2007.[43] This investment has since come under considerable criticism for its haphazard approach. "Before CIC committed about $5US billion for a 9.9 per cent stake in the US bank in 2007, it did not even bother to adhere to the international practice of hiring an independent financial adviser. Neither did Morgan Stanley."[44] Despite the significant stake, it seems that the CIC has also forgone any rights to a board seat or an active role in the management of the company. CIC has continued to maintain its substantial ownership stake in Morgan Stanley.[45]

The next largest allocation is the April, 2008 announcement of CIC's $3.2 billion placement with J.C. Flowers for 80% of a new private equity fund. The third largest commitment was the May, 2007 China Jianyin purchase of a $3 billion IPO stake of Blackstone. Recall that this stake (along with the other China Jianyin holdings, including the 43.35% ownership of CICC) came over to CIC as part of the Central Huijin acquisition. The Blackstone and Morgan Stanley purchases were made partly with an eye toward learning more about international investing and internal due diligence and risk management practices. In addition, these investments were seen as building strategic partnerships for CIC as it entered into relatively

[42] See "Exhibit 6: Global Investment Portfolio Distribution" on p. 35 of the CIC's 2008 Annual Report available at: http://www.china-inv.cn/cicen/include/resources/CIC_2008_annualreport_en.pdf

[43] "China Fund Grabs Big Stake in Morgan Stanley," *AFP*, December 19, 2007.

[44] Wang Xiangwei, "Fed's 'Printing Presses' Give Wen a Headache."

[45] In October, 2008 Mitsubishi UFJ Financial Group, Inc. invested equity into the struggling Morgan Stanley which was facing pressure as a result of the credit crunch brought on by the subprime mortgage crisis. This infusion diluted the CIC's stake down to 7.68%. On June 2, 2009, CIC bought another $1.2 billion of Morgan Stanley's stock effectively returning the CIC to its previous ownership stake of 9.86%. See: http://www.china-inv.cn/cicen/resources/resources_news01.html

uncharted waters for Chinese central bankers: namely large-scale asset management of foreign exchange reserves.[46] Because of the good deal of public and private criticism that CIC has received about these investments, "CIC has been discouraged from taking more direct stakes, at least for the time being."[47]

In the summer of 2009, with asset prices reflecting a substantial discount as a result of the global economic crisis, it seems that CIC went on a buying spree. In July, CIC purchased $1.5 billion of Teck Resources—Canada's largest diversified mining firm specializing in copper, metallurgical coal and zinc.[48] This private placement garnered CIC a 17.2% share of Teck and 6.7% of the voting rights. In September, 2009 it seems that the CIC bought $1.9 billion of PT Bumi Resources debt. PT Bumi is Indonesia's largest thermal coal mining company. Earlier that month, CIC bought a $850 million stake in Noble Group—a Hong Kong-based commodities trader. There are also reports that CIC has bought $300 million of convertible bonds in a Mongolian mining company named Lung Ming. CIC was also active in real estate, taking part in a GBP 800 million consortium that helped bailout London's Canary Wharf and investing AUS $200 million in Goodman Group, an Australian real estate investment trust. Apparently, CIC also awarded $800 million to Morgan Stanley to co-invest in a projected $5 billion global property fund. These purchases all seem timed to capitalize on the relatively low asset valuations brought on by the financial crisis. Although too early to tell, they may be a bell-weather of CIC's more active deployment of capital overseas.

[46] One example of the type of benefits that CIC hoped to gain from these acquisitions can be seen in Blackstone's provision of investment banking advisory services to CDB's failed $3 billion purchase of Barclays. China Foreign Investment Spree to Continue," SinoCast China Business Daily News.

[47] Henny Sender, "Sources of Needed Cash Scared Off," Financial Times, Jan 28 2009, p. 4.

[48] Recent filings have shown the value of this investment to have doubled in less than a year. Teck is also "a significant producer of gold, molybdenum and specialty metals, with interests in several oil sands development assets." See the company description found at: http://www.teck.com/Generic.aspx?PAGE=About+Us&portalName=tc For more information about CIC's purchase refer to CIC's press release that can be found at: http://www.china-inv.cn/cicen/resources/resources_news08.html

The only other major purchases have been the relatively small $200 million IPO purchases of VISA and the $100 million IPO stake in China Railroad Group (announced on November 21, 2007).[49] The Hong Kong Railroad buy seems to be a largely symbolic gesture of support in line with what has become common practice for state-owned companies that are listing on major exchanges.[50]

Even accounting for these direct investments, which together amount to a little over $16 billion in investments, CIC is still left with around $70 billion waiting to be invested overseas. Early indications seem to suggest that the majority of this pool will be or has been competitively awarded to third party investment managers across a range of asset types and investment strategies. There have been indications that the majority of these funds will be quietly placed with private foreign fund managers that meet CIC's investment criteria.[51] Indeed, there are reports that CIC has awarded Blackstone a $500 million mandate for its fund of funds asset management business. Thus, it is likely (although not guaranteed) that such activities will constitute a commercially-motivated capital allocation that is managed by professional asset managers in $0.5-5 billion allotments. As was the case with NSSF's use of third-party mandates, such an allocation would introduce another level of state-commercial actor distance which increases the likelihood that the CIC's activities would be insulated from politics.

[49] "World News: China Fund Plans to Steer More of its Money Overseas," Wall Street Journal.
[50] Jamil Anderlini, "CIC to Buy Stake in HK Rail Group Float," Financial Times, November 21, 2007; "CIC Invests in China Railway IPO," China Economic Review, November 21, 2007. I believe that China's initial investment in Blackstone was also partly colored by an intention to signal constructive Chinese government support for the IPO. Drawing on China's domestic IPO experience, if the government is a prominent investor/backer/supporter of an IPO it is often taken as a mark of support and friendliness. I am not convinced that the China Jianyin leadership intended to signal a Chinese capital invasion of US public markets—although that was in fact the response that it seemed to generate.
[51] "Mr. Gao also said the CIC has just finished the selection of external equity managers, but he didn't provide details. Those mandates are expected to be a major boon for the asset-management industry and span equity markets throughout the globe, including the U.S., Western Europe and Japan. He said the process of hiring fixed- income managers and talks with hedge funds and private-equity funds are continuing." *ibid.*

If this is true, such a capital management strategy will add a significant degree of commercialization to the CIC's activities and thereby reduce the potential for politicization. By putting its capital with third party fund managers and essentially becoming a "fund of funds" the CIC effectively ties its hands by adding another layer of state-commercial actor relationships in which the international third party fund manager has the CIC as its principal. Introducing this additional layer of commercially-oriented autonomy significantly increases the distance between the State Council and the commercial actors ultimately responsible for deploying the state's capital. At the same time, it will reduce the ease with which the CIC can be used as an instrument of economic statecraft since such a move would provide another layer of agency between the Chinese government and the commercial actors actually conducting the economic interaction. With another layer of state-commercial actor relations folded into the current structure of managing China's foreign exchange reserves, the ability of the central government authorities to effectively manipulate the movement of state capital in order to realize China's foreign policy objectives would be significantly diminished. It would become considerably more complicated to enforce effective state control over the CIC *and* for the CIC, in turn, to effectively ensure control over the third party asset manager. If China decides to use third-party fund managers to manage the vast majority of its foreign-invested capital, this would be an important measure in insulating such activities from the security consequences that might otherwise result from state-sponsored investment on such a large scale. Let us now turn to a more detailed consideration of the security externalities raised by the CIC.

8.6 CIC's Foreign Investment: Assessing the Security Externalities

The above examination of CIC's assets seems to indicate that the majority of its capital will be dedicated to recapitalizing China's domestic banking sector. The portion of assets that is available for international investment is the source for most trepidation regarding possible security externalities. Drawing on the typology presented in Chapter Two, this section will systematically evaluate the security concerns that might result from CIC's activities. For instance, some worry about the potential for the CIC to exercise *Coercive Leverage*. Although it seems plausible that any one firm (or even an industry) can become overly-dependent on Chinese sources of investment, it seems unlikely that the entire US economy would become dependent on Chinese investment simply by virtue of scale. In 2008, the US economy was about $14.4 trillion while the New York Stock Exchange had a market capitalization of around $10 trillion. Both dwarf China's total international investment outflow of about $55 billion in 2008.[52] The CIC is simply not large enough to effectively develop *Coercive Leverage* externalities over the US economy. At these levels, China's investment (if operating under state control) would be limited to generating *Coercive Leverage* externalities in a strategic sector(s) or over specific companies.

Concerns over *Interest Transformation* security externalities seem to be better founded. Creating concentrated domestic constituencies that have vested interests in favoring policies that are accommodating to China's strategic interests constitutes a potentially powerful tool for China's foreign policy. The debate over renewal of China's Most-Favored Nation trading status in the mid-1990s is a case in point. In that debate, specific domestic U.S. business interests that stood to gain from China's MFN status mobilized in support of extending "Permanent Normal Trade Relations" status to China. These efforts had what would eventually become decisive

[52] According to Lou Jiwei, "Judging from our investment strategy and scale, we are unlikely to present a major impact on the international market." See: "CIC to be Stable Force in Global Financial Market," Xinhua, December 11, 2007.

influence in Congressional deliberations over whether to renew China's MFN status.[53] It is not unreasonable to worry about similar modalities of influence with respect to China's state-sponsored investment activities.

A general *Corrosion* of the US economy that might result from China's state-sponsored investment seems unlikely as long as the investment takes place on a commercially-driven basis. In so far as government involvement skews the commercial calculus to encourage detrimental externalities, investment patterns may become corrosive to the general economy—although most concerns that are voiced regarding the corrosion of the US economy are usually driven by outsourcing (particularly in the manufacturing sector) and China's low-cost labor competitive advantage. Neither of these factors is especially tied to China's state-sponsored investment activities. In fact, China's state-sponsored investment may have the opposite effective. Rather than eroding the US economic position, *Bolstering* may be the likely security result stemming from bailout-like investment deals that provide much needed liquidity to credit constrained firms. There seemed to be some evidence of this sort of behavior early on in the financial crisis (for example, CIC's stake in Morgan Stanley, and Abu Dhabi's investment in Citigroup both provided much-needed capital injections) although it is too early to tell just how counter-cyclical sovereign wealth investing will be.[54]

There is some danger of *Strategic Transfer* given dual-use technologies and valuable knowledge that might be transferred as a result of acquisitions in sensitive security areas.[55] In

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[53] Recall the episode of Taiwan's fruit farmers in which China also effectively leveraged *Interest Transformation* security externalities to good effect.

