



Previewing Issues in 2018

Trump's DPRK Policy | The South China Sea | U.S.-China Trade

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Executive Summary

The inauguration of Donald Trump as the 45th president of the United States ensured that 2017 was an eventful year for U.S.-China relations. Two key issues were the locus of tensions in the relationship – the crisis on the Korean Peninsula and bilateral trade, economic and investment frictions. These issues will remain at the heart of U.S.-China relations in 2018.

Over the past year, Chinese President Xi Jinping and Donald Trump were able to contain these tensions and strengthen the bilateral ties between their two countries. But this trend is unlikely to continue in 2018. Tensions will spike as both sides begin to reach the limits of their cooperation on the crisis on the Korean Peninsula. China will only go so far in tightening the sanctions noose around North Korea for fear of causing regime collapse. That is a clear red line that Beijing will not cross. For its part, the United States is hampered by its insistence on pursuing the short-term policy goal of denying Pyongyang the assured capability to strike the continental United States with a nuclear-tipped missile. It is becoming increasingly clear that this goal is unattainable.

Looking into 2018, the status quo of the South China Sea will remain stable. Important steps were taken towards laying the groundwork for managing these disputes in 2016 and 2017, but any new progress will likely be slow and reflect changes to the rules of the game that have already been made. The South China Sea issue has taken a backseat to other more immediate concerns, such as the crisis on the Korean Peninsula. However, the fact that the issue has declined in prominence does not mean that the South China Sea is going away. In the coming year, the geopolitical competition between China and the United States will increase and will continue to set the stage for, and influence the disputes in the South China Sea.

On the trade and investment front, the Trump administration seems determined to force a showdown over the size of the bilateral trade deficit and the alleged non-reciprocal market access policies of China. With a large bilateral trade deficit and little progress within the U.S.-China Comprehensive Economic Dialogue (CED) process, President Trump is expected to pivot away from his centrist advisors on China trade policy and embrace the economic nationalist recommendations of U.S. Trade Representative (USTR) Robert Lighthizer, which align closely with his own views. Such a shift in policy, paired with punitive actions such as imposing tariffs and other forms of penalties on Chinese economic activities with the United States, could spark a trade war between the two largest economies in the world.

Section 1: DPRK Policy

The Next Six Months will witness the Highest Level of Tension on the Korean Peninsula since the Cessation of the Korean War in 1953

By Sourabh Gupta



Key Takeaways

- **The risk of a U.S.-initiated breakout of war, which could include a nuclear dimension as the conflict escalates, is as relatively low. Numerically, the risk is less than 30 percent – and probably much lower.** Because North Korea (DPRK) is in a position to inflict unacceptable human losses on Seoul and U.S. assets in the region if the United States initiates a conflict, the consensus view in Washington is that the Trump administration will be deterred from initiating armed hostilities against North Korea.
- **The risk of a U.S.-initiated breakout of war on the Korean Peninsula is nevertheless at its highest level since the armistice agreement that terminated the Korean War in 1953.** Not since then has the evaluation by a U.S. administration of the threat status posed by North Korea been as high as it is today.
- **The risk of a U.S.-initiated breakout of war on the Korean Peninsula has not yet peaked, and will continue to increase. The next 6 months will likely witness the highest-ever levels of tension on**

the Korean Peninsula since 1953. The risk of a U.S.-initiated breakout of war, which could include a nuclear dimension as the conflict escalates, could even cross the 50 percent threshold during this time.

- The key reason for this extremely elevated level of tension over the next 6 months is due to the **Trump Administration’s primary policy focus vis-à-vis the DPRK: to deny North Korea the assured combat-ready capability to strike the continental United States with a nuclear-tipped missile.** This does not necessarily mean that the administration *will* initiate a preventive or preemptive strike (or war) against North Korea. The United States will most likely learn to live with North Korea in a deterrence relationship once the latter perfects this capability. But for the time being, **the overriding goal is primarily to deny North Korea the assured capability to hit America with a nuclear-tipped missile – by way of military means and economic strangulation (or diplomacy).**
- Despite the anticipated spike in tensions, there is guarded hope among specialists and observers that the two sides will avoid a military confrontation. **Both sides will likely engage in aggressive posturing during this period, but, at the end of the day, each side will be dissuaded from pulling the trigger.** Mutual deterrence will hold. **Nevertheless, the scope for a miscalculation during this period will be very high.** The United States is set to conduct another round of joint military drills with South Korea in late-spring 2018,¹ which Pyongyang typically views as a prelude to invasion.
- **The United States’ recent signaling of a qualified willingness to explore “talks about talks” with North Korea without the precondition of a *prior* commitment by Pyongyang to denuclearize, could lower the relative temperature on the Peninsula during this period ahead.** So long as: (a) a request is made by Kim Jong-un or a senior representative directly to the United States in this regard; and (b) North Korea commits to a sustained cessation of nuclear and missile testing as well as threatening behavior ahead of the talks, and during these talks, the U.S. appears willing to explore the potential for dialogue. **Whether these dialogue threads will amount to much during this period of aggressive posturing remains to be seen.** At best, it could provide a foundation for *future* bilateral and multilateral engagement once the period of high tension has elapsed.

Key Reason for Elevated/Highest Level of Risk over Next 6 Months

President Trump’s **National Security Advisor, H.R. McMaster**, has mentioned on at least three separate occasions, starting late-Summer 2017, that Kim Jong-un will not be allowed to complete the development of a workable, nuclear-tipped, intercontinental ballistic missile (ICBM) capable of striking the continental United States. According to McMaster, if Mr. Kim achieves this goal, conventional deterrence will no longer be enough to deter him. **Indeed, in McMaster’s view, the key intention of Kim Jong-Un in developing a nuclear ICBM strike capability is to blackmail the United States into abandoning its ally, South Korea, and thus clear the path for an invasion of the South, down the line, to unify the peninsula on North Korean terms.**

