The Coming China Nexus of the Global Markets and U.S. Security Community

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The Claremont Institute was commissioned by the Diana Davis Spencer Foundation to address an underdeveloped market debate with respect to global security risk concerns and the interplay of the markets with the U.S. security community more broadly. China was selected as a case study.

To accomplish this undertaking, we requested that our Senior Fellow, Roger W. Robinson, Jr., be the principal author of this paper. He served for much of the period 2001-2006 as Chairman of the Congressionally-mandated U.S.-China Economic Security and Review Commission and before that as Senior Director of International Economic Affairs at the National Security Council under President Reagan. President Reagan described Mr. Robinson as “the architect of a more security-minded and cohesive U.S. East-West economic policy” for his work in crafting the economic and financial dimensions of the covert U.S. strategy to hasten the demise of the former Soviet Union. Prior to his government service, Mr. Robinson was a Vice President in the International Department of the Chase Manhattan Bank with responsibilities for the bank’s loan portfolios in the former Soviet Union, Central and Eastern Europe and then-Yugoslavia. He also served as a staff assistant to former Chase Chairman David Rockefeller from 1978 through 1980. He presently serves as President and CEO of RWR Advisory Group and Co-Founder and Acting Executive Director of the Prague Security Studies Institute.

Andrew Davenport contributed significantly to this report. Mr. Davenport has collaborated with Mr. Robinson extensively over the past 10 years in pioneering the study of the intersection of international finance and national security, with an emphasis on the role played by the U.S. – and the global – capital markets. Mr. Davenport has published in this area on a number of occasions, testified before the U.S. Congress and consulted for the Pentagon in this field of study.
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**EXECUTIVE SUMMARY**

The purpose of this paper is to help illuminate an underdeveloped market debate that promises to grow in intensity during the coming months and years regarding the interplay of the global markets and the U.S. security community. China was selected as a case study. Among the broader issues implicated by the intersection of these two communities are: the configuration of the next generation of economic and financial sanctions; the exploration of new, security-relevant dimensions of market-based financial risk and corporate and sovereign governance shortfalls; the convergence and divergence of the goals of market players and security policy practitioners; and how the prospect of more frequent overlap of these two spheres can be made to work for both sides.

With respect to China, this paper first covers the glaring disparity of the markets’ treatment of Southern eurozone countries (e.g., Greece, Spain, Italy, and Portugal) and that accorded China. The former are under rigorous, even harsh, market scrutiny on a daily basis, while China largely escapes this kind of intense, skeptical market evaluation, despite considerably less reliable statistics and weaker disclosure, transparency, governance, third party oversight, accountability and rule of law.

The national security implications of a slower-growth China are then probed, specifically, with regard to: China’s present credit ratings; provincial debt and “shadow” lending; the liquidity of its foreign exchange reserves; Chinese listings on U.S. exchanges; its financial system more broadly; and the internationalization of the Renminbi (RMB). Touching on these economic indicators/developments is designed to help define and amplify the differing perspectives on the global markets when viewed through a Wall Street versus a national security lens.

Special attention is next given to what is termed the “Wukan Precedent,” a local uprising in 2011 against corrupt and unjustified land seizures that ended with defiant protesters prevailing over provincial and central government authorities. In a slower-growth scenario – particularly if sustained over two or more years – Wukan may well be remembered as the “Gdansk ship yards” of China, the first real traction of popular discontent that ultimately led to the undoing of the Soviet Communist Party. Such discontent and its immediate causes (whether it is corruption, land seizures, etc.) are, in nearly every instance, exacerbated by lower growth rates and financial mismanagement or malfeasance. Moreover, the Internet, social networks and smart phones make it far more difficult for a calcified Chinese leadership structure, anchored in vested interests, to suppress incidents like the high-speed rail accident near Wenzhou in July 2011, the jailing of Nobel Price winner Liu Xiaobo, the scandal and banishment of Bo Xilai earlier this year and the recent heroism of Chen Guangcheng. In short, the connectivity between China’s economic growth and political instability is likely to emerge as an important area of study for both the financial and security communities in the immediate period ahead.

An area where the security community has a leg-up on the markets is a better understanding of the regional and global implications of an ascendant People’s Liberation Army (PLA). On the
civilian leadership side, the anointed new leader, Xi Jinping, by most accounts, is closer to the PLA than his predecessor and, accordingly, military leaders are likely to demand, and receive, greater latitude with respect to what they perceive to be in China’s vital interests. Regrettably for the markets, PLA discretion in the past has brought sudden deviations from market expectations with respect to China’s continued “peaceful rise” and ability to manage diplomatic crises with caution and maturity. Over the past decade the world witnessed several occasions when Chinese civilian leadership was either trumped, or left out in the cold, by the PLA, including: the forced landing of a U.S. Navy EP-3 aircraft on Hainan island in 2001; the anti-satellite test in 2007; the rare earths embargo against Japan in the fall of 2010; and the embarrassing debut of China’s first known stealth fighter, the J-20, in January 2011. The scope and timing of future such incidents could result in slowing China’s growth further by contracting foreign direct investment, lowering credit ratings, increasing borrowing costs and diminishing market receptivity to debt and equity offerings. This is especially true if the recent rare earths embargo is a harbinger of the PLA leveraging economic might as a new model going forward.

The paper then discusses why the markets and the security community should care more about the issues portfolio of the other. For the markets, the knock-on effects of actions by the security community are becoming more pronounced and the asymmetric warfare capabilities of potential adversaries become more developed. Another major reason why market participants should care is that the security community will soon come to care more about them. Presently, there is a glaring deficiency in 21st century war-fighting, namely: understanding the mindsets of serious market players; what cues market movements; how these cues are communicated to trillions of dollars of funds under management; how to participate in the information flow to the markets; how to interpret market developments through a security-minded lens; and how the security community can identify common ground with the markets with respect to integrating its concerns into market calculations of financial risk and good corporate and sovereign governance. When, not if, these and related issues are properly addressed, market players should not be playing catch-up ball.

Thus far, eight eurozone Heads of State have been turned out of office primarily by market-dicted austerity measures and onerous performance milestones for targeted governments. The markets are currently more untethered to the economic and financial policy pronouncements of governments than at any time in recent memory. This is largely a function of the deterioration of the credibility of political leaders stemming from the back-to-back global financial and eurozone crises, the latter of which has displayed immensely expensive dithering, reactive half-measures, untruths like that of the Greek government and being constantly behind the markets instead of leading them.

The markets have become what some in the security community might term a distinct “identity.” This multi-trillion-dollar “identity” is moving across the global landscape picking winners and losers and displacing certain governments in the process. It is likely that the security community will recognize the need to get smart on this new financial force structure and determine what can be done to anticipate the dispensation of penalties and rewards.
INTRODUCTION

Over the past 20 years, the meteoric rise of China has heavily influenced global corporations, investors and market players more broadly while serving as an equally influential development for the security community of the United States. One of the most interesting, yet under appreciated, stories of this period, however, has been how generally disconnected these two communities have been from one another. Market players have seemed inadequately concerned about the implications of the increasingly aggressive and non-transparent pursuit by China of its perceived “core” interests, both economic and military. For their part, security professionals have generally eschewed efforts to understand, much less shape, the intricacies of the market’s wish for new opportunities associated with an ever-expanding Chinese economy. This report seeks to bridge this gap and foreshadow the reality of these two worlds colliding in the near future. It also postulates a new reality where security professionals become proficient – and even activist – in how the markets are behaving toward China (i.e., rewarding or penalizing it) and where market players are increasingly attuned to the implications of Chinese geopolitical and military actions for the country’s economic growth prospects and overall risk/governance profile.