[54] There have been indications that the CIC will be a "stabilizing force in the international market," as noted in: "China Wealth Fund Aims for Stability, Openness," China Daily, October 16, 2007. Lou Jiwei noted that sovereign wealth funds have been a useful source of stabilizing capital for financial institutions "that suffer from the subprime crisis; they are stabilizing the market. CIC will also do the same thing." See: Xin Zhiming, "CIC Aims for Overseas," China Daily, November 30, 2007.

[55] Fortunately, the US has some institutional foreign investment review mechanisms in place. Whether or not these are adequate is outside the scope of this research.

addition, there is evidence that China's state-sponsored investment activities are at least partly guided by a desire to secure what the government views as strategic access to resources and technologies.[56] Tapping Morgan Stanley's and Blackstone's institutional knowledge seemed to be at least part of the motivation behind CIC's initial investments. In addition, CIC's recent investments in Teck, PT Bumi, Noble Group and Lung Ming all share a resource-oriented dimension.[57] To the degree that international investments provide access to strategically important assets, such activity would seem to warrant concerns from a *Strategic Transfer* security externality perspective.

Understanding exactly what these externalities may be and specifying the conditions under which the state is or is not able to direct the behavior of the CIC along foreign policy—as opposed to commercial interests—lies at the heart of whether state-directed investment is likely to be a matter of strategic concern.

8.7 CIC's Mandate & Coding the DV for the CIC Case Study

To code the DV, we first need to assess what the goals of the state are and compare those to what the commercial actor does in practice. In this case study, factional frictions and inter-bureaucratic battles prevented a clear, consistent set of the state's goals from being specified—particularly in CIC's early days. [58] Particular factions and bureaucratic interests would vie with each other for defining the goals of the "state" with respect to the CIC as a commercial agent of the state.[59] One vision of China's interests with respect to the CIC stressed the macroeconomic

[56] See for example, the instances of state-sponsored financial support discussed in Chapters Five and Six.
[57] For more on *Strategic Transfer* security externalities see Chapters Five and Six on China's resource extraction strategies.
[58] Author's Interview 080620, Beijing.
[59] "Such a concentration of the country's wealth in one entity has inevitably drawn intense interest ... from powerful forces within the state bureaucracy. Each of these groups has its own ideas on how the money can best be spent." From: Jamil Anderlini, "China Wealth Fund's Early Coming of Age," Financial Times, December 21, 2007.

utility of CIC. This group tended to stress the importance of a commercial orientation for the institution. The other perspective emphasized the larger national, strategic interests of China and wanted to see the CIC actively supporting China's stated political goals and priorities. While this struggle was especially pitched early on in the process of creating the CIC, it now seems that many of these power struggles have been resolved in favor of the MOF (backed by Wen Jiabao at the level of the State Council). As a result, I code this case as exhibiting a lack of state control in the initial period. However, since about mid-2008, it seems that MOF had increasingly been consolidating its power. The result has been that by the end of 2008, the state seems to have been largely unified and control is now present.

The CIC's initial mandate reflected the internecine power struggle that characterized CIC's formation.[60] This mandate had three different components. First, as is evidenced by its asset allocation up to this point, the CIC has been tasked with completing the recapitalization, limited privatization and ongoing management of China's state-owned banks.[61] The government had already decided that a portion of its excess reserves would be used to re-capitalize the domestic banking sector which was placed on unstable grounds as a result of the bad lending policies the banks had. Interestingly, these loans were provided to otherwise insolvent and inefficient state-owned enterprises. Since the government did not want these firms to collapse (for fear of rising unemployment and a lack of an alternative social welfare safety net to the *danwei*) it leaned on the banks to extend credit. The result was a portfolio of non-performing

[60] "There clearly isn't a consensus inside China on what the CIC should be doing." From: Brad Setser, "Does the China Investment Corporation (CIC) Have a Coherent Investment Strategy?" online blog #234551, available at http://www.rgemonitor.com/blog/setser/234551/ Setser is now a Treasury Department official at the National Economic Council.

[61] To the degree that these state-owned banks are motivated by policy outcomes that support the government's objectives, they can be used as effective levers for realizing national interests. To the extent that these banks are focused on maximizing shareholder value and risk-adjusted return, their malleability to serve commercially questionable foreign policy goals of the state will be limited.

loans that later required bank recapitalizations. As per the central government's wishes, the CIC continues to play an important role in recapitalizing the domestic banks.

Second main goal of the CIC is to provide a vehicle to allow China to diversify its highly concentrated holdings of US dollar denominated government debt. The CIC is tasked with managing an important part of the diversification strategy for China's excess foreign reserves. Due the relatively low-yield on US Treasuries, China sought to improve the returns on a portion of its foreign exchange reserves. Indeed, as noted earlier, the origins of the CIC can be traced in part to the Ministry of Finance critiquing the PBoC's management of the foreign exchange reserves.[62] Although a portion of these reserves were used to recapitalize China's domestic banks, the rest of the capital was to be invested abroad. How these investments were to be made (whether on a commercial or political/policy basis) became an important bone of contention.

The final (initially contested and since repudiated) mandate of the CIC was to support the outward expansion of Chinese firms.[63] Traditionally, China's state-owned banks served as dispersing conduits for state-directed capital allocation (for example, CCB specialized in project financing while the ABC provided credit to the agricultural sector). There have been suggestions that the National Development and Reform Council (NDRC) and several large state owned

[62] "The establishment of the China Investment Corporation was an initiative sponsored by State Council and the Finance Ministry to redistribute the balance of power between the ministry and the central bank, the PBOC." From: Paul Glasson, "Regional Focus to Global Push: The China Syndrome," The Australian March 4, 2009, p. 22. See also Author's Interview 080621, Beijing; and Zhang Ming and Sarah Eaton "Dragon on a Short Leash: an Inside-out Analysis of China Investment Corporation," Working Paper No. 0821, CASS: Beijing, November 26, 2008.

[63] I note that this purpose of the CIC seems to be strongly resisted by the commercially-oriented PBoC as well as what seems to be the public statements of the CIC's senior management itself. However, in the course of my research in Beijing, several interlocutors confided that this vision for the CIC's mission was being championed by the NDRC and some elements within the Ministry of Finance and the Ministry of Commerce. (Author's Interview 080620, Beijing; Author's Interview 080621, Beijing) It seems that most recently, the CIC has publicly sought to disavow itself of this goal. The trend certainly seems to be moving CIC away from such activities—reflecting, in part, the consolidation of Lou Jiwei's power and the ascendancy of a commercially-oriented leadership. One of the strongest pieces of evidence of CIC's move toward operating on a commercial basis was its 2008 annual report. Publicly available as of August, 2009 at: http://www.china-inv.cn/cicen/include/resources/CIC_2008_annualreport_en.pdf

enterprises have pressured the CIC to continue to play such a role underwriting the international investments, acquisitions, and projects of China's SOEs as they go abroad.

To the extent that the CIC can facilitate the economic activities that generate security externalities in line with China's objectives, it may be a useful agent for furthering China's strategic interests. Activities like underwriting acquisitions of strategic assets abroad, subsidizing militarily significant firms and industries, or using CIC's investment clout to lean on holdings or potential partners to cooperate with China's national interests are just some of the ways one could imagine that the CIC could play a constructive role in achieving China's strategic interests. To the extent the CIC operates as an independent, commercially-driven entity with a significant distance between the central government and the CIC, it will be difficult to use the CIC as a tool of China's foreign policy. Such a commercially-oriented firm would mainly consider an investment's potential for return rather than its strategic significance.

In an effort to directly address international concerns stemming from Chinese government involvement in international investment, CIC leaders have gone to great pains to publicly commit themselves to a purely commercial set of goals. For instance, Wang Jianxi (then Chairman of China Jianyin, now CIC's Chief Risk Officer) stated on September 10, 2007, "The mission for this company is purely investment-return driven."[64] On the day the CIC was created, Yang Qingwei (formerly NDRC's Director General of the Department of Investment, now CIC's Deputy Chief Investment Officer) claimed, "The company's principal purpose is to make profits."[65] CIC Chairman and CEO Lou Jiwei has also consistently emphasized the commercial nature of CIC's activities: "We will adopt a long-term and prudent investment principle and a safe, professional portfolio strategy that adapts to market changes, which will put

[64] Jason Dean and Andrew Batson, op. cit.
[65] "China's Trillion-dollar Kitty is Ready," Asian Times, October 2, 2007.

emphasis on a rational match of returns and risks."[66] Such public statements seem designed to both reassure nervous host nations about the CIC's investment presence in their markets as well as reinforce Lou Jiwei's vision of CIC's commercially-driven mission (free from the interference of non-commercial interests). Many of the CIC officials' statements have sought to explicitly address sensitive areas of international concern. For example, Lou has indicated that the CIC will not invest in infrastructure.[67] While the Vice Minister of Finance, Li Yong (李勇), has committed not to make acquisitions in foreign airlines, telecommunications or oil companies.[68] These statements signify CIC's intent to be a largely commercially-driven institution (albeit with some consideration for the political sensitivities of its investments). Perhaps more importantly, their public nature signifies the consolidation of CIC under a leadership that has publically committed itself to a commercial as opposed to political agenda.

In sum, the state goals were not unified initially in this case study (owing to the factions and bureaucratic divisions among competing domestic financial governmental institutions). Without a coherent, unified set of goals from the state, it was difficult to exercise very effective control over CIC. Once MOF had consolidated its power over the CIC, it seems to have been able to shape and manage the CIC's agenda, processes and activities. The commercial actor in this analysis seems to have had four key goals: recapitalize the banks, diversify China's foreign exchange holdings, and support outward expansion of Chinese SOEs (though this seems to have been since dropped as part of CIC's mission). In addition, the CIC must continuously struggle to prove its ongoing worth and viability as a relatively new bureaucratic institution. Such new

[66] "CIC to be Stable Force in Global Financial Market," Xinhua, December 11, 2007.
[67] "China's Sovereign Wealth Fund Seeks to be a Stabilizing Presence in Global Markets," Xinhua, November 30, 2007.
[68] See: Investment Fund Announces Strategic Plans," Xinhua, November 9, 2007 and "China Investment Corporation Unveils Investment Plan," Xinhua, November 7, 2007.

entities are subject to rivals' efforts to "kill the baby in the cradle."[69] This goal of institutional survival is perhaps the most important goal for the CIC. How did these goals match up to what the state wished to have the commercial actor do?