As per this view, the policy of deterrence that worked effectively during the Cold War does not apply in the case of North Korea. Kim Jong-Un believes that if he can threaten the U.S. homeland with an assured nuclear strike capability, the U.S. will not risk intervention in a future North-South conflict on the peninsula. And because the U.S. will not risk intervention in the conflict, there will be no restraints on Kim’s aggressive behavior, whose ultimate aim is to militarily unify the peninsula under Pyongyang’s rule. **Hence,**

to dissuade Kim Jong-Un from such aggressive conduct in the *future* leading potentially to a Second Korean War, North Korea must be denied the capability *today* to develop to a workable, nuclear-tipped, ICBM that can strike the continental United States and ‘decouple’ America’s security from that of its ally, South Korea. According to McMaster, the assumption that the North Korean regime wants nuclear weapons only to assure its survival is false³ and the Trump administration will not allow North Korea to develop the capability to hold the United States hostage with nuclear weapons during an eventual military contingency on the Korean Peninsula. McMaster clearly iterated this point during the first weekend of December when he noted *that “if necessary, the president and the United States will have to take care of it, because he has said he’s not going to allow this murderous, rogue regime to threaten the United States ... it’s a regime who’s ... intentions are to use that weapon for nuclear blackmail and then to ... reunify the peninsula under the red banner.”*

This view has also been endorsed by **Mike Pompeo, the Director of the CIA**. In mid-October, he observed that while Secretary of State Rex Tillerson was hard at work on the diplomatic front, *“the president has made very clear he is prepared to make sure that Kim Jong-Un doesn’t have the capacity to hold America at risk - by military force if necessary.”* An operational, nuclear-tipped ICBM in the hands of Kim Jong-Un is a game-changing existential threat to the United States, which Donald Trump is determined not to allow North Korea to possess.² **For his part, Secretary Tillerson has alluded to the commercial motivations that would compel North Korea to proliferate its technology as the reason why a nuclear-armed North Korea must not be allowed the comfort of settling into a steady, mutual deterrence relationship with the United States. White House Chief of Staff General John Kelly’s** precise views on the issue are unclear, but he is generally thought to favor McMaster’s interpretation of the crisis.

The U.S. intelligence committee’s recent (August 2017) assessment of North Korea’s nuclear weapons program estimates that **Pyongyang is less than a year away from having the assured capability of fitting a nuclear warhead on an ICBM and delivering it to any point in the continental United States. This has added a significant element of urgency to the administration’s interpretation of the crisis.** North Korea is thought to possess anywhere between 15 to 60 nuclear warheads,⁴ as well as an ICBM with the range – albeit lacking precision – that is capable of hitting the continental United States. It is unlikely that the two programs have been brought together to deliver a workable, nuclear tipped ICBM. **The November 29th Hwasong-15, ICBM test-launch indicates that technological improvements are needed in the areas of heat-shielding and missile reentry, terminal guidance and warhead activation.** However, these steps could likely be completed after two or three additional test firings, a process that could take roughly four to six months.⁵ CIA Director Pompeo affirmed this time-line in late-October when he noted that the DPRK is just *“months away”* from developing the assured capability to strike the continental United States with a nuclear-armed ballistic missile.

According to this line of argument, the Trump administration, has six months or less to deny Kim Jong-Un the assured ability to strike the United States – be it by military, economic or diplomatic means. As important elements within the Trump administration appear to see it, once North Korea obtains the assured capacity to strike the United States with a nuclear-tipped missile, the window for war will shut close very quickly. **For a U.S. initiated military option to exist, it must take shape *before* North Korea completes its nuclear arsenal.** The next 6 months provide the final opportunity to deny North Korea the ability to go nuclear with an assured ICBM strike capability – and, more broadly, the last opportunity to prevent the United States from being susceptible to future blackmail by Kim Jong-Un to abandon South Korea if he decides to attempt to reunify the peninsula by force.

What are the Envisaged/Suggested Military Options out there ...

U.S. military strike options vis-a-vis North Korea are a closely guarded secret. Presumably they span the range from decapitation strikes against the regime's command and control infrastructure using special forces to all-out war. U.S. Defense Secretary Jim Mattis has presented preemptive strike and regime change options to the President, despite his personal reluctance to support such preemptive action. Allegedly, a notable feature of his presented options is that they entail no U.S. troop presence north of the 38th parallel after the liquidation of the Kim regime and the securing of its WMD assets. Beyond government, there are a range of hawkish views about what the Trump administration *should* do – (not to be confused with what the Administration *will* do). Below are two such representative views:

Representative View A: *“The most dangerous provocation that North Korea has threatened is an (atmospheric) nuclear missile test firing over the Pacific Ocean. If North Korea does in fact launch a nuclear missile over and into the Pacific, the reaction should be a massive American and South Korean air and missile strike against all known DPRK nuclear test facilities and missile launching and support facilities. The strike should be launched from South Korean and Japanese bases, as well as U.S. ships and bases in the United States. Now is the time to consult with Japan and South Korea about this possibility as well as responses to other potential DPRK provocations. To launch a retaliatory strike of such scope, all three countries will need to increase their military readiness in case of North Korean retaliation and take steps to provide civil defense in South Korea and Japan to protect their citizens and the tens of thousands of Americans who live in both countries.”* (retired Admiral Dennis Blair)

Representative View B: *“Here is how Trump should respond (if Kim Jong-Un launches a long-range test missile towards the U.S.) - Take out the test site from which the North Koreans launched the missile, just like he (Trump) struck the military base in Syria from which the Assad regime had launched a chemical weapons attack on innocent civilians. Then, Trump should declare North Korea a ballistic missile "no-fly zone" and a nuclear weapons "no-test zone." He should warn the North Koreans that any further attempts to launch a ballistic missile will be met with a targeted military strike either taking out the missile on the launch pad or blowing it up in the air using missile defense technology. And any further attempt to test a nuclear weapon will be met with a targeted strike taking out the test site and other related nuclear facilities. So long as North Korea does not retaliate, Trump should assure Pyongyang that he will take no further military action against the regime. However, if North Korea does retaliate, then the United States reserves the right to, as Trump put it to the UN General Assembly, "totally destroy North Korea.”* (Marc Thiessen)

Regarding these representative views, there are three opposing points that bear noting. First, any military strike on North Korean territory is extremely risky. No one knows for sure how Kim Jong-Un will respond if his country is attacked – even if it is by way of a limited strike. No one fully understands what his

threshold for absorbing a (limited) strike is, but it is likely that *any* attack on North Korean strategic or military assets on its territory will invite a devastating response from Kim Jong-Un.