There is no doubt that over these past two decades, China has enjoyed an impressive, steady economic rise and has consistently attracted external financing and investment based on the promise of continued, robust growth, greater openness and improved access for foreign firms to its potentially enormous market. The nature and scope of Chinese dependence on foreign financing and investment, however, is not adequately understood due to China’s rather dismal record on what, for most nations, would be considered by the markets to be fundamental requirements for a strong, sustainable and vibrant economy. These requirements typically include transparency, disclosure, good corporate governance, accountability, credible statistics, a solid legal framework and firm civilian control over economic, financial, trade and foreign policy decision-making.

A central component of this report is the fact that, thus far, China has largely escaped the kind of withering market scrutiny that has befallen the peripheral eurozone economies, despite its litany of significant economic and financial vulnerabilities and governance shortfalls. This seeming disparity in market treatment is particularly noteworthy in light of what, for most security policy professionals, has been a troubling trajectory over the past decade with respect to the brazenness of their regional and global pursuits. Such pursuits have, for many in the region, lifted the veil on China’s self-described “peaceful rise.” Understanding how the markets might react going forward in this new era of Chinese economic, financial and geopolitical behavior will have potentially profound political and national security implications for U.S.-China relations.
Accordingly, this report forecasts how security policy professionals are likely to assert – and insert – themselves into the traditional arena of “the markets” to a much greater extent during the period ahead. It is widely acknowledged throughout the U.S. security community that the Chinese security apparatus has been playing in this market space for many years as but another instrument of national power projection. Indeed, this reality coupled with the opacity of the Chinese markets (particularly of many of its largest enterprises) may ultimately witness, yet again, the U.S. security community illuminating and defending not just U.S. national interests, but those of the global markets as well.
DIFFERENTIATING BETWEEN THE EUROZONE AND CHINA

The eurozone crisis has made the markets substantially more circumspect concerning government policies and pronouncements designed to safeguard and support economic growth and fiscal discipline. It is evident today that the ability to secure “buy in” from major global corporations and banks is not sufficient, as it once was, for world leaders to corral (via credibility and persuasiveness) market forces, boost confidence, bring stability and stimulate growth. Throughout the eurozone crisis, there have been numerous references to the fundamental problem embodied in their being insufficient political union backstopping the euro, driven home by a quotation reportedly misattributed to Henry Kissinger – but still apropos – pointing out the obstacles of not knowing who to call if one wants to talk to Europe. In the case of the eurozone, however, the more pertinent question is who might current world leaders call if they want to talk to the markets? The eurozone crisis has demonstrated this answer to be elusive.

It is clear in the aftermath of the global financial crisis – and in the midst of the eurozone’s efforts to emerge from its own crisis – that today’s corporations and sovereign nations are increasingly at the mercy of the financial markets’ trillions of dollars of funds under management and millions of independent actors. The consequences of the untethering of the global markets from their traditional receptiveness to multilateral government policy initiatives is likely to be on vivid display in the event of future market concerns over China and increased attention to its “black box” characteristics. In this context, the term “black box” refers to wholly inadequate Chinese disclosure, transparency, corporate governance, reliable statistics and numerous other glaring short falls that were not – and are still not – tolerated by the markets when dealing with countries such as Greece, Spain, Portugal and Italy.

This unnatural disparity in the markets’ treatment of Southern Europe versus China is likely unsustainable, especially as other key economic indicators break the spell over the markets that Chinese economic growth is a sumptuous, entitled oasis. Already, there is a shift underway in the markets concerning the level of confidence in China’s ability to maintain momentum in a slower-growth era. There is even some loss of market esteem for the growth that has already occurred. The “dots” being connected include: growing market skepticism over the health of Chinese banks; greater recognition of the vast number of non-performing loans at the provincial level; the distortions caused by “shadow lending;” enhanced suspicion toward select Chinese offerings on U.S. capital markets and “reverse merger” listings; and the perilous high-wire act marked by an overpriced real estate sector and the government’s unwillingness – and perceived political inability – to deflate its “bubbles” to an adequate degree.
As this market adjustment toward China gradually takes place – presumably accelerating if the bandwidth occupied by the eurozone crisis were to subside – more expert eyes will be trained on China, including the eyes of relevant nodes of the security community (including its NGOs). With the political dislocation resulting from the eurozone crisis (e.g., the toppling of some Heads of State and counting), this community would be remiss if it were not to view the financial markets as a distinct, global identity capable of systemic economic and political effect, especially with regard to China. How this new “identity” manifests itself in terms of advancing or degrading U.S. security interests will have important knock-on effects for the markets themselves. Ultimately, the global financial community and the U.S. security community will be increasingly operating in the same space at higher velocity and with more market-moving consequences.

Below is a brief description of the role that specific economic and political indicators inside China are likely to play as this symbiotic relationship develops.

**Economic Indicators: Security Relevance**

**Economic Growth Rate**

There are a growing number of security policy practitioners that believe China needs to grow at an annual rate of some 7% or better to avoid the prospect of a perilous level of social unrest. This principally means that falling below this growth rate over any significant period of time (i.e., 18 to 36 months) would likely make it very difficult for the economy to grapple with the country’s increasingly demanding labor force and restive population. In addition to the growing “middle class” that is demanding of higher incomes and improved standards of living, there is a growing portion of the rural population that has come to expect a bountiful pool of jobs in major cities of China.

These rural workers are increasingly unqualified – and possibly unwilling – to revert to the practices of their parents’ generation. For example, some 85% of those born after 1980 have never worked on farmland and this same demographic of young people now make up more than two-thirds of the 253 million rural migrant workers across China. According to the World Bank, some 49 million migrant workers lost their jobs between October 2008 and April 2009, with almost 24 million of these recouped following Beijing’s urgent stimulus efforts that propped up the economy on a tidal wave of lending and construction jobs on projects of dubious viability.\(^1\) Regardless of the sustainability of these recovered jobs, this dramatic swing in employment versus unemployment demonstrates the remarkable fragility of this portion of the workforce. In a severe downturn, this demographic could either: 1) be forced to return to a rural way of life that

they are not acclimated to, trained for or satisfied by; or 2) constitute a large number of urban-dwelling, unemployed and disenfranchised youth.

It is in this connection that some are pointing to the 7% growth threshold as a key line of demarcation at which point employment becomes, not only an economic problem, but also an issue of Communist Party sustainability. The markets have already demonstrated interest in this kind of analysis linking growth requirements to the potential for massive political unrest, particularly as even the political leadership of China is coming to terms with this potential “red line” nearing.