As evidenced by the allocation of CIC's capital, its management, and investment activities, it seems that the CIC today has been set on a largely commercially-oriented path that emphasizes its task of managing a portion of China's excess foreign exchange reserves. This seems to be precisely what the (now unified) state would like this particular commercial actor to do. An examination of the evidence on CIC's goals seems to suggest that while state control may have been lacking in the early stages of CIC's existence, processes and institutions have since been put into place that facilitate ongoing, fairly limited P-A control going forward. The CIC will also likely take the political preferences of the senior leadership into consideration as the CIC executes its capital allocation duties. This is reflected in the CIC's reporting structure which ultimately is directly accountable to the State Council under Wen Jiabao. In addition, it seems that much of the senior leadership of the CIC is personally loyal to Wen Jiabao, implying that the CIC would willingly defer to his preferences. Thirdly, its investment decision process suggests that large investments will seek direct State Council level approval before moving forward. The CIC today seems to be largely fulfilling the interests of the State Council, namely conducting commercially-oriented diversification of China's foreign exchange reserves.

That said, the CIC has taken a number of steps to maximize its own agency and provide it with some room to pursue its own bureaucratic interests and to maintain its freedom of action as much as possible. Although this is unlikely to result in an outright loss of state control, CIC's pursuit of a more commercial orientation will make it increasingly difficult for the government to effectively wield the CIC as a political instrument of China's foreign policy. Perhaps most

[69] These dynamics were discussed in more detail in the SAFE case study of the Chapter Seven.

importantly, commercialization (which seems to be in the CIC's own narrow bureaucratic interests) is a route that is less likely to present security threats that may be generated by the CIC's international investments. The next section moves beyond the question of whether the state has been successful at controlling the CIC to a closer examination of the factors that facilitate or hinder state Control in the case of the CIC.

8.8 Evaluating the CIC

As discussed above, evidence from the CIC case seems to suggest that in the early days of the CIC, there was relatively little state control. As the CIC has matured, there is more evidence of state control. What explains this variation? In this section, we examine the IVs presented in Chapter Two in light of the CIC case. How well do changes in these IVs account for the observed variation in control?

In the CIC case, the state was initially divided across bureaucratic and factional lines. This division provided the commercial actor with an opportunity to play one portion of the state off the other to maximize the commercial actor's own preferences. It is mainly because of the divided state that we observe the lack of state control in the early days of the CIC. However, it seems that the Ministry of Finance has since consolidated its leadership over the CIC and as a result, the state has become more unified. CIC's early investments provide evidence of free-wheeling deal-makers exercising considerable freedom of action. The Morgan Stanley investment reflected an instance in which the commercial actors took initiative and acted on their own interests. Likewise, the Blackstone purchase is also often cited as a case where state control was absent. "The way it [CIC] made its investments was also highly dubious. It made its first investment in Blackstone in June 2007, three months before CIC was formally established, making one wonder how much due diligence it conducted before throwing away $3US billion."[70] In both instances, the government was divided among competing visions for the CIC (or its predecessor institutions).

There have been numerous reports of a bureaucratic struggle between the Ministry of Finance, the PBOC, and the NDRC for control over the CIC. These battles seem to have been particularly pitched during discussions regarding CIC's design and creation.[71] While the PBoC under Zhou Xiaochuan (周小川) had generally pushed for greater central bank independence and a liberal economic orientation (both of which would enhance its bureaucratic stature), the NDRC has sought to preserve its own power within the government bureaucracy by resisting moves to limit the state-directed allocation capital and the NDRC's ability to "guide" the economy. Part of the critique over generating a higher return on China's foreign exchange reserves that lead to the creation of the CIC was an effort on the part of the Ministry of Finance to wrest the management of the banking sector away from the PBoC.[72] Before the banking recapitalizations of the early 2000s, the MOF enjoyed unchallenged control of China's banking sector. As the PBoC began to tap foreign exchange funds to recapitalize the banks and prepare them for eventual public listings, the PBoC increasingly gained control over more and more of China's financial sector. MOF resented this erosion of its influence and sought to gain control over China's banks. Today, it seems that this strategy has largely worked and the MOF now controls, either directly or indirectly (largely via CIC), almost all of the state's banking assets. Now that the CIC has been functioning for over a year, most sources seem to indicate that the MOF is in

[70] Wang Xiangwei, "Fed's 'Printing Presses' Give Wen a Headache."
[71] Author Interview 080620, Beijing; Author Interview 080623, Beijing.
[72] See Victor Shih's unpublished manuscript entitled, "Tools of Survival: Sovereign Wealth Funds in Singapore and China," for more on how the leadership of the Ministry of Finance tends to be loyal to Wen Jiabao, while the leadership of the PBoC tends to be associated with Jiang Zemin and Zhu Rongji.

the driver's seat at CIC, with a clear chain of control lead by the State Council.[73] The unification of the state has thus enabled the leadership to exercise more effective control over the CIC.[74]

The goals of CIC seem largely to reflect the goals of the factional forces within the state leadership. In this sense, there seems to be relative compatibility on the *Goals IV*. However, since the state itself was divided over its vision for the CIC, we observe that the commercial actor had some space to emphasize and define its own interpretation of what its goals ought to be. Initially, the divisions at the top made state control more difficult. As the CIC was institutionally consolidated, it seems that the more commercially-oriented mission has taken on a more dominant role. This consolidation has anchored the CIC to more explicit, commercially-oriented goals. Although this consolidation would seem to facilitate greater state control in the future, the commercial nature of these goals limits the instrumental usefulness of the CIC as an agent to support the strategic foreign policy preferences of the state. The CIC was established to help diversify China's foreign exchange reserves. This goal does not conflict with the CIC's desire to earn a respectable rate of return on its portfolio. Although the CIC's goals of establishing itself as a viable bureaucratic player entail less than national level priorities, these more narrow bureaucratic interests do not generally pose a problem for China's goals. The area with the greatest amount of goal friction revolved around the CIC using its resources to provide additional support for national Chinese strategic interests. Although this goal seems to have been discussed early on in CIC's bureaucratic life, it was resisted by the CIC leadership (and is no longer a part of CIC's mandate). As discussed above, such "national" goals were largely the

[73] As a point of fact, the State Council is the ultimate principal to which the CIC reports—at times this principal is divided by factional frictions or bureaucratic/institutional preferences. However, for the time being it seems that Wen Jiabao and the Ministry of Finance have consolidated their leadership positions over CIC thus creating a unified State. Author Interview 090909, Washington, D.C.

[74] The theory suggests that this sort of a unified state will facilitate the state's ability to control the CIC in the future.

product of a divided leadership which now seems to be consolidating around commercial goals that are more in line with the CIC's own institutional interests.

From a *Relative Resources IV* perspective, the CIC's financial expertise has provided it with a considerable advantage. The state is often dependent on the CIC to source investment opportunities, conduct due diligence, negotiate investment terms, and execute capital placements. In all of these matters, the CIC is working with a relative information asymmetry that undermines state control. In addition, because there was a lack of relative financial expertise at the highest levels of government (most of that expertise was resident in the commercial actor), the state was forced to rely on and trust the commercial actors that possessed the relevant expertise.[75]

The case of CIC is probably best categorized as an "Oligopolistic" market structure since the only real alternative to CIC for investing China's foreign exchange reserves is SAFE.[76] As mentioned in the SAFE case study, the CIC was created partly with a view toward generating an alternative commercial actor for managing some of China's foreign exchange reserves.[77] In this sense, SAFE and CIC are two semi-competitive investment arms of the state and thus, the *Market Fragmentation IV* has a slightly competitive value. The bureaucratic rivalry that simmered between the PBoC and the MOF seems to have spilled over and is being continued

[75] In addition, the CIC has been getting augmented by foreign subject matter experts that international private sector partners have provided on-loan to help staff up the CIC. These resources further skew the *Relative Resources IV* in the CIC's favor.

[76] When there are a limited number of commercial actors available to the state, we might expect that these two dominant commercial actors might collude to resist the will of the state (in which case the *Market Fragmentation IV* would be coded as "Concentrated") however, the competitive dynamic and bureaucratic rivalry that exists between SAFE and CIC precludes any collaboration, prompting a coding of "Oligopolistc." Thus, any freedom of action that might be gained as a result of the concentrated market structure is overwhelmed by the existence of an alternative commercial actor (in SAFE) that is fully capable (and more than willing) to invest China's foreign exchange reserves.

[77] Author's Interview 080620, Beijing; See also Victor Shih's unpublished manuscript entitled, "Tools of Survival: Sovereign Wealth Funds in Singapore and China,"

between SAFE and CIC.[78] Such bureaucratic competition facilitates effective state control. This competitive element is significant because it provides the state with an alternative commercial actor to execute its wishes. The result is greater state control since the existence of an alternative commercial actor waiting in the wings that may be more willing to do the wishes of the state lends a certain amount of discipline to the state-CIC relationship (just as it does to the state-SAFE relationship).

In terms of the *Reporting Relationship IV*, the CIC, like all of the commercial actors examined in this chapter, is a wholly owned, managed and operated government entity.[79] The CIC's organizational structure is loosely modeled on the NSSF. It, too, is governed by board of directors which is responsible to the State Council. In turn, the State Council can nominate the Chairman of the CIC. All of these factors favor state control over CIC. The institutional architecture seems to suggest that yes, most likely the CIC will be subject to continued state control. This is especially true for large, high profile investments. At the same time, the entity also seems to want to fight for its autonomy by stressing the commercial orientation of its activities (and thus, the need for the state to rely on CIC's professional judgment regarding its activities). Moreover, the subject matter expertise required to be "good" at finance seems to provide the CIC considerable weight in bureaucratic fights.

The coding of the theory's independent variables for the CIC case is summarized in the following table:

[78] Brad Setser, "The Implications of Sovereign Wealth Fund Investments for National Security," Testimony before the US-China Economic and Security Review Commission February 7, 2007 p.7. See also Victor Shih's unpublished manuscript entitled, "Tools of Survival: Sovereign Wealth Funds in Singapore and China." and Michael McCormack, "Chinese Sovereign Wealth Funds: 2008-2010 Opportunities for Foreign Asset Managers" (Shanghai: Z-Ben Advisors 2008).

[79] For example, the CIC has been funded with its initial tranche of registered capital using the proceeds from special bonds that were effectively sold to the PBoC. This means CIC interest payments are directly payable to the state; another indication of the close reporting relationship.