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Second, there is broad consensus that Kim Jong-Un is not suicidal. Rather, he calculates where the threshold of risk for inviting armed reprisals lies, and makes a point to operate beneath this threshold. Despite recent threats to target Guam with missile tests, North Korea has not launched a missile on a southward trajectory for many years. Despite threatening to conduct an atmospheric nuclear test over the Pacific Ocean, Kim

Jong-Un has conducted all his tests underground. Despite vowing to target the continental United States with an ICBM, all his three ICBM tests have been on a lofted trajectory and only one of these test missiles overflew Japan. These are strong indicators that Kim Jong-Un is a rational actor. He is not looking to invite an armed confrontation but is preparing himself fully if one does break out.⁶

What is the Most Optimistic Diplomatic Option?

Most North Korea policy watchers in Washington argue that the United States should double-down on the approach of 'maximum pressure' and force the North Korean regime into submission through sanctions. In this regard, the next step should be a complete oil embargo on North Korea. There are more thoughtful views in circulation that aim to tamp down on the tensions and provide an off-ramp to re-opening a dialogue process with Pyongyang. A **representative view** of this line of thinking is as follows:

Step one is to avoid a military conflict in the short run by making clear that a preventive military strike by the United States is not only unconstitutional and a violation of international law, but also inevitably catastrophic. Reducing the risk of preventive war by the Trump administration will also reduce the risk of a pre-emptive first strike by the DPRK if it fears that the United States is about to attack. The Trump administration must take steps to ensure that South Korea and Japan have confidence in the American deterrent, and are not tempted to move towards their own nuclear capabilities. This is a serious long-term danger, but not an urgent threat.

Step two is to negotiate a freeze on missile and nuclear tests by the DPRK. This will require the USG (United States Government) to move off the position that a freeze-for-freeze cannot be considered without preconditions. The opportunity presented by the Moon Jae-In government's request to suspend military exercises in the spring at the time of the Olympics should be seized. A sufficient reduction in

exercises going forward should be agreed so as to get agreement on a freeze in tests and the start of 'talks about talks'.

Step Three. During the 'talks about talks', the purpose must be to seek agreement that the immediate goal of formal talks is to negotiate a permanent cessation not only of tests but of production of nuclear weapons material and long-range missiles in return for some easing of sanctions. There should also be agreement that the ultimate goal of the negotiations over a period of years is the de-nuclearization of the Korean Peninsula as part of a comprehensive and legally binding international agreement which also creates a security structure for northeast Asia and an end to hostilities and hostile intent among the six powers and ends sanctions.

Step four is to negotiate the terms of the verifiable freeze on production of nuclear weapons material and long-range missiles while providing sanctions relief to the DPRK. (Morton Halperin)

What are the Headwinds to Realizing this Diplomatic Approach?

In mid-December, U.S. Secretary of State Rex Tillerson signaled a qualified willingness to explore ‘talks about talks’ with North Korea without preconditions so long as: (a) a request is made by Kim Jong-Un or a senior representative directly to the United States in this regard; and (b) the DPRK commits to a sustained period of cessation of nuclear and missile testing and threatening behavior ahead of the talks, and during the course of talks.

The Trump Administration’s overarching policy goal remains CVID (comprehensive, verifiable, irreversible denuclearization). That being said, as per the Tillerson view, the U.S. recognizes that North Korea has a lot invested in its nuclear and strategic program for now to accept the U.S. precondition that it commits to CVID *before* talks can be started. An important related concern in the U.S.’ eyes is also proliferation-risk – the potential for North Korea to sell its technology to bad state and non-state actors in the absence of any diplomatic engagement.

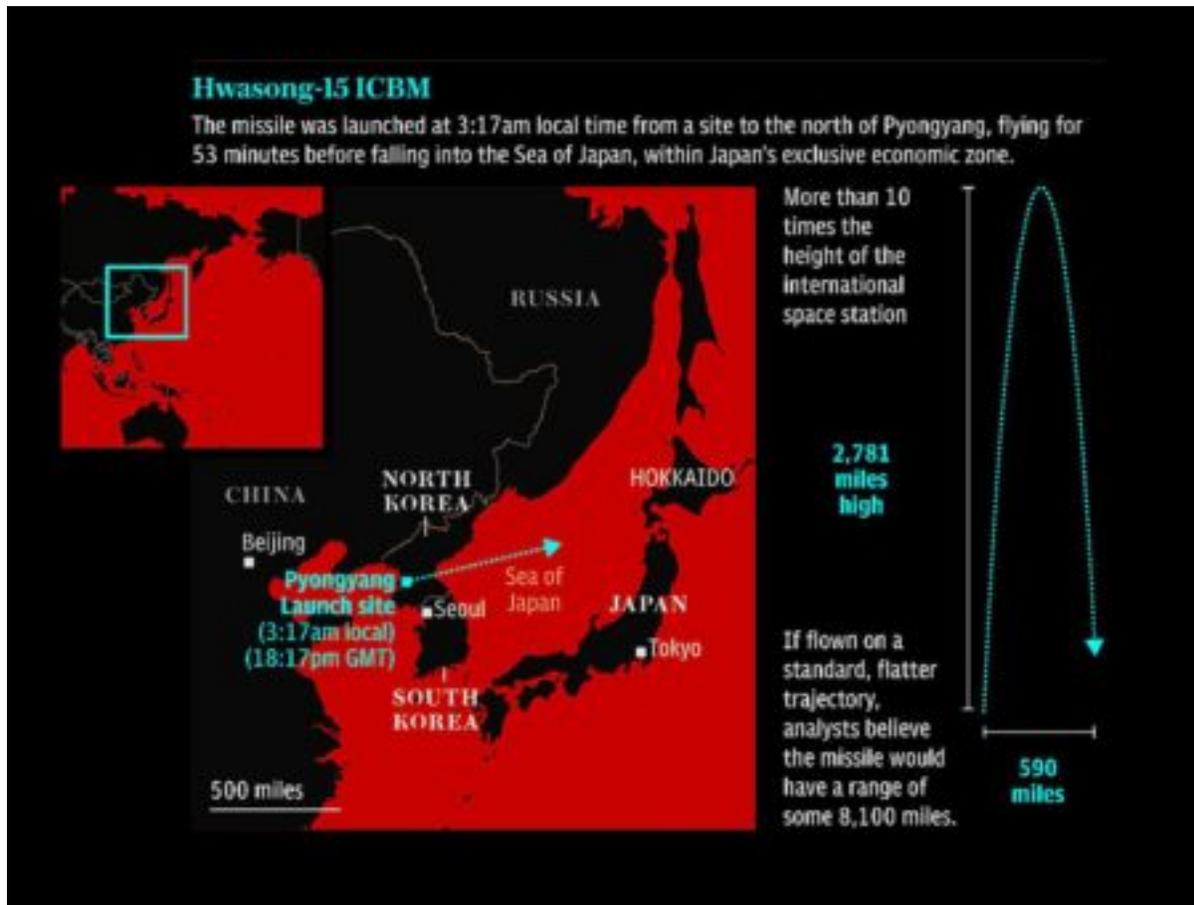
Tillerson’s overture comes at a delicate moment in the complex game dynamics of the Korean Peninsula issue. Kim Jong-un still remains some tests away from a threshold point of assurance in terms of his delivery vehicles’ technical ability to strike the U.S. mainland with a nuclear warhead. It is possible that he will scheme for opportunistic breakdowns in the diplomatic process to upgrade and perfect his capabilities. For its part, the U.S. has yet to unleash its full toolkit of sanctions (most notably a U.N.-mandated oil embargo) and disincentives on the regime in Pyongyang. Until such sanctions are maxed-out and visibly seen to be impotent, the Trump Administration will not reconcile itself to any far-reaching bargain with a regime as odious as the North Korean one. **Essentially then, Tillerson’s qualified willingness to explore a diplomatic pathway out comes at a time when both sides have yet to exhaust their options and reach a mutually unsatisfying but stable equilibrium atop which a durable settlement can be explored – let alone constructed.** Whether the diplomatic process, including any round of ‘talks about talks’, can survive a further round of breakdown is a critically important question that will have a bearing on war and peace on the Korean Peninsula.