Large-scale social unrest of the type that toppled communist leadership and gained free elections in the village of Wukan remains the single greatest risk to Beijing. The kind of “social contract” between the government and the people that has, to date, placated a large segment of the Chinese population – namely continued economic prosperity in return for restricted individual liberties and representation – would become badly frayed, and possibly even defaulted upon, were the growth rate to drop another 1.25% to 1.5% from where it is today even for a year or two (barring another massive new stimulus package). China’s economic growth rate for Q1 2012 was 8.1%, down from 8.9% growth recorded for Q4 2011.2

While more robust Chinese economic growth than expected would generally be welcomed by the markets, this would not necessarily be the case with respect to the security community, depending on China’s geopolitical, military and even economic disposition toward the United States and its regional allies. For instance, if China is accelerating its offensive military build-up and/or becoming more belligerent with its regional neighbors over territorial or other disputes, a more stressed Chinese growth rate might well be favored by some in this country.

In more extreme circumstances, there could also be consideration given by U.S. security officials to the role and influence of the markets on China through a more “eurozone lens.” There may even be a fresh security community view that the litany of trade and other economic/financial abuses by China – that has, thus far, been primarily administered by the Treasury Department, Commerce Department, U.S. Trade Representative and other economic-oriented agencies – could provide an alternative, non-kinetic set of pressure points through which to deter aggressive Chinese behavior. In short, if growing Chinese belligerence recurs during a period when the Communist Party is struggling to keep its growth rate just above the level where it will likely encounter domestic instability, the U.S. security community would be hard-pressed not to view such a strategic vulnerability as part of its – and the nation’s – tools to avoid any direct conflict.

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2 “China’s Economic Growth Rate Falls to Nearly 3-year Low.” Joe McDonald. AP. April 13, 2012.
Chinese Credit Ratings

Over the past several years, China has maintained a strong sovereign credit rating, despite the global financial crisis of 2008-2009. The three largest credit ratings agencies, Moody’s, Standard and Poor’s and Fitch presently rank China (Aa3), (AA-), and (A+) respectively. Even China’s largest banks, which are under considerable pressure due to the scale of expected non-performing loans stemming from China’s stimulus injection of some $586 billion to help ride out the financial crisis, enjoy relatively favorable treatment by the credit ratings agencies. Beijing’s stimulus funds were funneled through Chinese state-owned banks to other state-owned enterprises that, in turn, financed a torrent of public infrastructure projects as well as commercial and residential real estate deals. Most agree that this allocation of credit was more reflexive than thoughtful and lacked prudent, disciplined lending practices. It is remarkable in this environment that two of the “Big Four“ Chinese banks, the Bank of China and China Construction Bank, actually experienced credit upgrades late last year, despite the shares of major Chinese banks declining rather significantly over the course of 2011, due primarily to potential balance sheet problems.

Indeed, there is a real question as to whether the credit ratings agencies are accurately reflecting the true state of China’s economy and track record on debt repayment or whether they are simply “buying in“ to the notion that risk is mitigated by the central government’s massive reserves and their perceived willingness to provide bail outs, if needed. When one analyzes the array of upbeat, optimistic credit ratings assigned to Chinese banks and the government itself, it is difficult not to opine on whether credit ratings agencies might still be afflicted with some of the same analytical deficiencies that tarnished their reputations and credibility with regard to the subprime mortgage debacle that precipitated the global financial crisis. This simply appears to be a reluctance to engage in a truly independent, rigorous scrub of the Chinese numbers, behavioral precedents and iceberg-like systemic vulnerabilities.

The credit ratings agencies have explicitly stated that part of the rationale for the favorable credit ratings of the banks is precisely because of Beijing’s willingness to step in during any potential crisis – a perilous basis on which to adjudicate proper ratings. It begs the question of the extent to which the risk analysis of the credit ratings agencies, and other risk managers, are lured by the convenience of assuming that the Communist Party stands credibly behind every key node of its economy. A similar view was held of the EU some two to three short years ago with regard to the ratings and credibility of its member states being propped up by the perception of there being, in virtually every plausible scenario, a sort of “lender of last resort“ that was the EU establishment. This lasted until the “too big to fail“ phenomenon was challenged head-on, similar to the scenario presented to the U.S. government in the preceding years. Is history repeating itself already in the case of China?
It is in this context, that China’s “black box” on disclosure, transparency, accurate statistics, governance and rule of law will likely become more meaningful in the period ahead. For example, the pre-World War II Chinese government (then the Republic of China) defaulted on an entire series of sovereign debts between 1900 and 1940. Despite the supposedly sacrosanct successor government doctrine and a settlement with the British on a portion of these same bonds in 1987, the credit ratings agencies have ignored what is technically an instance of “selective default” by China on bonds held by Americans. As credit ratings often have a direct relationship on the cost, and even availability, of borrowing – not to mention shape broader market perceptions of China – this is an instance that warrants a “deeper drill” by those in Congress charged with oversight responsibilities in this area. Specifically, what precisely is still owed by China to the U.S. government and its citizens and why has it never been officially demanded, much less paid? How is this not a factor for the Nationally-Recognized Statistical Ratings Organizations in determining China’s creditworthiness and associated ratings?

These types of flaws in the system and their escalating risk should be regarded as a drag on the Chinese economy and its ability to attract adequate investment capital and borrowings. The credit ratings agency treatment of China could become an important strategic issue in the bilateral relationship, particularly in the event of a more confrontational China. The reputations of the credit ratings agencies are still recovering, despite the continued reliance of the markets on their findings. This is an interesting topic from a security perspective.

Provincial Debt and “Shadow” Lending

Much of the Chinese stimulus efforts in 2008 and 2009 were directed at the provincial capitals of China with an eye toward ensuring that employment remained high and social unrest low. As this large-scale lending, primarily to state-owned enterprises, took place on an accelerated basis, due diligence and creditworthiness assessments suffered mightily. This sizeable debt overhang, estimated by some to be in the range of $1.7 trillion, is made worse by an inordinately high percentage of loans that are not expected to be repaid on schedule, if at all.

Much of the investment at the provincial level was in real estate and related construction projects that today stand largely unoccupied. Nevertheless, property prices continued to soar and loans to get in on the action continued unabated. Chinese economic leaders reacted to the overheating of the property market by numerous increases in bank reserve requirements and somewhat higher interest rates to cool down new lending. This has placed real estate developers in a huge bind and starved small and medium-sized companies of the capital they need to remain viable. This, in turn, has forced businesses to engage in so-called “shadow” borrowing at usurious interest rates from other commercial enterprises and high net worth individuals or even pooled community savings. Earlier this year, Societe Generale estimated the volume and depth of this off-
balance sheet lending to be some $2.4 trillion with an estimated $635 billion considered “underground banking” – although no one knows for sure, including the Chinese government.

The question before the markets, and increasingly before the U.S. security community, is whether the available statistics on China’s overall debt situation and property construction “bubble,” reflect the realities in urban and rural China or are merely a publicly-palatable slice of the real situation. For the most part, these types of facts and deliberations have been rather distant from the security policy professionals and military planners, but that is likely to change soon. This is, in part, because it can be persuasively argued that China itself is a “bubble” of a kind, given its refusal to adhere to financial market rules of the road that would otherwise present a more balanced and accurate picture of the country for prospective foreign investors and lenders.