Table 8.1: CIC Case Summary Table

	IV Coding	Evidence	DV Outcome
Goals	Compatible	Goals are defined by state; some early divergence over CIC independence and commercial incentive vs. supporting foreign policy goals/firm outward expansion—has largely been resolved in favor of commercialization; Both Agent and Principal goals can be achieved.	State control likely; Evidenced by State Council review and approval procedures; though growing less likely as CIC commercializes.
Market Structure	Oligopolistic	Mainly bureaucratically competitive with SAFE & to a lesser degree SS Fund, but as state entity, CIC faces limited real competition.	State control likely.
Unity of State	Initially Divided Bureaucratically & Factionally; MOF now seems to be dominant and Principal is unified under Wen Jiabao and the State Council	Competing bureaucratic interests: MOF vs. PBoC; Competing Personal Factions: Wen Jiabao's protégé's vs. Zhu Rongji's; No evidence of municipal/provincial centers of authority as CIC is a central government organization.	State control unlikely during periods of divided state as seen by early CIC behavior and investments; After state consolidates, control was institutionalized as evidenced by risk management and review procedures.
Reporting Relationship	Direct for large activities; Indirect for day-to-day	Government Ownership: Direct and complete State Management: Indirect via CIC senior management with only limited (also governmental) "independent" oversight; as CIC commercializes, expect reporting relationship to become more indirect.	State control likely as a result of effective and clear reporting structure that enables oversight/political interference in high-profile cases.
Relative Resources	Asymmetric in favor of CIC	Financial/investing Expertise: state almost completely reliant on talent at CIC. Budget Endowment and Personnel Count: Empirics are unclear, although CIC's permanent staff and HQ suggest advantage over State Council's overly-taxed management resources.	Suggests state control unlikely as evidenced by early investments in Morgan Stanley and Blackstone when resources were almost entirely concentrated at the CIC (and its pre-cursor, Central Huijin).

Are there legitimate security fears surrounding the CIC's activities? The answer seems to turn on whether the CIC operates on a commercial basis. To the extent the CIC can increase the distance between itself and the state it will be less easily controlled or used to support the political, foreign policy, or non-commercial objectives of Beijing. Currently, the CIC goes to great pains to ensure that it is driven purely by commercial interests. I do not doubt that the current senior management team would like that vision to become reality, as that orientation would likely maximize CIC's own narrow preferences. However, the reality is that the CIC controls a large pile of money that has been earmarked to be invested—i.e. allocated by the state. The natural result is that there will be competing claims about how that allocation happens.

Several structural elements make politicization not an unlikely outcome in the future. First is the mixed institutional structure of the management team—while it seems to be increasingly MOF-dominated there are other voices inside and outside the room. Second, the CIC must still vet its largest investments with the State Council which then has the ability to exercise control over the CIC's behavior. There is also some danger that the CIC will be pressured into supporting China's larger national interests. Although the increasing professionalization is trending toward greater commercialization and away from having the CIC act as a policy arm of the central government, China's history of such policy mechanisms and the statutory design of the CIC both leave open the possibility of the state exercising greater control over the CIC.

This question may very well be resolved by two key dynamics. The first is the degree to which the CIC is able to lock-in a purely commercial orientation. To accomplish this, continuing the recent efforts to improve transparency is critical. A lack of transparency hurts efforts to place CIC on a purely commercial footing because secrecy allows for more effective politicization and organizational hijacking. The adoption of the Santiago Protocols on Sovereign Wealth Funds and the August, 2009 publication of the CIC's first annual report are two important steps in improving the CIC's transparency. Non-transparent operations strengthen the hand of hard-line NDRC officials who would prefer to hold onto to the reigns of the economy in order to direct plan-based allocations of capital. In order for the CIC to solidify its own bureaucratic autonomy, it ought to move toward locking in transparency and commercially-oriented independence from non-commercially motivated, political interests. If the State Council seeks to provide international reassurance to the host nation recipients of China's outward direct investment, it ought to provide CIC with an insulated, commercial space in which to pursue profitable returns for the state.

The second key dynamic to watch is the factional struggle for power: in particular, the tugging between domestic political factions that favor a plan-oriented, government-directed approach to China's economic development and the more liberalizing, reform-oriented elements of China's leadership. If reform-oriented, commercially-driven interests remain at the helm, it is likely that the CIC will to continue to liberalize and effectively increase the state-commercial actor distance (i.e. limit the ability of the state to control the agent for its non-commercial, national interests). If statist interests are ascendant, the institutional structure and China's history of state-directed central planning and capital allocation are very conducive to permitting the CIC to be used to serve the foreign policy interests of the state. With roughly $90 billion in capital to be invested abroad, the dollar figures at stake are large (though not as large as some fear) and have the potential to generate significant impact. As this capital base grows, the stakes will go up. Having this capital directed in a non-commercial manner could raise significant strategic concerns for other countries. Unfortunately, there seem to be indications that reform-minded, liberalizing elements within China's central leadership have been forced to retrench in light of the recent economic crisis and the subsequent discrediting of a more liberalized economic development model. If the CIC veers from its current commercializing path, the likelihood of the CIC being used to pursue strategic national interests will increase substantially.

8.9 CIC Case Study: Conclusion

This chapter set out to determine whether the CIC posed a strategic security threat as an instrument of Chinese economic statecraft. Answering this question required two paths of inquiry. First, what are the security externalities that might result as a consequence of CIC's activities? Second, to what degree is the government able to control the behavior of CIC in order to strategically generate such security externalities?

While this chapter's analysis does suggest that CIC is capable of producing security externalities, CIC's current development path seems to indicate a relatively commercially-motivated orientation that should limit the strategic consequences of its activities. *Interest Transformation* and *Strategic Transfer* seem to be the most likely security externalities that may result. Some *Coercive Leverage* type of security externalities may also be possible although on a more limited scale. A close inspection of the CIC's resource allocation shows that only a portion of its total capitalization is dedicated to foreign investment, with the rest being used primarily to reorganize the domestic Chinese banking system. This fundamentally limits the size of the CIC's internationally deployed capital thus also limiting its strategic impact. Perhaps more importantly, evidence suggests that the CIC's current development path puts it on a commercial footing that limits the degree to which the state can control its behavior (and thus deliberately generate security consequences) as part of an economic statecraft strategy. Improvements in transparency, an incentive structure that supports a commitment to commercial operations, and increasing reliance on third-party mandates for foreign capital allocation all seem to suggest that the CIC will not prove to be a very effective tool for achieving China's foreign policy interests.

Several characteristics of the CIC case study suggest state control may be difficult. First, the CIC was at the epicenter of a bureaucratic struggle for control and influence over China's finances. As a result of this divided state during the CIC's early operations, state control was weakened and the CIC enjoyed a good deal of relatively independent agency in conducting its affairs. Once more centralized control was consolidated, the ability of the state to direct the behavior of the CIC was strengthened. Second, the CIC leadership has a strong incentive to carve out a bureaucratic living space for its existence as a new financial institution charged with investing China's assets (particularly in light of SAFE—which already had the mission of managing China's foreign exchange reserves). This has led to a preference for professionalism, autonomy, and a strong commercial orientation; all of which undermined tight state control. Third, the CIC is led by a considerable coterie of senior CCP financial talent. The senior administration of the CIC included some of the brightest financial stars of the Communist Party leadership. This has helped skew the *Relative Resources IV* in favor of the CIC—affording it additional room to avoid tight state control.

Of course, not all factors point toward weak state control. The strongest influence in favor of close state control is along the *Reporting Relationship IV*. By reporting directly to the State Council, the door remains open to direct political state control over the CIC. If ideas favoring increased roles for the state in the management of China's economic activity gain popularity among China's leadership, the CIC will likely come under increasing pressure to act in support of national objectives—even if those have little commercial merit. Under these conditions, the formal reporting structure and processes of the CIC's institutional architecture make it difficult for CIC to avoid political interference. Second, today's CIC leadership seems to be effectively consolidated under the influence of the Ministry of Finance. This consolidation seems to suggest another avenue of closer state control as the state becomes more unified. Third, SAFE's direct investment of a small portion of its considerably larger foreign exchange reserves provides the government with an alternative commercial actor that is capable of performing CIC's work, should CIC prove unwilling to abide by the government's preferences. This competitive dynamic along the *Market Fragmentation IV* also suggests that CIC can be more easily brought to heel to do the state's bidding.

Despite these factors that leave open the possibility for further state control, current trends seem to suggest that the CIC will strive to operate along largely commercial grounds. Although it is still much too early to draw definitive conclusions, this examination of CIC seems to suggest that it is on a path of professionalization and commercialization. By increasing the distance between the state and the commercial actor, it becomes increasingly unlikely that the CIC will be able to be used as an effective tool to realize Chinese foreign policy objectives. On balance, the CIC is unlikely to constitute a threat assuming that it continues to evolve in the direction of its current commercial orientation.

Despite a good deal of initial trepidation over the Chinese government's ability to use the China Investment Corporation (CIC) for strategic purposes, the evidence suggests that using the CIC as an effective instrument of economic statecraft may be more difficult than some fear. This chapter's exploration of the empirics provides evidence for optimism regarding the CIC's future direction and the strategic ramifications of its investment activities. At the same time, there seem to be a number of aspects of the CIC case that suggest caution may yet be warranted. The framework presented in Chapter Two provides a useful analytical approach to monitor and assess developments in the evolutionary path of the CIC and other commercial actors that may be used as tools of economic statecraft.

Chapter Nine

Conclusion

9.1 Summary of the Dissertation

This study set out to develop a general, middle-range theory of economic statecraft that gave appropriate agency to the commercial actors actually responsible for conducting international economic interaction. This theoretical construct begins with an understanding of economic statecraft that has its roots in the concept of security externalities. These externalities are the security consequences that result from the commercial activity of firms or other entities that conduct international economic transactions. When states seek to deliberately generate such strategic effects by manipulating the activities of commercial actors, they are engaging in economic statecraft. Such manipulation rests on the state being able to direct and control the commercial actors. Chapter Two set out a theoretical framework of five factors that account for when the state will be able to control commercial actors (and thus the conditions under which economic statecraft will be likely to succeed).[1] Together, this theory answers both elements of *how* economic statecraft actually works in practice: the typology lays out the manner in which economic statecraft works and the five independent variables specify the conditions under which economic statecraft occurs.