Third, no matter how devastating a U.S. strike on North Korea’s nuclear facilities and related targets might be, it will likely only be able to remove a small fraction them. Most of those strategic assets are stored underground in undisclosed locations, meaning that U.S. intelligence estimates about their precise location is imperfect at best. In late-October, the vice-director of the Joint Staff of the U.S. Navy, Michael Dumont, confirmed in written testimony to Congress that ***“the only way to locate and destroy with complete certainty all components of North Korea’s nuclear weapons program is through a ground invasion.”*** Without complete certainty that North Korea’s nuclear weapons program can be eliminated in a preventative strike, this option is disastrous. Kim Jong-Un would almost certainly order a retaliatory strike leading to a large loss of human life on the Peninsula and beyond.

Background on the New and Elevated Phase of U.S.-DPRK Tensions

The current phase of tensions and the (severe) hardening of the Trump administration’s stance against North Korea can be traced to early-July of 2017. On July 4, North Korea conducted its first ICBM test, with the missile flying more than 4,000 miles and placing Hawaii and Alaska within its range. Later that month, on July 28, a second 6,000-mile ICBM test was conducted, bringing the West Coast of

the United States and the Midwest within its range. **These successful tests fundamentally altered the Trump administration's perceptions of the existential threat posed by North Korea. President Trump's hardline tone and inflammatory tweets about Kim Jong-un and National Security Advisor McMaster's harsh analysis of North Korea's strategy to blackmail and decouple the U.S.' security from that of South Korea essentially date back to these two launches.** Despite conciliatory noises by Rex Tillerson, Donald Trump has consistently maintained a hardline stance on the North Korea issue since the end of July. He, by and large, stopped communicating messages of reassurance after July 2017.⁷



In September 2017, tensions escalated further. First, when North Korea conducted its sixth nuclear test on September 9th and later on when, on the floor of the U.N. General Assembly, **Donald Trump proclaimed that North Korea might have to be “totally destroyed.” Kim Jong-Un interpreted that address as a “ferocious declaration of war” and promised that he would take “a corresponding, highest level of hardline countermeasures.”** The next day, Kim’s foreign minister stated that North Korea “had entered a phase of completing the state nuclear force ... [and that it] was only a few steps away from the final gate of completion of the state nuclear force.” Following the November 29th test-missile launch, which demonstrated North Korea’s capability to strike Washington, the regime announced that “the great historic cause of completing the state nuclear force” has been “realized.” Technical experts nevertheless believe that North Korea will need to conduct a few more tests before its nuclear deterrent is operational and combat-ready. These tests *might* take place over the next few months ... although the regime’s assertion

that its nuclear forces are completed suggests that Kim Jong-Un may be willing to call a pause/timeout on his testing program for a given (and undefined) period of time.

A key issue is whether or not the United States can deter a nuclear-armed North Korea if it develops the ability to target the U.S. homeland, and whether taking military action to prevent this scenario might be necessary. Either choice brings with it considerable risk for the United States, its allies, regional stability, and global order.

There is sub-set of hardened analysts' views (some with prior U.S. government experience) who contend that the risk of allowing North Korea to develop the capability to target the U.S. homeland with a nuclear weapon outweighs the risks associated with a regional war. These analysts frequently cite Pyongyang's

The much larger mainstream faction of analysts and former government officials, however, see Kim Jong-Un as deterrable. War can, by-and-large, be avoided by implementing the policy of containment that kept the Cold War from going hot.

history of bombastic threats, hostility toward the United States and its allies, and the regime's long-stated interest in unifying the peninsula on its terms as evidence to back up their claim. The much larger mainstream faction of analysts and former government officials, however, see Kim Jong-Un as deterrable. War can, by-and-large, be avoided by implementing the policy of containment that kept the Cold War from going hot. North Korea needs to be convinced that any

use of nuclear weapons or invasion of South Korea would invite a devastating response. For a long period of time ahead too – *if ever*, Kim Jong-Un will not enjoy the requisite conventional forces superiority to translate his ambitions of unification into reality.

At the end of the day, it all comes down to whether or not Trump and his administration believes that Kim Jong-Un is deterrable.⁸ And if not, whether over the next few months he must be denied the combat-ready capability to strike the continental United States with a nuclear-tipped missile. One way or the other, the conduct of *both* parties over the next six months will go a long way towards answering this question.