A symptom of the “bloom coming off the rose” is the increasing willingness of trading partners and their corporations to raise China’s serial violations of World Trade Organization (WTO) rules. A recent example includes Japan’s unusual willingness to raise China’s self-serving restrictions on rare earth exports – alongside the U.S. and Europe – in the WTO. Similarly, the EU is deliberating over whether it might begin initiating WTO grievances even in the absence of corporate complaints in order to circumvent the problem of companies facing promised government retaliation should they have the temerity to express themselves concerning unfair trade practices. This is a startling reminder of just how out of step China’s economic reality really is from other more mature foreign governments and market actors.

It is worth considering to what extent – if any – this kind of intimidation (i.e., fear of Chinese government retaliation for foreign investors “blowing the whistle” on unfair trade practices) has delayed the markets ability to coalesce around the view that China’s economic, financial and geopolitical behavior is not consistent with the level of sustainable growth required by Beijing politically. Moreover, the allocation of capital and enormous provincial debt and bad loans resulting from the 2008 stimulus package are evidence of fundamental flaws in China’s “state capitalism” model. For its part, the security community is likely to understand the possible consequences of Western government entities stepping forward to point out China’s abuses more directly and openly than has been the case in the past. Here, again, you have the potential for security professionals and market players to operate in the same space, albeit with potentially different agendas.

**Foreign Exchange Reserves**

China has exploited its vast foreign exchange reserves like few countries in the past. Primarily generated by an artificially undervalued Renminbi (RMB), its reserves presently sit at some $3.3 trillion (approximately $1.15 trillion of which is held in U.S.)
Treasuries). Most market observers assume that these reserves are highly liquid and can be used at the discretion of Chinese leadership to purchase strategic resources, shore up Chinese banks, engage in military procurements and other purposes.

This may not be the case. It can be argued that these reserves are the principal reason why China has been able to side-step standard market requirements concerning disclosure, governance, accountability and the rule of law, timely and accurate statistics, etc. The market’s general perception is that the country is so flush with cash and layered by Chinese government guarantees that it does not require exhaustive due diligence and creditworthiness assessments by market players. If this is even partially true, then the maintenance of multi-trillion-dollar reserves is an optical requirement for China that, in effect, concedes that its reserves are less liquid than generally understood. Indeed, because U.S. credit ratings agencies tend to rely on the likelihood of a central government bail-out in any worst-case scenario, one can be confident that senior executives at China’s “Big Four” banks would be loathe to see the credibility of the government’s commitment to backstop their losses undermined by the spending down of reserves, even if strategically opportune.

The Soviet Union invented the “Potemkin village” for visitors to admire the stability and prosperity of Moscow’s command economy. Might China be holding, in effect, partially Potemkin reserves? While it is true that the reserves actually exist, they are encumbered by as much as a trillion dollars in non-performing loans coming due, underfunded pensions for workers in state-owned enterprises, a perilous property/construction bubble and other actual and contingent liabilities.

This question becomes one of strategic concern to the U.S. security community, depending on the answers to these and other questions. If China’s reserves are ultimately seen to be, in effect, “frozen in amber” and more of a show-case than walking around money, the markets could rather quickly become less enchanted with China’s economic prospects and pull back somewhat on: foreign direct investment; glamor credit ratings; the willingness to traffic in the Renminbi; the offering of relatively cheap debt; and the appetite for public offerings of state-owned enterprises, to name but a few.

The possibility that these reserves are not as liquid as is presently believed has implications for the security community’s assessments of future military procurements (especially high-end technology and systems from Russia), Beijing’s ability to unload suddenly U.S. debt instruments, its attitude toward kinetic conflict in the South and East China Seas and its willingness to continue defiant geopolitical actions, such as the Syria UN Security Council veto. Of course, it also provides a potential target of opportunity for those seeking non-military means to moderate China’s behavior. It would clearly be pertinent were one to conclude that China’s ability to maintain outsized foreign exchange reserves is a fundamental requirement for the success of the Communist Party.

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Chinese Listings on U.S. Exchanges

Over the past 15 years or so, China has viewed the prestige and depth of the U.S. capital markets and exchanges as a preferred destination for fundraising, although via a considerably more rigorous process than that of Hong Kong. Chinese technology companies alone have reportedly raised some $7.8 billion since 2000 via 48 separate initial public offerings (IPOs). Although, Hong Kong has also been a key point of entry for Chinese companies to access Western capital within a credible, disciplined, and respected capital markets regime, it has generally been viewed as a higher order to list on U.S. exchanges. On a number of occasions, however, Chinese companies have learned that the U.S. markets carry unique risk in the potential for their public listings to result in intense public scrutiny of their books, physical operations as well as the track records of some on sensitive political issues.

At the beginning of the decade, notably in the period from September 1999 through 2000, China’s experience on the U.S. capital markets was rather dismal, in large part catalyzed by the near-collapse of its $10 billion PetroChina IPO on the New York Stock Exchange (NYSE). The IPO was originally going to be issued by the China National Petroleum Corporation (CNPC) until its 40% stake in the Greater Nile Petroleum Operating Company of genocide-ridden Sudan was brought to light. This, in turn, galvanized strong resistance to the offering by human rights organizations, organized labor and environmental and national security activists. Under withering public pressure, a subsidiary of CNPC was created, in the form of PetroChina, to carve out the non-controversial assets and operations of CNPC and present a more palatable company to American institutional and other investors. The IPO was heavily criticized, nonetheless, experiencing substantial delays and a reduction of over 70% in funds ultimately raised (from the original $10 billion goal to $2.89 billion). This debacle resulted in a cascading, negative effect on the appetite for Chinese offerings in the U.S. exchanges in 2000, leading to the withdrawal of two sovereign bond offerings as well as the $1-2 billion Baoshan Iron and Steel IPO and the halving of Sinopec’s IPO from its originally planned $7 billion amount. Overall, China sacrificed some $12-13 billion in foregone fundraising opportunities in the U.S. in 2000, representing a reduction of some 50% of its expected total for that year.

NGO activism and decisions by large governance-oriented U.S. institutional investors to eschew participation in the PetroChina offering provided Beijing a lesson on the rigors of the IPO process in the U.S. and the scrutiny of the markets. Listing strategies were amended, behavior was modified and, for a period, Chinese listings and access to the U.S. capital markets did reasonably well. Over the past 12 months, however, a new type of

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scrutiny has plagued Chinese companies stemming from their use of a new avenue to embed hundreds of Chinese companies in the U.S. capital markets with sub-standard disclosures and accounting.

Despite the option of listing in other countries, Beijing has for many years realized the importance of being able to access the U.S. markets and is aware of how unwise, if not impossible, it would be to avoid these markets altogether. Indeed, the size of the U.S. capital markets makes up roughly 30% of the world’s investible capital. As a result, Chinese entities have attempted to find new, creative ways to avoid the kind of controversy that engulfed PetroChina and other listings.

One such method that has gained notoriety involves “reverse mergers,” through which a Chinese firm purchases an already-listed U.S. “shell” company (i.e., not doing much, if any, real business), thereby side-stepping the need for an SEC filing, the issuing of a prospectus and other U.S. investor protection provisions. Since the discovery of this newest “technique,” China has reportedly listed over 400 of its companies on U.S. exchanges using this method. Following the high-profile outing of many of these companies for having misrepresented themselves, the SEC and the markets have essentially closed off this option completely and the U.S. government has initiated contentious discussions with Beijing over establishing greater confidence in the performance of Chinese auditors.