Given the centrality of state-business relations in this account of economic statecraft and given its growing stature in world affairs, China is an especially attractive test case. Because of China's mixed economy and current economic transitional state, Chinese economic statecraft

[1] Of course, as discussed in Chapter Two, success in economic statecraft also requires three other conditions in addition to state control. First, the size of the economic interaction must be large enough to matter. Second, the nature of the economic interaction must be inelastic enough to matter. Third, the goals that the state seeks to achieve with the economic statecraft cannot be out of proportion to the economic means being employed.

provides useful variation across a number of cases to illustrate the dynamics of the theory. Specifically, I have selected three important areas of China's grand strategy that feature economic statecraft prominently. Exploring the intricacies of the episodes across these three areas has provided useful material for demonstrating, probing and refining the theory.

In the first area, China's strategy focused on efforts to leverage *Interest Transformation* security externalities in the context of the cross-Strait relationship with Taiwan. Chapter Three examined a case of successful Chinese economic statecraft that was designed to transform Taiwan's desire to seek greater independence.[2] The Mainland authorities worked with Taiwan's opposition parties to provide economic concessions to the support base of Chen Shui-bian as part of an effort to undermine regional support for the DPP. Chapter Four compared this success with Beijing's frustrated attempts to use economic statecraft in an earlier period of the cross-Strait relationship. Specifically, that chapter examined Beijing's efforts to use *Coercive Leverage* against prominent Taiwanese corporations with Mainland operations in order to influence the outcome of Taiwan's presidential elections.[3]

Chapters Five and Six examined Chinese efforts to secure access to strategic raw materials. Specifically, Chapter Five looked at China's search for oil and the strategic difficulties engendered when Chinese oil companies embarked on their "Going Out" strategy. China's difficulty controlling its commercial actors in this setting was juxtaposed with the state's ability to successfully direct commercial actions as part of China's efforts to prevent the concentration of iron ore supply—another strategic resource. Chapter Six focused on a case study of China's largest overseas investment and its strategic ramifications. The area of strategic

[2] Although such redefinition of national interests usually would be expected to take quite a bit of time, Chapter Three examined one episode in which such economic statecraft generated strategic results in a relatively short amount of time.
[3] This chapter also briefly illustrated the *Bolstering* security externality logic that motivated early Chinese cross-Strait engagement.

raw materials is one that often entails *Strategic Transfer* types of security externalities. Oil and iron are both critical raw materials fueling China's basic economy and war-fighting ability. By examining cases of China's efforts to work through commercial actors to secure access to these strategic resources, Chapters Five and Six highlighted the business-government dynamics accounting for when the state was able to be effective and when commercial actors' activity was counter-productive for national strategic interests.

Chapter Seven also sought to illustrate cases in yet a third empirical context: sovereign wealth funds. As China continues to liberalize and reform its economy, traditional avenues of direct state control seem likely to weaken. However, these massive, state-controlled finance entities seem to provide a continuing lever for exerting state influence over the conduct of strategic commercial activities. Chapter Seven juxtaposed two of these government financial entities to understand the institutional dynamics enabling SAFE to be used as an effective instrument of economic statecraft while NSSF seems to pose little potential for strategic influence. Finally, Chapter Eight applied the theory to evaluate a case of contemporary strategic concern: the CIC. Having explored and demonstrated specific elements of the theory in Chapters Three through Seven, Chapter Eight applied the full theoretical framework to evaluate CIC's potential as an instrument of Chinese economic statecraft. The evidence suggests that the CIC will function on a largely commercial basis (albeit "with Chinese characteristics").

9.2 Main Findings

Chapter One's review of the literature highlighted the absence of a theory of economic statecraft that adequately accommodates the role of commercial actors in international relations. This dissertation has sought to lay the groundwork for developing and demonstrating a general, middle-range theory of economic statecraft. This section summarizes the study's main findings and highlights the significance of those contributions.

First and foremost, this dissertation has contributed to improving our understanding of how economic statecraft works in practice. The nature of the relationship between economics and security can be usefully conceptualized using a security externalities framework. Security externalities are defined as those security effects that are not fully internalized among the parties directly conducting any given economic interaction. This approach frames the relationship between economics and security as one in which the international economic activities of commercial actors generate security consequences for nation states. The study used a typology that specifies the range and types of these security externalities. Each type of security externality has its own causal logic that informs a particular national strategy designed to generate a specific security externality. This framework also produced a precise definition of economic statecraft itself: namely, the deliberate state manipulation of economic interaction to capitalize on or to reduce the associated security externalities that are generated by commercial actors. These insights led to a closer examination of the business-government dynamics that lay at the heart of economic statecraft. Such dynamics play a central role in determining economic statecraft's success.

The existing literature highlights some combination of three factors that account for successful economic statecraft. First, the state employing economic statecraft cannot be seeking a goal that is out of proportion to the economic means available to achieve that goal (*Purpose Commensurability*). This is the first pre-requisite for successful economic statecraft. To understand a state's potential leverage, one ought to consider the magnitude of the economic interaction relative the target state's total economy (*Size*) as well as the ability of the target to substitute alternatives and the importance of the economic interaction (*Inelasticity*). Lastly, this study demonstrates that one must also consider whether the sending state can direct its economic interaction so as to take advantage of its potential economic power. Control over commercial actors is the factor that enables the state to direct its economic power.

The study's empirical work examined a set of cases in which China sought to achieve national objectives using economic tools. Since this study sought to improve our understanding of how economic power is actually employed by states, case selection was predicated on identifying cases of potential economic statecraft. This research design enabled the analysis to focus on how states go about using economic power. Although all the cases met the three pre-requisites for economic statecraft to be successful, not all of these cases exhibited successful economic statecraft. In some instances, the state controlled the commercial actors responsible for conducting the economic activity while in other cases, the state did not have as great a degree of control. When the state was able to control the commercial actors, economic statecraft was successful. When the state was not able to control the commercial actors, economic statecraft was not successful.[4] This result demonstrates that control over commercial actors is an important factor accounting for successful economic statecraft. On their own, the other three criteria were insufficient to explain the conditions under which economic statecraft is likely to be effective. States must also be able to control the commercial actors conducting that economic activity. Although control of the commercial actors that carry out international economic activity is not the only factor necessary for economic statecraft to succeed, it is an important aspect of the phenomenon that has not received appropriate treatment in the existing literature on economic statecraft. Understanding exactly how a state is able to incentivize commercial

[4] This outcome was an artifact of the research design which sought out cases in which the other three conditions for successful economic statecraft were already present. The research design was discussed in more detail in Chapter Two.

actor(s) to engage in particular types of behavior that generate security externalities is a critical element of understanding how states actually exercise their economic power in practice.

States must resolve a series of business-government coordination challenges if they are to be effective at mobilizing and directing their economic power. Drawing on the principal-agent theory literature in economics, Chapter Two deduced five factors that can be used to predict when states will be able to control commercial actors (and thus direct their activities to generate the desired security externalities—that is, to engage in economic statecraft). These determinants of whether a state will be able to mobilize and direct its economic power are: 1.) the intrinsic compatibility of goals between the state and the commercial actors that carry on the economic activity of the state, 2.) the commercial market structure, 3.) the unity of the state, 4.) the nature of the reporting relationship between the commercial firm(s) and the state, and 5.) the relative distribution of resources between the state and the commercial actor(s). Each of these factors has a posited relationship to the ability of the state to control or direct the behavior of commercial actors. The casework then illustrated and explored these factors across three different empirical contexts: the cross-Strait relationship, China's efforts to secure raw materials, and China's sovereign wealth funds.

Economic statecraft is not an easy tool for states to wield, but when they master it, economic statecraft can have powerful strategic effects. In the case of the opposition party visits and the lifting of the fruit tariffs, the Mainland was seeking to change the ruling party on Taiwan. Exercising such influence should be a fairly tall order, yet in this episode, the Mainland's economic statecraft seems to have been effective. The state was able to control the commercial actors mainly because the state was acting in a unified manner. In contrast, the Mainland's earlier efforts to diminish the DPP's electoral success met with less success. In this earlier period, divisions between the central and local government authorities undermined the

Mainland's ability to control the commercial actors. In the Taiwan example, China learned how to get more and more from its strategic use of economics as the cross-Strait relationship has evolved over time. That case suggests China's growing sophistication has yielded improved results from its economic statecraft. There also seems to be some support for the state becoming more effective at coordinating and directing commercial actors in the realm of China's "Going Out" strategy and the efforts to secure strategic resources. When the state devotes enough senior leadership attention to a high-profile issue, it seems that the state is able to be effective at controlling the commercial activity (and the resultant security externalities). In the case of China's oil companies operating in Africa, the conduct of powerful commercial actors undermined some of the state's larger priorities. However, in the Rio Tinto episode (another case of economic activity designed to secure strategic raw materials), the commercial actors' behavior furthered national priorities and facilitated strategic objectives. Again, the ability of the state to control the commercial actors featured prominently. Finally, the study found that the degree of commercialization (including: transparency, governance, professionalization, third-party asset managers, etc.) is a key factor in determining how easily China's sovereign wealth vehicles can be used to pursue the state's foreign policy goals. For example, in the Costa Rica episode, SAFE acted as willing arm of the state to achieve China's foreign policy objectives while the NSSF provided an example of state capital being used for explicitly commercial purposes with great pains taken to insulate the allocation of state resources from political or strategic machinations. The following table provides a simplified overview of the cases.