Endnotes

¹ The “Key Resolve” and “Foal Eagle” drills are expected to be delayed until the end of the 2018 Winter Olympics and Paralympics in Pyeongchang, which end on 18 March 2018. Whether “Foal Eagle”, the combined field training exercise, will be truncated or toned down due to its late start remains to be seen.

² There are different views on this issue within the most senior ranks of the Trump administration. In a joint briefing to the U.S. Congress in early-September 2017, Defense Secretary James Mattis and Chairman of the Joint Chiefs of Staff, Joseph Dunford, laid Kim Jong-Un’s motivation to acquire a full-fledged nuclear strike capability down to his need to guarantee regime survival as well as a means to maximize his leverage prior to returning to the negotiating table. For their part, Mattis and Dunford framed U.S. strategy as: (a) putting maximum pressure on North Korea and China to negotiate an end to the North’s nuclear program, and (b) enhancing regional deterrence and strengthening missile defense systems in the area in the meantime, both to protect the U.S. as well as protect Japan and South Korea. Secretary of State Tillerson’s view that the U.S. is open to exploring “talks about talks” with North Korea without preconditions so long as (a) a request is made by Kim Jong-un or a senior representative directly to the US in this regard, and (b) North Korea commits to period of sustained cessation of nuclear and missile testing ahead of the talks and during these talks, also suggests that there are other senior Administration players who believe that diplomacy could provide an off-ramp from the tensions. An alternative view would be that this is a last-gasp effort to limit the DPRK’s crossing of the strategic deterrence threshold by way of diplomacy.

³ For what it is worth, rumors swirling in Washington D.C. suggest that Mr. Tillerson is on his way out of office and will be replaced during the early months of 2018 by Mr. Pompeo in the Secretary of State position.

⁴ As per the intelligence estimate, North Korea has successfully miniaturized a nuclear warhead, i.e. achieved the capability to build a nuclear bomb that is small enough to fit onto a delivery vehicle (missile). This estimate was produced before North Korea tested an underground nuclear device on 8 September 2017 that was many magnitudes the yield of the device detonated over Hiroshima.

⁵ It is interesting in this context to note that after the successful test-fire of the DPRK’s latest ICBM on November 29, the Kim Jong-Un regime announced that it had “finally realized the great historic cause of completing the state nuclear force.” Taken literally, it would mean that there is no reason to conduct a nuclear or ICBM missile test in the future and that, if the U.S. drops its stance of hostility, the DPRK is willing to return to the table of negotiations. U.S. technical experts are of the view however that the DPRK’s ICBM capability still suffers from technical glitches and that it will require a few more tests to iron these difficulties out. There is still some work to do before the “great historic cause of completing the state nuclear force” can be accomplished.

⁶ That Kim Jong-un is a rational actor and not an impetuous or reckless leader is also the consensus view of U.S. intelligence community. As a senior intelligence official explained, “rational actors have clear goals and know how they want to get there based on reality. He hasn’t demonstrated anything that would make one reconsider his rationality.

⁷ The severe hardening of the Trump administration’s stance against the DPRK in July 2017 calls into question the role Secretary of State Rex Tillerson’s assurances to the DPRK (and China) as well as his standing within the Administration. Prior to his trip to the ASEAN Regional Forum meeting in Manila in August 2017, Tillerson laid out the Four Noes policy: U.S. does not seek regime change, regime collapse, accelerated unification or an excuse to send troops north of the DMZ. By this time however, the White House had already shifted to the path of denying the Kim regime a combat-ready ICBM capability – come what may. There are three competing views of Tillerson’s role and standing. First, that he stands outside the White House’s circle of trust and is on his way out. He is a marginal figure and his pronouncements should be read in that light. Second, that he is very much a central figure within this Administration, on the DPRK issue at least, and that the White House (Trump/McMaster) and the State Department (Tillerson) are playing the ‘good cop/bad cop’ routine. Third, that there is indeed a brighter-than-anticipated, and coordinated, window of diplomacy in the offing. It is not a coincidence that Tillerson’s conciliatory overture on ‘talks about talks’ was preceded by a visit to Pyongyang (via Beijing) by the UN’s Undersecretary for Political Affairs and,

more intriguingly, by China's "temporary closure" of the Sino-Korean Friendship Bridge across the Yalu River as the North Koreans conduct maintenance-related repairs on their side. A brief shutdown of crude supplies by China in early-2003 is credited with having pushed Pyongyang to engage seriously with the Three-Party Talks that Beijing facilitated from April 2003 onwards.

⁸ As discussed, there are powerful voices for and against this view within Trump's cabinet and senior advisors.

Section 2: The South China Sea

What to Expect in the Asia Pacific Maritime Domain

By Nong Hong



Key Takeaways

- The South China Sea has enjoyed a period of relative calm since the election of President Rodrigo Duterte and the conclusion of the China-Philippines arbitration in mid-2016. That period of calm will hold in 2018.
- China-ASEAN relations, which are by far the most important determinant of peace and stability in the South China Sea, will continue trending in a positive direction. This should provide a boost to the on-going negotiations and consultations on the Code of Conduct (CoC).
- The South China Sea issue has become less prominent within the broader context of U.S.-China geopolitical competition in the Asia-Pacific, having taken a backseat to other more immediate concerns, such as the crisis on the Korean Peninsula.
- Beneath the surface, there are irritants that could complicate the management of the South China Sea. Foremost among them is the role of extra-regional actors, most notably the United States and its allies,

Japan and Australia. The U.S. Navy's Freedom of Navigation operations as well as its close-in reconnaissance and surveillance operations in the South China Sea will continue to remain a contentious issue in 2018.

- Should certain ASEAN countries, such as Vietnam, aim to take advantage of the relaxation of tensions through adversarial actions in the South China Sea, the region could yet again become a hotbed of geopolitical rivalry. Longer-term, the geopolitical competition between China and the United States will continue to set the stage for, and influence, the disputes in the South China Sea.