Although the fundraising activities of hundreds of Chinese firms in the U.S. on a “backdoor” basis has clear security implications, of equal concern are the Chinese bonds that have been issued in the U.S. for companies with ties to the PLA and/or Chinese intelligence services. Even Sinopec, a well-known Chinese oil major traded on the New York Stock Exchange, failed to disclose in the risk section of its prospectus that two of its wholly-owned subsidiaries had been officially sanctioned by the U.S. for the proliferation of weapons of mass destruction (i.e., Nanjing Chemical Industries Group and Jiangsu Yongli Chemical Engineering and Technology Import/Export Corporation). This was, by any measure, a “material omission” in SEC parlance.

The U.S. capital markets as a mechanism for certain questionable Chinese fundraising activities, fraudulent book-keeping and corporate shell games involving sanctioned entities is not lost on the U.S. security community, nor is the apparent dependence of Chinese companies on the U.S. capital markets for fundraising and global market credibility. Indeed, the security community is likely to become more alert to the true identities and operations of Chinese entities seeking a foothold in the U.S. debt and equity markets and the role of surreptitious access routes to public listings and funding that can enhance the capabilities of these firms. The extent to which China is losing credibility in the U.S. capital markets, due to its search for "loopholes" in our country's regulatory environment and listings of PLA-affiliated enterprises, is also relevant to the

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security-related agencies and groups within the Executive Branch and the Congress. These concerns include the use of suspect Chinese auditing firms, versus world-class institutions, to cloak the shortcomings of its listed enterprises, thus protect the Chinese economy from gradually eroding global credibility.

For example, China is in the process of bolstering its own auditing firms to take the place of major Western corporations that now dominate the space. There is also a move afoot to strengthen and enhance the activism of its own Chinese credit ratings agencies, which should be regarded as a preemptive move in response to the markets slowly turning somewhat more negative on its economy and finances, similar to the fate that has befallen certain eurozone countries (although probably less severe, at least for now). It will also likely lay the groundwork for rejecting more vocal Western market demands for Chinese companies to strengthen disclosure and governance standards to those of their global counterparts. Ultimately, these types of strategic economic initiatives are likely to be viewed by the U.S. security community as moves to “brick up” key strategic vulnerabilities, not just redress its economic and financial shortfalls.

Chinese Financial System

Much has already been written about the volume of bad debt the Chinese banking system has been compelled to shoulder in the interest, in effect, of “liquefying” the domestic economy to keep growth rates high, its population employed and civil unrest at a minimum. Most observers, however, identify China’s failure to integrate and open its financial industry as a potentially even more important failure in its rise to economic superpower status. Accordingly, it can be expected that Beijing will seek to remedy this vulnerability, but probably in a rather narrow way that protects the country from the type of dislocation caused by the global financial crisis – which Beijing leadership takes pride in having largely avoided. Indeed, reform measures taken over just the past few weeks underscore Beijing’s seriousness in this area.

Over time the competitiveness of the country’s banks on an international basis will likely be pursued as a key national objective. This means there would be considerably less room for revelations of improper involvement in countries or institutions engaged in proliferation activities, counterfeiting, arms sales, money-laundering and illicit contraband. These kinds of reputational “hits” to Chinese banks will almost certainly become less tolerable to the markets as China’s footprint in the global trade and financial communities expands. Beijing’s standard operating procedure of segregating activities that are objectionable to Western sensibilities, however, will not be as easy as in the past and likely leave these banks vulnerable to scandal and, depending on the circumstances, even class-action lawsuits (not to mention official sanctions if the abuses are security-sensitive).
For the U.S. security community, Chinese and other banks are becoming more of a focus. One need only witness the stature of financial sanctions in seeking to resolve the Iranian nuclear crisis, which includes a number of measures that implicate major Chinese banks, even if they are not likely to be enforced by the Obama Administration. The government, notably the Treasury Department, has expanded the circle of security-minded scrutiny to include the correspondent banking networks of banks still doing business with Iran. Indeed, it has also discovered the occasional abuse of interbank deposits and other more sophisticated ways of quietly attracting sovereign funding.

This may not bode well for China, as it has not entirely “sterilized” its major banks from involvement in PLA and other security-related activities, including espionage. Accordingly, the markets would be well advised to take account of this “global security risk,” as it is termed by the Securities and Exchange Commission (which has an office of the same name) with respect to Chinese banks. To the extent that new market attentiveness to these types of financial concerns proves a disincentive to Beijing’s co-mingling of their banks’ market-related and security portfolios, all the better for both the markets and the National Security Council. This entails a granular dissection of China’s banking system, however, that has barely begun by either the markets or the security community.

Internationalization of the RMB

For the past several years, China has made clear its preference for a viable alternative to the U.S. dollar as the world’s reserve currency. This effort gained profile in 2009, when an essay by China’s Central Bank Governor, Zhou Xiaochuan, called for the creation of a new currency to serve this purpose and suggested some expansion of the “Special Drawing Rights” (SDRs) established by the IMF in the 1960s. SDRs today serve merely an accounting function in the IMF’s dealings with member states, although it was originally envisioned that the synthetic currency might one day serve this “international reserve” purpose. The SDR’s value is determined by a basket of major currencies, which is the approach that has generally been encouraged by Beijing. For its part, China still does not have a freely convertible currency. That said, according to a 2011 SWIFT report, some 70 countries and over 900 financial institutions currently do business in the RMB and – alongside calls for a more open Chinese financial system – many are preparing for increased levels of international transaction settlement via the RMB in the coming years.\(^6\)

The U.S.-originated global financial crisis of 2008 – 2009 contributed a good deal to new pockets of international skepticism concerning the dollar as the international reserve currency. Although the resiliency demonstrated by the U.S. economy in the years that followed has somewhat neutralized these voices, the crisis itself offered fertile

territory for Beijing’s formidable public diplomacy machine to move into high gear in seeking to accelerate the acceptance of the RMB as a currency for inclusion in a basket mechanism designed to displace the dollar.

Independent of this lofty aspiration and geopolitical tool, China likely views the internationalization of the RMB as a necessary milestone on the road to full currency convertibility. They almost certainly regard broader use of the RMB as a subject of national pride. There are, however, equally compelling strategic reasons why Beijing is keen to build an expanding network of bilateral dependencies on China that the rise in RMB use would likely entail. They also understand that this could enhance the global perception of a more equal “superpower” relationship with the U.S., with all of its intimidating knock-on effects for neighbors in the Asia-Pacific region and beyond.
THE WUKAN PRECEDENT

It may well be that the uprising in Wukan, a coastal settlement of some 20,000 people near China’s industrial heartland in Guangdong province, is remembered in the same vein as the Gdansk shipyards of Poland, a harbinger of things to come. The essential outlines of this well-covered drama are the corruption of city officials and the unfair sale of farmland for commercial use in the village. This triggered a determined rebellion by village members who banished the local Communist Party chief, his police and other town officials during the course of a two-week citywide protest. So passionate and wronged were the protesters that the villagers stared-down the intervention of Chinese troops that had been sent to the scene. This principled and courageous stand by the people of Wukan ultimately led to one of the protest leaders being announced Communist Party chief and the election of an independent committee of villagers who, in turn, would serve as the supervisory body for free and fair elections for the future administration of Wukan.