Table 9.1: Casework Summary Table

	Cross-Straits Relations			Securing Strategic Resources		Sovereign Wealth Funds		
	Fruit Tariffs/ Opposition Visits (Fall 2004-Present)	**Mainland's Coercive Leverage (1996-Fall 2004)**	**Attracting Taiwanese Capital (1979-1996)**	**China's Oil Majors in Africa**	**Chinalco, CDB and Rio Tinto**	**SAFE**	**NSSF**	**CIC**
Description of Case	Mainland attempting to strengthen Taiwan's opposition parties to undermine ruling DPP	Mainland attempting to lean on Taiwanese investors to influence outcome of Taiwan's elections	Mainland attempting to attract investment, foster trade links	China relies on commercial actors to secure access to oil; national oil companies (NOCs) expand abroad	China attempts to use commercial actors to prevent upstream supplier concentration in iron ore	China seeks to encourage Costa Rica to switch diplomatic recognition from Taiwan to Mainland	China seeks to establish commercially-oriented pension reserve fund	Applying theory to examine the degree to which CIC may be used as an instrument of Chinese economic statecraft
Finding	Economic statecraft successful; Erosion of support for independence-oriented DPP	Economic statecraft unsuccessful; Heavy-handed attempts to pressure Taiwanese businesses strengthen anti-Mainland sentiment.	Economic statecraft successful; Taiwanese investment provides important capital and managerial expertise	Economic statecraft mixed; NOCs obtain oil, but undermine other strategic priorities	Economic statecraft successful; State coordinates Chinese commercial actors to block BHP acquisition of Rio Tinto	Economic statecraft successful; SAFE used as transacting agent to buy Costa Rican bonds at below market rates; Costa Rica switches diplomatic recognition	Economic statecraft not attempted; NSSF institutional design and activities suggest strong commercial orientation	Economic statecraft possible but currently unlikely; initial uncertainty over CIC's orientation, but leadership now seems consolidated around commercial orientation
Explanation	State Control because unified state enables coordinated policy that appeals to farmers' economic self-interests	Center-local divisions within the state undermine efforts to control Mainland-invested Taiwanese businesses	State Control because unified state, compatible goals, competitive market motivates Taiwanese firms	Weak State Control due to relative resources favoring NOCs, bureaucratic divisions within state	State Control because compatibility of goals, reporting relationships, unity of state, competitive space	State Control because direct reporting relationship, competition from CIC, unity of state	Limited State Control due to divided representation in governance structure, relative resources favor NSSF	Weak State Control early due to bureaucratically divided state and relative resources; current State Control due to reporting relationship and unified state (MoF)

The ability of the state to control the economic behavior of the commercial actors was a critical factor enabling economic statecraft in each case that was examined. The study found evidence of China's strategic use of economics to achieve national objectives across all three empirical contexts. At the same time, these three empirical contexts also provided cases in which the activities of commercial actors did *not* support China's national security objectives. Examining both types of cases provided insight into how economic statecraft works. These types of paired comparisons held background conditions constant while allowing the key variables of interest to fluctuate. In each case, control over commercial actors was observed to be the determining factor of successful economic statecraft.

In short, the theory is an account of how aggregate economic actors' micro-level incentives and consequent behavior generate national security outcomes at the level of state grand strategy. This middle-range theory provides an integrated explanation of what economic statecraft is, the manner in which economics effects security, the conditions under which economic statecraft is likely to be effective, and a theoretical framework of specific challenges a state must resolve if it is to successfully wield its economic power in pursuit of national strategic objectives. The theory fills a significant gap in the literature by linking microeconomic, firm-level behavior with the macro-level grand strategy of states to explain how states use firms to pursue their strategic goals. Taken together, these elements provide an important bridge between vague, general notions of "economic power" and the actual behavior of firms in a modern, global context. The resulting theory illuminates the micro-foundations of economic statecraft as it is practiced in grand strategy.

The contributions of this study are significant in three respects. First, from the empirical perspective, China is a major rising power in the international system. Understanding how China behaves on the international stage is important. In particular, China uses economic power to achieve its foreign policy objectives. Understanding exactly how China exercises economic power helps to inform our understanding of the capabilities and limitations of economic statecraft. In addition, the state's relationship to market forces and business actors is another important empirical feature of contemporary international relations. The dynamic nature and rapid development of these relations has outpaced our field's ability to understand their strategic implications. Although certainly the case in the context of China, emerging complexities in state-business relations and the strategic significance of these interactions are by no means limited to the Chinese case.

In addition to improving our understanding of China's economic statecraft, this dissertation also contributed to improving the understanding of economic statecraft as a general theoretical phenomenon in international relations by calling attention to the importance of commercial actors—particularly business-government dynamics. In this study's treatment of China's economic statecraft, we observe the importance of commercial actors and the factors that enable the state to direct the behavior of those actors in order to generate security consequences. Understanding the importance of commercial actors enables analysts of economic statecraft to focus on the critical business-government nexus that plays such an important role in how states actually use their economic power in the contemporary international system.

This project has its origins in the multitude of work on economic statecraft that has been done in international relations. This dissertation revisited a classic question in international relations (Why does economic statecraft work?) but in a much more nuanced way than the extant literature has asked it.[7] This study's approach sought to address larger issues of state-market relations and how the state influences business actors and the international economic interaction they conduct. It is a work about how states exercise economic power in the international system.

[7] I am indebted to Ken Oye for this observation.

This study provides a synthesis between realist assumptions about great power interests and economic modalities of international interaction that have generally been the purview of liberal theories of international relations. In this respect, this work is an intellectual descendant of Kirshner, Baldwin, Nye and Keohane, Knorr, and Gilpin, as well as Hirschman and Staley before that. Upon these foundations, this dissertation has sought to build a theory of economic statecraft that advances our field's treatment of the topic, specifically by deepening our understanding of how states exercise their economic power in practice. Works on grand strategy have recognized that states have a range of tools they can use to achieve their strategic objectives. One of these is tools is economic power. All states possess this set of tools, but different states seem to use this tool to varying degrees. Indeed, even within the context of the same state, the economic instrument of national power seems to be used to varying degrees and with varying results. Explaining what accounts for such variation helps improve our field's understanding of why and how economic statecraft works.

Finally, in addition to the theoretical and empirical significance, this study provides a useful contribution from a policy perspective as well. The next section examines the policy implications of this research.

9.3 Policy Implications

This project grew out of real-world questions about how states actually exercise their international economic power under contemporary conditions of globalization. Not surprisingly, the work has policy implications at several levels. First, the theory suggests a set of policy implications for the conduct of economic statecraft as a tool of national power. Second, there is a set of policy implications concerning China's reform and liberalization, its rise and its use of economic power. Finally, there are a number of more narrow case-specific policy implications that are somewhat idiosyncratic to the particular empirical contexts examined in this dissertation.

The study carries important policy implications for the conduct of economic statecraft as a tool of national power. This study has focused on developing a better understanding of exactly how states exercise their economic power in the international system. By examining specific instances of economic statecraft, this study shed light on the manner in which economics can be used to achieve strategic objectives. The theory provides policymakers with a framework for both assessing when and how economics may entail strategic consequences. The typology of security externalities lends clarity and precision to what are often poorly specified public policy discussions about economics and security. It also provides indications of how to assess threats and how to evaluate instances of potential economic statecraft more sharply. This dissertation also investigated the conditions under which such exercises of economic power are likely to succeed. Of course, understanding the factors that drive success in economic statecraft enables policy makers to craft more effective strategies of economic statecraft. This, in turn, will also enable economic power to be used to greater effect in the international system. In some cases, states may find it attractive to rely on effective tools of economic power rather than blunt instruments of military power to achieve their strategic objectives.

The second major area of policy implications concern China specifically. For the past thirty years, China has been engaged in a massive reform and liberalization effort that has fundamentally re-oriented its economy (and society). This effort has generated considerable economic growth and unlocked Chinese potential that had lain dormant for more than one hundred fifty years. This economic growth has also enabled a significant expansion for China's potential to use its economic power to pursue its strategic goals. This study explored the conditions under which China's rising economic clout will be able to be used to pursue China's strategic foreign policy objectives. This analysis carries important implications for the effectiveness of such economic statecraft. Continuing economic liberalization should result in China's commercial actors being motivated more by profit rather than governmental directive.[8] If these liberalization efforts stall and China becomes locked in some partial model of state capitalism, it may possess enough "economic gunpowder" to be dangerous while also enabling the state to retain the capabilities to direct that economic power.[9] Although, as this study has shown, exercising that economic power effectively is not always easy.

Finally, the study's findings suggest policy implications related to the specific empirical contexts that were examined. China's engagement with Taiwan will likely be broadened and deepened to more effectively create vested interests in Taiwan favoring amicable cross-Strait relations.[10] Strategies based on *Interest Transformation* have proven to be much more effective for China than those based on *Coercive Leverage.* These efforts offer the most efficient path toward eventual reunification. Given Taiwan's geographic realities, Taiwan's best policy may very well be to cooperate with Beijing at developing closer economic ties. However, Taiwan must be keenly aware of the gradual *Interest Transformation* security externalities that such

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[8] Such commercialization will strengthen China in the long run, but as has been demonstrated by the massive changes brought on by China's reforms of the last thirty years, continuing commercialization will also likely alter China's own definition of its national interests. Such liberalization will hopefully (likely?) produce a China that integrates into the international world system peacefully.

[9] In an international system dominated by the U.S. that largely plays by liberal, free market rules, such a rising power can be a significant source of concern. For this reason, US-China policy must continue to impress upon China the importance of continuing its reform and liberalization efforts. Such efforts serve both American and Chinese long-term interests.

[10] Such dynamics have the strong potential to be self-reinforcing and expansionary. Commercial actors will not want to give up market access, in fact the tendency would be for commercial actors to seek to expand economic links. "Indeed, as their business stakes increase enormously over time, it becomes increasingly difficult for politicians and officials to reverse and undermine ongoing commercial ties." Steve Chan, "The Politics of Economic Exchange: Carrots and Sticks in Taiwan-China-U.S. Relations," Issues & Studies 42, no. 2 (2006): p. 13. The self-reinforcing nature of the *Interest Transformation* security externality is that commercial actors act *in their own narrow interests* to promote greater engagement and deeper ties. This trend will likely further undermine Taiwanese desires for *de jure* independence.

cooperation will be likely to produce. Proactive measures to institutionalize Taiwan's core values might help defend against erosions of the *de facto* sovereignty Taiwan enjoys today.

The examination of China's "Going Out" strategy also implies that the Chinese state *can* effectively coordinate its commercial actors' search for raw materials, but such coordination often requires high-level attention from senior leadership to overcome internal divisions within the Chinese state and information asymmetries between the state and the commercial actors conducting the economic activity. State control is thus unlikely to be consistent enough to adequately micro-manage China's supply of raw materials. Rather, state influence is likely to be concentrated on the largest deals. China has embarked on a path of liberalization and commercialization. This transition is an ongoing process and ought to continue. As the state cedes greater and greater decision-making to the commercial actors, the state will need to grow more comfortable with a market-based provision of goods and services to meet China's needs. This transition will likely be most difficult for those goods and services that China considers to be "strategic." However, failure to move toward more efficient market-based solutions will likely result in long-term inefficiencies in exactly those areas that are most strategically sensitive for China.