Code of Conduct

China and ASEAN are in the process of devising a forward-looking and multilayered Code of Conduct (CoC) for the South China Sea (SCS). 2018 will reflect a high degree of expectation from stakeholders in the region - and indeed the world - that progress will be made towards drawing up the contents of the CoC. Even with strong political will in place, the negotiations will encounter various obstacles, e.g. establishing the exact nature of the CoC; defining the applicable geographical area; whether the CoC should be a legally binding document with established dispute settlement provisions; etc. These obstacles reflect the differences among ASEAN member states on the one hand, and the divergence between China and other claimants on the other.

China is inclined to favor a multilateral mechanism which is applicable to the area surrounding the Spratly Islands, is limited to the concerned parties, and does not involve external stakeholders. It does not aim to resolve sovereignty or maritime jurisdiction issues through the CoC process. There are also differing points of view regarding the CoC's role within ASEAN. For instance, President Aquino III of the Philippines has said that he wants the CoC to serve as a dispute-resolution mechanism with legally binding force. And while Vietnam takes the same stance on the legal attributes of the CoC as the Philippines, it does not side with the Philippines on solving territorial and border disputes through a third-party mechanism. There are also long-standing differences among claimant countries regarding the relevant maritime space where the CoC will apply. China wants the CoC to only cover the Spratlys area; Vietnam seeks for the CoC to be applicable to the Parcel area as well. The Philippines hopes to extend the applicable area to Scarborough Shoal, and Malaysia has its own disputes with Vietnam. These conflicting interests and divergent viewpoints can only be addressed through patience and compromise.

In this context, setting the CoC as the cornerstone of the legal-cultural community of the SCS area could pave the way for the difficult negotiating process ahead. This is in accordance with the interest of both

For China, establishing an institutionalized set of rules for the South China Sea benefits its national interest and is consistent with its advocacy for international law.

China and ASEAN. For ASEAN, the SCS issue should not leave a negative impact on its economic integration and political cohesion. For China, establishing an institutionalized set of rules for the South China Sea benefits its national interest and is consistent with its advocacy for international law. ASEAN and China should work together to develop a broad consensus on the nature of the CoC, especially the functional extent,

geographic scope, and its legally binding obligations, as soon as possible. They should seriously consider a proposal to build a legally binding code of conduct to facilitate the resolution of lesser sensitive issues.

This mechanism could be applied to solve disputes other than territorial sovereignty and maritime delimitation, such as fishery disputes and maritime environmental issues.

Freedom & Safety of Navigation

For the United States, the Freedom of Navigation Operation Program (FONOP) is used to challenge territorial claims on the world's oceans and airspace that it considers to be excessive, using diplomatic protests and/or operational assertions. In some coastal states' view, including China's, by wearing the hat of "FONOP," the United States aims to secure its access and dominance in the South China Sea as well as balance China's power through intelligence gathering, surveillance and reconnaissance. The FONOP is a key tool for the United States to maintain its military and strategic dominance in the Asia-Pacific. In 2018, the United States will continue its FONOPs' in the South China Sea, while China will continue to protest them through diplomatic channels. Both countries will likely succeed in managing their differences and enhancing their maritime cooperation in the region, despite these conflicting views.

The most urgent challenge in this regard is to secure a safe environment for navigation in the South China Sea in 2018. In disputed waters pending maritime delimitation, confrontations between law enforcement agencies from claimant states and between government vessels and fishing vessels could lead to dangerous situations and trigger an outbreak of tensions. In 2018, China and ASEAN need to further demonstrate their commitment to apply the Code of Unplanned Encounters at Sea (CUES) in the South China Sea.



China and the United States should continue their efforts to reduce the risk of miscalculations and close encounters between naval ships and aircrafts. The respective strength of the Chinese and American navies in the region also puts them in a unique position to cooperate on providing enhanced search and rescue and humanitarian assistance in the South China Sea, a move that would strengthen the bilateral relationship between the two navies and their governments.

The Aftermath of the Arbitration

China's negative reaction to the Arbitral Tribunal's Award in favor of the Philippines will remain a sticking point in 2018. The Philippine government has so far chosen to forego near-term implementation of the "Award." Nevertheless, the possibility still exists that the arbitration case will be raised by the Philippines

as the domestic political climate shifts. Other claimant states who stand to benefit from the precedent established by the “Award” may make use of it too. Countries outside the region such as the United States, Japan and Australia will continue to push for its implementation. The forces from both within and outside the region will likely continue to gang-up together to “solidify” and “enforce” the “Award” on the diplomatic, legal and maritime fronts. This will continue to pose a pressing challenge for China as it attempts to move beyond the arbitration and make efforts to secure its rights in the South China Sea, promote maritime cooperation and advance negotiation and consultation of the CoC.

These judicial institutions have upset the regularity and legal stability that state parties had come to expect when they originally ratified UNCLOS.

Nationalism and public discourse will continue to play a large role when the strategic and political status quo in the South China Sea is challenged by external factors. The media will almost certainly continue to use a misleading narrative on China’s attitude towards international law, with attention grabbing headlines such as “China challenging rule-based order” in media coverage and analysis of the South China Sea arbitration. Far less attention is given to analysis which tries to bring a more balanced view to the table. ‘Transformation of ways of thinking theory’ should be introduced to policy makers and scholars who study the South China Sea, as a foundation to guide their policy and research. It is essential that diplomatic communities and academics are able to keep an open mind, be unbiased in their analysis, channel the power of nationalism towards productive ends and provide constructive research that can contribute to actually resolving the many disputes in the South China Sea.

The Debate Surrounding UNCLOS

In 2018, the effect of the debate surrounding the role of the United Nations Convention on the Law of the Sea (UNCLOS) will continue to influence dispute settlement practices in the South China Sea. Thus far, the SCS arbitration between China and the Philippines remains the first attempt by a claimant state in the South China Sea to resort to a third-party forum. Though the case failed to make a positive contribution to resolving the underlying dispute between the two claimant states, the legal implications surrounding it are as profound as they are controversial. Article 298 of UNCLOS allows states to opt out of the compulsory settlement mechanism in disputes related to sovereignty, maritime delimitation, and military activities, among others. This article was achieved through a lengthy negotiation process as a compromise to address the demands of some states that did not wish to address certain disputes through a third-party mechanism. In the SCS arbitration, the utilization of Article 287 in a case that clearly involved sovereignty and maritime delimitation has set a poor example that will undoubtedly serve to undermine the true spirit of the dispute settlement mechanism provided by UNCLOS.