It is precisely this kind of scenario that Chinese leadership fears most. The media deserves a great deal of credit for putting this dramatic local uprising in lights and helping inoculate the protesters from violent reprisals on the part of government forces. It also amplified the meaning of this extraordinary precedent vis-à-vis the path to hoped-for democratic pluralism. The internet also displayed its special qualities in keeping the flow of accurate information alive, despite Beijing’s best efforts to extinguish this fuse before it ignited similar local activism across swaths of China.

Less fulsomely reported, however, was the connectivity between Wukan’s tipping point and China’s economic and financial future. The markets seemed to generally regard the Wukan precedent as an encouraging story of democratic experimentation at the village level and reasonable and resilient management of this political crisis by Chinese leadership. The security community focused on the meaning of the concessions made by the Chinese authorities to the protesters and the extent to which such corrupt conditions exist elsewhere that could be given similar expression.

For its part, Beijing is likely not living day-to-day in fear of a political awakening triggered by the Chinese people’s collective dream of democracy. They are similarly not overly concerned that corruption in and of itself will mean the undoing of one-party Communist rule. Beijing’s primary concern is the sustainability of its impressive economic gains and the correlating “quality of life” expectations of its population. For Communist Party leadership, Wukan represents a microcosm of the potential costs of failing to deliver on these two points. It is a reminder of the strength, commitment and ability of the Chinese people to rise up, if the level of dissatisfaction reaches a sufficient level.
There may well be many new examples of Wukan-like uprisings that are equally unambiguous on the matter of what serves as the detonator (i.e., unemployment, lost savings, worsening corruption stimulated by local and provincial financial hardships, failed enterprises, etc.) that will, once again, cause the financial community and the security community to overlap in their area of operation.

What both sides of this debate likely agree on is that China stands at the proverbial crossroads of two very different destinies. The new leadership choices, thus far, are less than encouraging in terms of the influence of the PLA and advocates for a harder line by Beijing with respect to the U.S., Japan and possibly other allies. Such a hard line is, by some accounts, already in evidence, witness China’s recent veto of the UN Security Council Resolution on Syria.

This is not to suggest that China has lost its bearings with respect to the bodyguard of diplomacy required to protect economic growth and many other imperatives involving constructive engagement with the U.S. and most other countries. We are rather speaking about a matter of degrees here. China’s activities in, and interactions with, the markets were not materially affected by the Wukan uprising. That said, from a security and market perspective there is much to be gained from gaming out what a 7% or lower growth rate would mean for China over an 18 to 36 month period. What would be the prospects for a series of “Wukans” or Bo Xilai scandals in a lower growth scenario that could, in turn, catalyze troubling questions from average citizens concerning the ultimate authority in the country, the Communist Party? What are the implications of voices of conscience like Chen Guangcheng, the blind activist from Shandong, becoming more influential and numerous as the level of economic dissatisfaction rises?
THE MARKET IMPLICATIONS OF PLA ASCENDANCY

The world is awash in data and anecdotes concerning China’s special brand of state capitalism and whether or not it can continue to perform to market expectations. The list of useful indicators is long and growing in the effort to track the seismology of, and prognosis for, the Chinese economy. Interestingly, one of the least prominent and properly understood categories of financial risk facing the global markets is the international security dimension of China’s rise. While “event risk” and other elements of the political risk portfolio are, by no means, new to the markets, there is an absence of attention to the broader context and environment in which such events occur. Indeed, the same kind of non-transparency and non-disclosure that hobbles a clear picture of the Chinese economy is even more pronounced in the strategic/military domain.

One need only reflect on the lack of public insight into the leadership succession presently underway and the veil of secrecy and suspicion surrounding the recent sacking of rising star Bo Xilai from his position as Communist Party Chief of Chongqing to grasp fully the implications of one-party Communist rule and its impact on the country’s political and economic stability. This set of concerns has also been given expression by the unlawful house imprisonment of Chen Guangcheng and the kind of treatment that he can expect at the hands of Chinese authorities were he, or his family and/or associates, to remain in the country.

Just when a close observer of China feels confident that they have a good handle on what animates Chinese leadership in the region and globally, an event or decision by Beijing takes place that seems to defy political self-interest in a way that is measurably destructive to purported Chinese strategic priorities. Most of the time, the culprit is the People’s Liberation Army (PLA) and its supporters among the civilian leadership. There have been several incidents over the past decade or so that most analysts concur were a product of military initiatives superseding prudent civilian leadership policies, especially those designed to advance market perceptions of China’s “peaceful rise.” The Hainan Island incident of 2001, the anti-satellite test of 2007, the rare earth embargo in the fall of 2010 and the debut of China’s first known stealth fighter, the J-20, in January 2011 all reportedly took place without proper coordination or even discussion with civilian leadership.

It is rather safe to predict that the frequency and level of disruption caused by these types of civilian-military disconnects will grow in the period ahead, unless the likely next Chinese President, Xi Jinping, is willing to surrender preemptively to the PLA’s perceived requirements. Although the most likely events to trigger the temporary subordination of civilian control in China would be escalatory spirals involving territorial disputes with Japan in the East China Sea, North Korea, Vietnam in the South China Sea and possibly Taiwan, more troubling for the markets is the greater frequency of PLA-originated policy
responses impacting on the international trade and financial portfolios. The most noteworthy precedent here is the rare earth embargo against Japan in September 2010 following the arrest of a Chinese trawler captain for ramming a Japanese patrol boat in the East China Sea.

What is extraordinary about this case, which is still unfolding, is the scale of the damage done internationally to China’s reputation as a reliable supplier and the squandering of what, especially in hindsight, was a most unusual point of strategic leverage. The PLA-inspired disruption in the export of rare earth elements – in which China holds a roughly 97% global market share – to a highly dependent consumer country like Japan represented a breathtaking error in judgment that is reminiscent of the Soviet Union’s disastrous handling of the Chernobyl meltdown. Both actions revealed the heavy-handed calculations of authoritarian leaders that resulted in the undermining of an image that other constituencies within the same government had sought vigorously to protect through more thoughtful diplomatic engagement with the international community. In short, these types of events puncture the veil of good intentions and good faith, behind which undemocratic regimes often slip.

An equally suitable comparison involves the Soviet Union’s attempts in the late-1970s and early 1980s to increase substantially their energy supplier status with regard to Western Europe. Out of concern for the strategic implications of this objective, as well as the elevated revenue flows it would provide to Moscow, President Reagan made it a priority to catalyze a multi-year delay in the construction of the first strand of the twin-strand, 3,600–mile natural gas pipeline project from the Urengoi gas field to the West European gas grid and to terminate altogether construction of the second strand of that pipeline. This project would have brought Western European energy dependency to well over 60% and created a 100% dependency on the part of several individual European countries as well as cities like Berlin. In addition, Soviet annual hard currency income, which totaled only some $32 billion at the time, was expected to nearly double when both strands of the pipeline were fully subscribed.