Finally, if China wishes to assuage foreign partners regarding its growing outward bound investment flows, the work on sovereign wealth funds implies that these flows ought to be as commercially-oriented as possible. Specific institutional measures that increase the distance between the Chinese government and the investment decision making seem to be the most effective way to achieve this type of reassurance. If China is intent on using its sovereign wealth funds to pursue strategic national objectives, this study suggests that a lack of transparency and public accountability as well as close political control over the allocation and use of state capital are important characteristics enabling economic statecraft.

In conclusion, three major implications stand out from this research. First, commercialization of the actors responsible for conducting economic activity is the key to avoiding state use of economic power. Such non-politicized orientation of commercial actors is the strategic equivalent of "spiking the guns" of economic statecraft. This is not to say that commercial activities will not generate security externalities, but merely that the state's ability to direct such security externalities is difficult if the state does not control the commercial actors. Second, economic statecraft is not an easy lever of national power for states to wield. To be effective, many factors need to align. However, mixed, state capitalist systems like China's are most likely to exhibit the necessary characteristics that enable the pursuit of national objectives through economic means. Finally, China is likely to continue to use economic power to pursue its strategic objectives going forward.

9.4 Looking Forward

The intersection of economics and security is a critical, continuously changing landscape. This study has sought to organize and theorize one aspect of that field, namely economic statecraft. China's use of its economic power is likely to continue to evolve and change. In the wake of the current financial crisis, classical liberal ideas of economics in which the state plays a minimal role in the economy have fallen out of favor. This sentiment is particularly pervasive in China where a rapid recovery has prompted some to view the financial crisis as hastening and affirming China's rise to great power status. China's resilience seems to have reaffirmed the advantages of its economic model. Debunking the attractiveness of liberalization has strengthened the case against further economic reform. If the reform effort stalls, and the government leadership decides to maintain a heavy hand in guiding the economy, this would carry significant implications for China's economic power. An active role for government would imply that the state would more easily be able to direct China's economic power. However, as mentioned at the outset of this study, extensive state direction of the economy leads to long-run inefficiencies that would eventually limit China's "economic gunpowder." This is a key trend to watch going forward. Will China move forward and continue to reform and liberalize or will it remain mired in its current hybrid model of state capitalism?

Rising states and the dynamics of great power transitions lay at the root of some of the world's greatest wars and have historically been a source of systemic danger. The national power of rising states fundamentally rests on economic foundations. In addition to fueling military capabilities, that economic power can, itself, be instrumentally directed to pursue national strategic objectives. Understanding how this happens has been the basic driver of this study. As this project draws to a close, it is clear that economic statecraft is likely to continue to occupy a prominent role in China's grand strategy going forward. The rising importance of China in world affairs is unlikely to fade anytime soon and the strategic significance of international economic relations continues to be an influential feature of international relations. Both topics provide ample opportunities for continuing exploration.

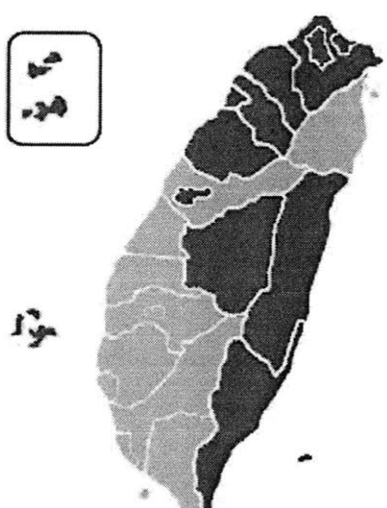
Appendices

Appendix A

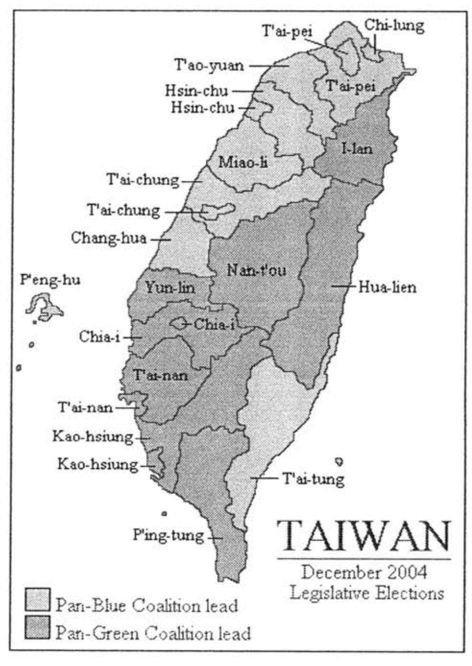
Taiwan's Electoral Geography

This appendix provides supplemental information concerning the DPP's electoral dominance of the Taiwan's southern areas during the period preceding China's *Interest Transformation* strategy. Counties that the Pan-Green (DPP) won are noted in green while counties the Pan-Blue (KMT & PFP) won are noted in blue. In the very tight March 2004 Presidential Election, and the December 2004 Legislative Yuan Election, the pattern is quite clear. The Pan-Blue alliance usually dominates in the northern and urban areas while the Pan-Green alliance usually dominates in the southern and rural areas.

March 2004 Presidential Election[1]



December 2004 Legislative Yuan Election[2]

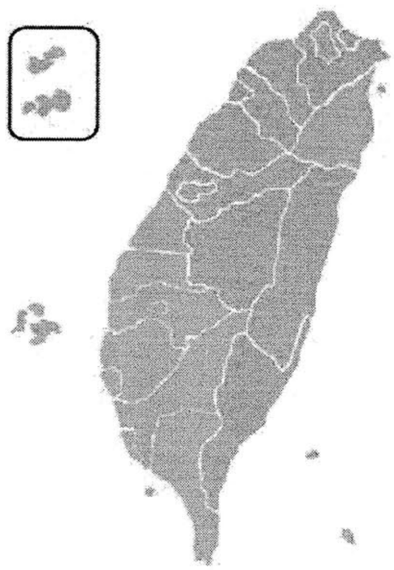


[1] This map (entitled: "2004 年台湾总统大选的选票分布") is taken from the Wikimedia Commons project. Available at: http://commons.wikimedia.org/wiki/File:Taiwan_election_2004.jpg

[2] This map (entitled: "Taiwan: December 2004 Legislative Elections") was developed by Dr. Adam Carr as part of the electoral maps section of his world-wide election archive available at: http://psephos.adam-carr.net/

This pattern of DPP regionalism also held true in the 2000 Presidential Election (although the Soong-Lien split made this election a bit anomalous). In the map below of the 2000 Presidential Election, counties that voted for Soong (PFP) are colored orange and Chen (DPP) are green.[3] Once again, DPP stronghold counties are predominantly in the southern portion of the island.

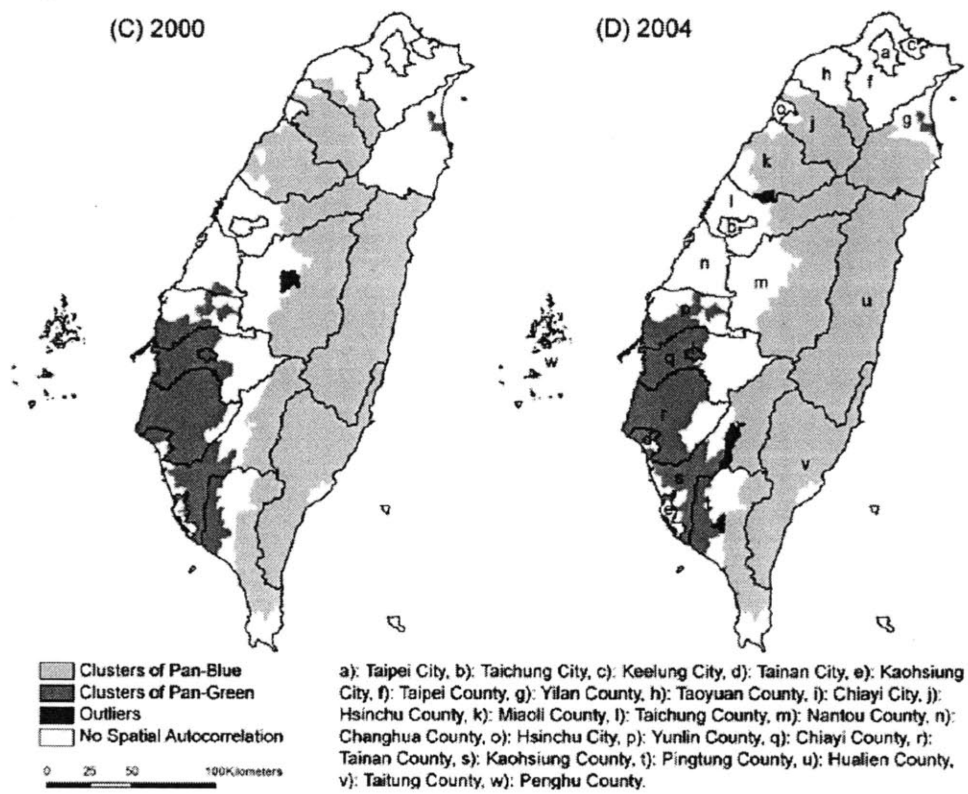
March 2000 Presidential Election[4]



[3] Lien captured roughly 23% of the popular vote but won no plurality in any of the counties, hence no blue on this map.
[4] This map (entitled: "Taiwan_2000_Election") is reproduced from Wikipedia. Available at: http://en.wikipedia.org/wiki/File:Taiwan_2000_election.png

Finally, Lay, Yap and Chen have written a related article that examines the spatial autocorrelation among township-level election results.[5] Their research confirms the general point made here: that pan-Green support has been concentrated in the southern portions of Taiwan. Their maps have the added benefit of detecting the "statistical significance of spatial association for these results."[6] As is evident in their maps reproduced below, the following counties in particular are considered pan-Green bastions: Tainan, Kaohsiung, Chiayi, and Pingtung.[7]

Lay *et al*'s electoral geography maps of the Presidential elections reproduced from their Figure 1 on p. 779:



SOURCE: By Ko-Hua Yap, based on data from the ROC CEC database, at <http://210.69.23.140/cec/cechead.asp>.