More broadly, the arbitration case has shined a spotlight on the abuse of the sensitive issue of “judicial law making.” As a general practice when adjudicating a dispute, international institutions must identify, elaborate and apply relevant international laws and rules to eliminate the source of the dispute. Judicial interpretations should hew to the letter and spirit of the relevant laws and rules, and pay due regard to prevailing state practice. Disputant parties resort to international judicial institutions based on their trust in international law and their expectation of a fair redress of grievances. Of late, however, the principle of “judicial law making” in the international maritime jurisprudential space has been tarnished by the proclivity of UNCLOS-constituted judicial bodies to fashion fresh legal rules that depart from the intent of

the legal texts as well as prevailing state practices. In the process of doing so, these judicial institutions have upset the regularity and legal stability that state parties had come to expect when they originally ratified UNCLOS.

The geopolitical competition between China and the United States will continue to influence the South China Sea disputes in 2018, even though they no longer represent the top foreign policy priority in U.S.-China relations.

Another legal and policy area which deserves attention pertains to China's future trajectory regarding maritime dispute settlement. Will its conventional approach of bilateral negotiations and consultations remain its preferred method for settling inter-state disputes? Or will China come to accept that third-party resolution mechanisms have a useful – and perhaps even pivotal – role in settling

disputes with neighboring countries? The Arbitral Tribunal's ruling on the South China Sea provides an opportunity for China to rethink its traditional approach to dispute resolution.

China-U.S. Relations

Donald Trump's recent visit to the Asia-Pacific sent a clear message that the South China Sea was no longer the driving issue in U.S.-China relations, as it had been since 2010, when then-U.S. Secretary of State Hillary Clinton listed the South China Sea as the top U.S. national interest at the East Asia Summit in Hanoi. However, Trump's unpredictable comments, his offer to mediate these disputes, his failure to fill key Asia posts in his foreign policy team and his lack of a cohesive Asia strategy in general have unnerved allies who look to the United States to defend their interests.

During his trip to Asia in November 2017, Trump and his team repeatedly used the term "Indo-Pacific" instead of "Asia-Pacific" to describe the region, which some see as an effort to undermine China's role. In his speech, "Defining Our Relationship with India for the Next Century," at CSIS on October 18 2017, Secretary of State Rex Tillerson highlighted the role of India and frequently used the term of "Indo-Pacific." Though U.S. Department of State officials attempted to downplay the strategic goal behind the term "Indo-Pacific," many D.C.-based analysts share the view that America's 'Quad' plan with India, Japan and Australia is designed to counter China's geopolitical influence in the region.

In mid-December, the United States released its 2017 National Security Strategy, which referred to "rival powers aggressively undermining American interests around the globe." The report states, "[China's] efforts to build and militarize outposts in the South China Sea endanger the free flow of trade, threaten the sovereignty of other nations, and undermine regional stability" as part of "a campaign designed to limit U.S. access to the region." The Trump administration's report then proposes that the United States should seek to "uphold a regional order respectful of sovereignty and independence" in response, as well as "help South Asian nations maintain their sovereignty as China increases its influence in the region."

The U.S. Navy will likely conduct freedom of navigation operations more frequently in the South China Sea in 2018. Meanwhile, due to the significantly enhanced capabilities of its navy, and recently developed facilities and deployments on some of its South China Sea islands, China will be able to command more effective counter-measures against American military activities in these waters. It is safe to say that the

geopolitical competition between China and the United States will continue to influence the South China Sea disputes in 2018, even though they no longer represent the top foreign policy priority in U.S.-China relations.

China-ASEAN Relations



Since July 2016, the main developments in the South China Sea have been largely focused on the China-ASEAN relationship. This coincided with the arbitral proceeding coming to an end. In a statement issued by Rodrigo Duterte, the president of the Philippines and ASEAN Chair in 2017, he listed three major threats that ASEAN faces: terrorism, piracy & maritime armed robbery, and illegal drug trafficking. The disputes in the South China Sea were not included in this list of priorities. The Party Secretary of Vietnam, Tran Dai Quang, recently issued a statement that Vietnam hopes to settle its maritime disputes through peaceful negotiation. Lee Hsien Loong, Prime Minister of Singapore, coordinator of the China-ASEAN Dialogue and ASEAN Chair in 2018, praised the recent step taken by ASEAN and China to initiate the Code of Conduct negotiations. In the joint statement that was put out at the 50th ASEAN summit, all parties reaffirmed the importance of non-militarization and self-restraint in the South China Sea and stressed the importance of improving relations between ASEAN and China. In their joint statement, China and the Philippines noted that the situation in the South China Sea had become increasingly stable as a result of joint cooperative efforts between China, the Philippines, and other ASEAN states. They further agreed to strengthen maritime cooperation in areas such as marine environmental protection, disaster risk reduction, and possible cooperation in the area of marine scientific research. The Chairman's Statement of the 20th ASEAN-China Summit reiterated the commitment to the full and effective implementation of the Declaration on the Conduct of Parties in the South China Sea (DOC), and adopted the Leaders' Declaration on a Decade of Coastal and Marine Environmental Protection in the South China Sea, which is reflective of the shared commitment to implement the DOC and desire to transform the South China Sea into a sea of peace, stability and prosperity. China and ASEAN have agreed to start negotiations on a Code of Conduct for the South China Sea to ease regional tensions over territorial disputes in the area.

In 2018, China and ASEAN will continue this positive trend of maritime security cooperation through various institutions, e.g. ASEAN-China Dialogue, China-ASEAN Maritime Cooperation Fund, Belt & Road framework.

Among the Claimants

Vietnam has shown signs of moderating its policy in its South China Sea-related disputes with China, following the improvement of China-Philippine relations that occurred in the second half of 2016. China and Vietnam agreed to utilize the established border negotiation mechanism between the two governments and seek a fundamental and long-term solution to their maritime disputes in the South China Sea. This having been said, Vietnam's sincerity in following through on its pledges is open to question, given its quiet but unrelenting adversarial moves in the South China Sea. It continues to strengthen cooperation and coordination with the United States and Japan on South China Sea issues and has been actively seeking to create a favorable external environment for its own attempts to accelerate land reclamation in contested areas. This is a tactic known in ancient Chinese military doctrine as "feigning action in one place while making the real move in another."