Regrettably, President Reagan had no precedent for the Soviets making use of natural gas as a strategic weapon on which to defend his actions. Accordingly, the speculative nature of the President’s concerns fueled an especially intense dispute among transatlantic allies over the development of the Siberian gas pipeline. Had there been such a “politicization” precedent for Soviet natural gas, this serious rift in alliance relations would have likely been considerably less acrimonious. (Of course, years later, many such precedents exist involving Moscow’s willingness to leverage its gas supplier status for strategic purposes.)

The PLA-instigated rare earth embargo against Japan in 2010 now saddles China with a clear precedent of its willingness, not only to threaten, but to implement, acts of economic warfare, even in response to unrelated, diplomatic disagreements. It bears repeating that the root cause of this Chinese embargo and lunge at a critical sector of
Japan’s economy was the ramming of a Japanese patrol boat by an allegedly intoxicated Chinese fisherman and his subsequent detainment. Not surprisingly, Beijing’s actions have now stimulated a “crash” effort by Japan, and a number of other countries, to diversify their supply of rare earth elements away from China as rapidly as possible. A more thoughtful, less petulant, reaction by the PLA to the trawler captain incident would have perhaps reminded the military to hold the use of such an astonishing monopoly for an issue of utmost importance to China or perhaps maintaining the ambiguity of that willingness as an even more valuable strategic asset. Market calculations of China’s behavior as a “rational actor” would simply not apply here.

The basic problem ahead for the markets concerning PLA ascendency is somewhat similar to the challenge facing those trying to preserve a secure environment in space: rapidly growing traffic. As space becomes populated with more debris, satellites and other orbital objects, the risks of collisions and other disruptions multiplies. The same is true of the China market. As global financial ties to China intensify and deepen, including the expanding international use of the RMB and the number of asset classes becoming exposed to “China risk,” the prospect of collisions between market expectations and market-moving PLA-inspired policy initiatives will likely rise in number and importance. The PLA’s hand will likely also be strengthened in the period ahead in the categories of cyber warfare, industrial espionage and pervasive technology theft, something companies need to keep in mind when entering the Chinese market or engaging in business competition with Chinese enterprises – or simply possessing a “breakthrough” technology or service.
THE OVERLAP OF THE FINANCIAL AND SECURITY COMMUNITIES

Market players can expect savvy national security professionals to come to understand what moves markets to a much greater extent than is the case today. Consistent with several of the subjects treated (i.e., the strategic significance of individual market indicators within China, the linkage between the economic fortunes of the Chinese people and political unrest, the role of the PLA in enhancing “China risk,” etc.), security professionals are developing a new appreciation for how market signals and new data are communicated, how and why certain geopolitical information is discounted or acted upon by the markets and what types of economic and financial intelligence cues market players as to whether or not to move forward on a trade, investment, merger, acquisition, etc.

Skepticism as to whether security professionals will actually become consumers of such information should be allayed by the simple question as to whether competitors or adversaries are already pursuing these same avenues vis-à-vis the United States. Indeed, former Treasury Secretary Hank Paulson disclosed in his 2010 memoir that Russia had urged China in a “disruptive scheme” to dump, in tandem, their holdings of Fannie Mae and Freddie Mac bonds in 2008 in order to stimulate further emergency action by the U.S. government. Beyond the context and lessons of the global financial crisis, there are numerous examples of the asymmetric damage that can be done through the financial markets ranging from the “flash crash” of May 6, 2010 to the several occasions of single stock and currency brokers costing their trading houses billions of dollars in losses.

One would be naïve to believe that these events are simply lost on other state actors. Although the United States has a long record of seeking to explain why it is unbefitting of our country to engage prospective adversaries in their fields of “asymmetric” battle, there are a number of ways in which U.S. security interests align very well with: universally-accepted market principles of good governance; credible and accurate statistics; proper transparency and disclosure; shareholder rights; accountability; and an impartial and fair legal framework.

Why Should the Markets Care?

Why should the markets care about new interest on the part of the security community in their “portfolio”? First, market mavens and analysts need to care because the actions of the security community can move markets with some ease, especially given the velocity of the knock-on effects in a “real time” globalized economy. This includes instant analyses of why unusual military deployments have been announced and numerous other kinds of publicly available signals regarding U.S. strategic focus and resolve,
Second, the gradually increasing attention paid to Wall Street and the markets more broadly by the Pentagon, the intelligence community, the National Security Council, the military services and others will eventually lead to a skill mix on the part of senior security officials concerning what might be referred to as a comprehensive “security overlay of the markets” (i.e., viewing the markets through a security-minded lens).

Of course, U.S. objectives vis-à-vis the markets would be quite different from those of foreign security establishments intent on manipulating the markets using, for example, fraudulent information or cyber warfare. In the case of the U.S., the security community might one day seek to unearth troubling, market-relevant information concerning a targeted country which could, if properly disseminated, result in: the downgrading of its credit rating; an increase in its borrowing and sovereign debt insurance costs; and/or other stresses in the system, including pressure on the rate of economic growth. In short, security professionals could introduce into the markets information that is accurate, yet not well understood – or even completely unknown due to China’s poor record on disclosure and transparency. The security community could also make effective use of its intelligence-gathering capabilities in redirecting resources to inconvenient economic and financial data about a company or the economy more broadly. This kind of activity was pursued by the short-selling firm Muddy Waters, which first discovered and publicized inaccurate disclosures from the Chinese firm, Sino Forest. The stock price of Sino Forest subsequently plummeted, its debt rating was downgraded by Standard & Poor’s, its listing with the Ontario Stock Exchange was suspended and the company ultimately went bankrupt on March 30, 2012.

This would not be the first time that such overlap existed between security professionals and the markets. White House efforts to leverage the price and supply of oil and gas to harm adversaries is an established strategy at this point, used to particularly good effect by the Reagan Administration with respect to the Soviet Union. Naturally, the markets have evolved to a remarkable extent in the succeeding three decades and are today considerably more complex economically, technically and even politically. This complexity is on display in the case of current efforts to starve Iran of its oil revenues. Years of diplomatic energy and political capital have gone into decreasing the international demand structure for Iranian oil (e.g., EU prohibitions that take effect in July, decreased imports by Japan, etc.), only to see the price of oil increase during this critical timeframe by an amount that may approach the value of the reduced export volume.

Were there any doubt that the wake-up call to security community officials has still not been received concerning the critical role that the markets play in 21st century war-fighting, it should have been eliminated by the political carnage already left in the wake of the eurozone crisis (e.g., retiring some eight Heads of State). As mentioned earlier, the
markets are increasingly viewed by some in the security community as an “identity” on the global scene that needs to be defined and properly understood.