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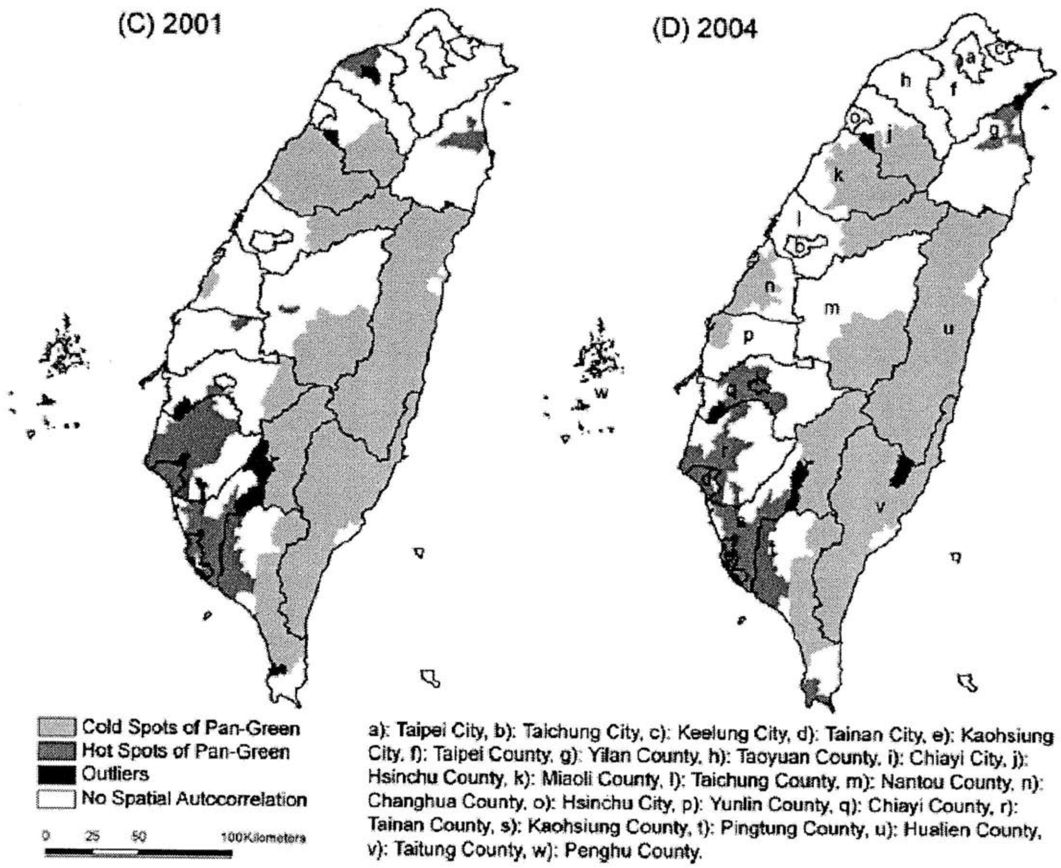
[5] J. Lay, K. Yap, and Y. Chen, "The Transition of Taiwan's Political Geography," Asian Survey 48, no. 5 (2008): 773.
[6] *Ibid.* p. 777.
[7] *Ibid.* p. 782.

Lay *et al*'s electoral geography maps of the Legislative elections reproduced from their Figure 2 on p. 784:



SOURCE: Ibid. with Figure 1.

Appendix B

Overview of China's Sovereign Wealth Funds

This appendix provides a brief introduction to each of the six entities discussed in the case work on China's sovereign wealth funds. This appendix is designed as a supplement to familiarize the reader with the general lay of the landscape of the entities that manage China's state capital offering some sense for how these six entities relate to one another and to China's outward bound investment flows.

National Social Security Fund (全国社会保障基金)

The National Social Security Fund was China's first real sovereign wealth fund. It was established in 2000 to help ensure adequate funds to cover China's social security needs by providing a backstop against investment losses of smaller municipal and provincial social security funds that had gotten into trouble by the late 1990s. The NSSF has a strongly commercial orientation to maximize investment returns. Of the entities covered in this chapter, the NSSF seems to be the least motivated by non-commercial goals.

The NSSF is run by a board of directors that reports to the State Council. The chairman, vice-chairman and the directors of the board are all appointed by the State Council. Technically, as a governmental agency at the ministerial level, the NSSF reports to the State Council, however, the Ministry of Finance (MOF) and the Ministry of Labor and Social Security (MoLSS) "supervise the investment operations and custody" of the NSSF. The NSSF had about US $113.7 billion in assets at the end of 2009. This has largely come from funds provided by the central government. The NSSF also gets funds from publicly listed SOEs, individual worker contributions, and its own investment returns. The NSSF makes significant use of third party asset managers to invest a substantial portion of its overseas funds.

The China Investment Corporation (中国投资有限责任公司)

The CIC was set up to diversify China's excess foreign exchange holdings which, by 2007 had become exceptionally large. The State Administration of Foreign Exchange (SAFE) had previously been exclusively responsible for managing these funds. These holdings were concentrated in dollar-denominated debt (mainly treasuries and US government agency debt). Given the rising value of the Chinese yuan and the relatively low interest being paid on government debt, these dollar-denominated assets were losing real value for China. As a result, $200 billion dollars of China's foreign exchange was allocated to capitalize the newly-formed CIC in 2007. The CIC was charged with using a considerable portion of this funding to complete the recapitalization of China's domestic banking sector, however, it seems to have about $80-90 billion that it is allocating to invest abroad. This figure will likely grow as CIC proves itself.

The CIC reports directly to the State Council and has institutional representation from a number of major interests in China's world of state finance including the Ministry of Finance (China's fiscal authority), the People's Bank of China (China's central bank), National Development and Reform Commission (China's central planning bureau), etc. Although its early development seems to suggest a good deal of factional and inter-bureaucratic jockeying, today it appears the Ministry of Finance is the dominant force and that the CIC is set to develop along commercially-oriented lines.

State Administration of Foreign Exchange (国家外汇管理局)

The State Administration of Foreign Exchange (SAFE) is charged with supervising and managing China's foreign exchange reserves. As part of its duties it oversees the investment of excess foreign exchange reserves. U.N. estimates place this figure around $300 billion.[1] It seems to have begun foreign exchange management functions as part of China's response to the 1997 East Asian Financial crisis. Since 1998, it has been reporting to the PBoC as a vice-ministerial agency.

SAFE is primarily responsible for three types of open market operations. First, it allocates foreign exchange for trade clearing. Banks must clear their foreign exchange through SAFE. Only SAFE is allowed to convert yuan into foreign currencies. Second, SAFE is responsible for maintaining China's sovereign liquidity. This means SAFE must decide when and how much and in what manner to invest China's roughly $ 2 trillion of foreign exchange reserves. Finally, SAFE buys and sells foreign currencies to maintain the RMB's designated exchange rate range.

SAFE tends to be very opaque and there is little publicly-available information about its activities. Despite this secrecy, there were indications that SAFE took fairly substantial positions in publicly-traded equities listed on the London Stock Exchange in 2008. In addition, there are some reports of private equity investments and direct investments in the energy industry.

[1] See: Section C of Chapter 1, "FDI by Sovereign Wealth Funds" in the UN World Investment Report 2008. Available at: http://www.unctad.org/en/docs/wir2008p1_en.pdf

China Export-Import Bank (中国进出口银行) & China Development Bank (国家开发银行)

China Export-Import Bank (Ex-Im) and China Development Bank (CDB) are two of China's three policy banks. "Policy banks" are distinct from "commercial banks" in that policy banks have a statutory mandate to support China's national policy objectives as opposed to being commercially-driven institutions. This makes them an interesting case for studying the use of economic interaction to achieve a state's foreign policy objectives. Policy banks grew out of the 1994 reorganization of China's banking sector. At that time, the ostensibly commercial activities of the major banks were separated out from the centrally-planned credit provisioning activities that had been mandated by the government economic planning apparatus. Today, policy banks continue to closely support government policy priorities.

Ex-Im reports directly to the State Council and is wholly owned, operated and managed by the Chinese government. The Ex-Im Bank enjoys a leadership position in shipping finance—providing the same sort of services that originally helped create the Dutch investment market in the early Seventeenth century. Ex-Im specializes in providing export and import credits, underwriting the finances associated with international shipping, facilitating inter-bank transfers and "pursuing state policies in industry, foreign trade and economy, finance and foreign affairs . . ." It also invests in infrastructure development and provides loans for firms engaging in international trading activities. In 2008, Ex-Im had approximately RMB 566 billion (about $80 billion) in assets.

CDB began in 1994 by providing the project finance for large, capital intensive domestic infrastructure projects like the Three Gorges Dam. The CDB was an early pioneer in bond financing in China. It continues to dominate that market. It has since spread out into funding international projects as well as taking direct investment stakes in multinational finance companies like Barclays. CDB is financed by selling bonds (rather than through deposits). As a policy bank, both CDB and Ex-Im have had to underwrite commercially questionable ventures in order to support government policy. While providing needed capital for government priorities, this has saddled both entities with significant legacies of bad debt.

As of the end of 2008, the CDB has been re-organized as a joint-stock corporation (instead of a policy bank). This has traditionally been an intermediate step to a full public listing of SOEs' shares on the stock market. If this transition continues, it suggests that CDB will be placed on a more commercial footing and an important statutory obligation to support Chinese state policy will have been removed. Despite this new organization, CDB has continued to feature prominently in providing financing for Chinese SOEs to expand their international operations and make acquisitions abroad as part of China's fiscal stimulus response to the current economic crisis.

China-Africa Development Fund (中非发展基金有限公司)

The China-Africa Development Fund (CADF) was stood up to provide financing to support China's economic activities in Africa. At the China-Africa Summit held in Beijing in November 2006, Hu Jintao announced the establishment of what was to become a $5 billion fund designed to support China's economic activities in Africa. At $1 billion in registered capital today, CADF is the smallest of the entities examined here. CADF has already invested about $400 million of its initial funding in more than 20 projects in Africa and it is expected to increase by $2 billion in 2010. CADF is owned, operated and financed by the CDB. CADF is essentially an investment pool of the CDB that has been ear-marked for supporting Chinese investments in Africa. Effectively, the CDB is able to direct the CADF to conduct its operations in conjunction with the CDB's (and by extension, China's) interests.

Most CADF investments involve a Chinese partner looking to expand into Africa. CADF provides financing, advisory services, and helps to facilitate China-Africa joint ventures in three main areas: infrastructure development, energy and mineral extraction, and agriculture. CADF is explicitly designed to promote China's foreign policy objectives in Africa using economic relations. Because its mandate is explicitly to foster economic ties that are designed to improve diplomatic relations between China and Africa, its goals, by definition, are synonymous with China's strategic preferences vis a vis Africa. Early indications seem to suggest that CADF has been staffed largely with CDB affiliates that have been detailed to the CADF.

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