What would this mean in the case of China? In answering this question, it is useful to keep in mind that the security community will likely view China from a different perspective than the markets in a number of instances. For example, while the markets generally wish to see the risk profile of doing business in, or with, China lower, security-minded observers may see benefit in higher market risk profiles with respect to certain state-owned enterprises, like the Chinese oil majors still doing business in Iran. As the markets have amply demonstrated, they are willing, in effect, to give China preferential treatment with respect to their demands for disclosure, transparency and other key market fundamentals, justifying this decision on the basis of China’s attributes, including the size of the Chinese market, Beijing’s $3.3 trillion in reserves or fear of government-instructed retaliation for any overt criticism. Those in the security arena would be inclined to draw a more stark comparison between the advantages and disadvantages of a strong Chinese economy, urging – and possibly providing evidence that persuades – the markets not to be as accepting as they have been to date. As these two camps learn to cohabitate, each would benefit from understanding what motivates the other.
RECOMMENDATIONS

In addition to serving as a case study for what is likely to be a more active and nuanced relationship between the markets and the U.S. security community in the near-term, China is also likely to serve as the tip of the spear with regard to this Wall Street-Washington nexus. The good news is that there is considerably more convergence in the present directions of the markets and the security community than differences, assuming that risk and good governance continue to be mainstays of prudent market activities globally. While some of what has been asserted has been recognized for quite a long time, the relevance of the global financial markets to political stability worldwide is clearly on the rise. Accordingly, a few policy prescriptions are offered to both market players and security professionals to initiate a more institutionalized partnering of these interests.

The Markets

- There is a need for greater sensitivity to “global security risk” considerations, defined by the SEC as the risk associated with doing business with U.S.-sanctioned countries. Take the time to look into the background of the establishment of the “Office of Global Security Risk” at the SEC in 2004 (which relatively few on Wall Street even know exists) and redefine traditional political risk analysis to include the reputational damage that can accompany business associations with entities or countries that are understood to be bad actors with regard to national, or international, security concerns.

- Steer clear of business dealings with U.S. or multilateral sanctions violators in China and elsewhere as the reputational harm inflicted by the media, the Congress, the Administration, and other authorities on the violating company is now more contagious and can migrate to secondary market players rather quickly (e.g., new Treasury Department scrutiny of the correspondent banking networks of banks doing business with Iran).

- Conduct more robust, security-minded due diligence on the companies and banks of “competitor” countries, like China, prior to deciding to bring them to the U.S. debt and equity markets, as many state-owned enterprises can have colorful ties to their military and intelligence establishments which should properly be regarded as “material risk” information for prospective investors.

- Demand more disclosure on the part of companies from security-sensitive countries being considered for expanded business ties or partnering arrangements.
• In general, political risk assessments should incorporate a greater appreciation for the “macro” security considerations of the country in which they are doing business, rather than focus almost solely on what is legal or illegal or the likelihood of specific operations being disrupted. These more “macro” analyses should encapsulate the nature of the country’s security community and its overlap with domestic industry as well the direction of the country’s strategic relationships with other world powers.

• Seek opportunities directly with the security community or representative security-minded NGOs, to learn more about what a “security overlay of the markets” would look like and deploy preemptive risk-mitigation strategies as needed.

The Security Community

• Encourage more interaction between relevant U.S. government agencies and market professionals concerning how prospective adversaries of the U.S. fund themselves and their global activities and other such questions, including the integration of market reactions, including estimated movements in major market indicators, into war games.

• Redirect intelligence-related taskings to examine more carefully the vulnerabilities and “stress points” of the domestic economies and the market activities of competitor countries like China, particularly with respect to market-related risk and governance considerations.

• Establish training modules for the security community focused on understanding and possibly employing strategies stemming from market-based risk and governance concerns and how these considerations pertain, directly or indirectly, to the war-fighting capabilities of specific prospective adversaries.

• Develop a real-time Global Markets Observation Center that assesses, on a daily basis, the markets behavior toward “countries of interest” through a national security lens staffed by a new cadre of professionals with a global finance/Wall Street/security policy skill mix.

• Help create a “Track 1 ½” process with selected partners in the NGO community with respect to a “deeper drill” on the China nexus of the global markets and U.S. security concerns.
CONCLUSION

As stated earlier, fortunately, there is a good deal more convergence than divergence in the way the markets and the security community view the world. The relationship between the two could be materially strengthened were a more serious effort made on both sides to acquaint themselves with the main drivers and indicators that each deems most useful to their respective missions (i.e., making – and preserving – money and building value versus safeguarding the freedoms and assets that permit the markets to function). Although their missions are quite different and diverge in a number of circumstances, they can come together around shared interests in mitigating risk and strengthening governance.

Traditional economic, and even financial, sanctions are slowly atrophying – as did trade sanctions years ago – because of too much foreign availability of equipment, technology and capital and growing international resistance to multilateral sanctions, except in the most dire circumstances. Even then, the most effective sanctions (i.e., financial) are often “dumbed down,” stripped of their teeth or phased in over an unreasonably long period in order to gain an allied consensus even among a “coalition of the willing.” Accordingly, multilateral sanctions cannot be relied upon entirely to deter or effectively counter an existing threat.

These are among the reasons why it is useful to prepare now for a “post-sanctions” generation of measures to penalize security-related abuses and reward responsible, peaceful behavior. A “security overlay of the markets” like that recommended could identify specific areas of convergence around traditional market concepts – risk and governance – that could be configured to persuade a potential adversary that the costs associated with irresponsible and reckless behavior in the security portfolio would likely exact far higher costs in the responses of the markets than is the case today. The markets could, in turn, close-up to a greater extent with the security policy professionals that provide the largely stable, predictable and safe global environment that the markets need to prosper, but often take for granted.

This is not a call for “politicking” the markets or somehow trying to manipulate them to serve the security interests of the U.S. and its allies. It rather involves the security community better understanding, and tapping into, those elements of market behavior and expectations that could, if creatively managed, disadvantage a nation seemingly bent on acting in a manner that undermines U.S. security interests. This can be accomplished by several means, including the unearthing and release of accurate data points concerning a targeted country’s economic and financial vulnerabilities for market consumption.
For their part, the markets care about financial risk, which increasingly emanates from geopolitical “situations.” Market players also care about governance, which tends to be seriously flawed under the auspices of authoritarian regimes. Accordingly, the markets should welcome an ever-closer dialogue with decision-makers in the security community and vice versa. Although Wall Street met Washington long ago, the game is changing dramatically. In addition to the standard agenda of meetings in Washington, Wall Street executives would be well advised to arrange visits to the Pentagon, the NSC, the intelligence agencies, security-minded NGOs and other nodes of the security community.

The last time that security-minded economic and financial cards were played in earnest, the United States navigated its way to a peaceful end to the Cold War and the collapse of the Soviet Union. The competition with China is an entirely different exercise with continued U.S. engagement as its centerpiece and complimentary economic benefits still within reach. That said, points of significant disagreement and peril persist. The level of non-transparency on the security side of the U.S.-China relationship, and the reality that Beijing’s security apparatus penetrates practically every meaningful sinew of the country’s political and economic life, is coloring Chinese economic and financial decision-making more regularly than was the case.

Accordingly, it is important that the markets and security professionals understand and take account of these evolving risk and governance factors to a greater extent than in the past. The security community needs to be able to put itself into the professional mindset of market players, particularly bond traders and risk management experts, and be able to respond to geopolitical provocations in a market venue, which has amply demonstrated over the past several years the ability to cause substantial political dislocation. The markets, in turn, need to recognize that global security risk is becoming a more ominous and frequent concern that should be gotten in front of now. A dozen years ago, “Masters of the Universe” at an unnamed U.S. investment bank did not see the CNPC IPO controversy coming and suffered greatly trying to salvage the deal from embarrassing collapse (ultimately being forced to turn to friends of Beijing like Hong Kong mogul Li Ka-shing). This kind of conundrum will likely increase in frequency and blowback in the period ahead.