Vietnam has also taken advantage of the opportunities provided by China's commitment to the CoC negotiation process with ASEAN to carry out unilateral oil and gas exploitation in the disputed areas of the Nansha islands. It has done so with the intention of presenting this as a *fait accompli* before the CoC consultation phase is completed. Vietnam has actively sought to strengthen its territorial claims by expanding its *de facto* control of certain disputed waters through a variety of approaches, such as fishery operations, marine scientific research, resource development, and law enforcement. It has also invested significant sums on public discourse management and international relations campaigns, including in Washington, D.C., to garnish international support for its claims.

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As for the Philippines, over the year that has passed since the "arbitral award" was rendered, it has moved rapidly to normalize its relations with China. The two countries have established an inter-governmental consultation and negotiation mechanism to manage their South China Sea disputes and bilateral cooperation on law-enforcement mechanisms and fisheries have made significant progress. However, Duterte's outreach to China and his abeyance on the arbitral decision has been met with great resentment and resistance within sections of the Filipino political establishment. There have been constant calls for Duterte to resist China's economic "lure" and insist on enforcing the award. Meanwhile, the U.S.' and Japan's behind-the-scenes support to these opposition forces against Duterte's South China Sea policy should not be overlooked. Therefore, despite the continued improvement in China-Philippine relations, the bilateral consultations independent of the arbitral award, and the promotion of bilateral maritime cooperation, China-Philippine relations will not necessarily be headed for a period of smooth sailing in 2018.

With regard to Taiwan, the concept of "Taiwanese independence" will continue to be the guiding principle for the policies of the Tsai Ing-wen government. Under the concept of "Taiwanese independence" and the

“New Southbound Policy,” Tsai’s SCS policy will continue to drift further away from that of the Chinese mainland. Her willingness to compromise the Ma Ying-jeou government’s resolute stance on fisheries and related sovereign rights issues with Japan to placate Tokyo and thereby rebalance its regional relations, could be a harbinger of future policy actions. While the Tsai-led authorities in Taipei cannot entirely disregard the SCS disputes, it is possible that they could try to bolster its independence-leaning aspirations by introducing SCS policies that diverge from, or are entirely contrary to, that of the Chinese mainland.

As China continues to develop its islands and reefs in the South China Sea, promote maritime cooperation, and engage in the CoC negotiations, several issues will rise to the fore and become the focal points of contention. These include the legal status of the developed features, the scope of the “disputed areas” in these waters, the definition of “historic rights,” the legal implications of the DOC, and whether or not judicial processes should be prioritized in resolving the SCS disputes.

Non-Claimant Players

The Trump administration has revived the decade-old geopolitical concept of the “Indo-Pacific” region and is promoting a so-called “Quad” — a potential security arrangement among the four large democracies of India, Australia, Japan, and the United States. Given the dominant maritime nature of the Indo-Pacific, and given that all four prospective members are sea-going powers, any security arrangement would likely be focused on cooperation in the maritime sphere. Indeed, the Quad concept is driven in part by developments in the South China Sea. The contest there has become a “symbol of China’s inexorable rise.” Moreover, if such an arrangement materializes, it would have significant implications for relations between China, the other claimant states, and outside powers involved or those who are considering getting involved.

As key military allies of the United States with a penchant for intervening in the region’s affairs, Japan and Australia will continue to play an unhelpful role in the South China Sea in 2018. The Abe government in Japan has been a persistent factor in stirring up the SCS disputes and hampering the cooperative management of the underlying disputes. In 2018, Japan is likely to further interfere in the security and politics of the South China Sea through such means as Maritime Self Defense Force (MSDF) port visits, joint military drills, and provision of military and law enforcement equipment to littoral states as well as by pushing for anti-China language in joint statements on SCS issues via multilateral mechanisms. Meanwhile, it will keep sensationalizing sensitive issues, such as China’s facility deployments, its maritime militia, and its Air Defense Identification Zone so as to fabricate a pretext to justify and normalize its military’s presence in the South China Sea.

Australia has also developed a track record of interfering in South China Sea issues that it is not a party to — although it has mainly done so through diplomatic and political means. For example, in his address to the 2017 Shangri-La Dialogue, Australian Prime Minister Malcolm Turnbull asked China to uphold the “rule of law” and called for the preservation of the “rules-based order.” At the ARF Foreign Ministers’ Meetings in 2016 and 2017, Australian foreign minister Julie Bishop echoed the sentiments expressed by the United States and Japan in calling on China to abide by the decision of the Arbitral Tribunal. This insistent demand was repeated again in its newly-released Foreign Policy White Paper in December 2017. Australia, along with Japan, is also an avid supporter of the recent U.S. “Indo-Pacific Strategy.”

Conclusion

Since the election of President Rodrigo Duterte and the conclusion of the China-Philippines arbitration in mid-2016, the South China Sea has enjoyed a period of relative calm. That period of calm and continuity will likely hold in 2018. China-ASEAN relations, which are by far the most important determinant of peace and stability in the South China Sea, are expected to continue trending in a positive direction. This should provide a boost to the on-going negotiations and consultations on the Code of Conduct (CoC). The SCS issues have also become less prominent within the broader context of U.S.-China geo-political competition in the Asia-Pacific. Nevertheless, lurking beneath the surface are irritants that could complicate the management of the SCS issues. Foremost among them is the role of extra-regional actors, most notably the United States and its allies, Japan and Australia. The U.S. Navy's Freedom of Navigation operations as well as its close-in reconnaissance and surveillance operations in the South China Sea will continue to remain a contentious issue in 2018. Should certain ASEAN countries, such as Vietnam, aim to take advantage of the relaxation of tensions through adversarial actions in the South China Sea, the region could yet again become a hotbed of geo-political rivalry.

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Section 3: U.S.-China Trade

Expect Heightened Tensions in the First Half of 2018

By Sourabh Gupta



Key Takeaways

- With a large bilateral trade deficit and little to show in terms of progress within the U.S.-China Comprehensive Economic Dialogue (CED) process, U.S.-China trade ties are headed for a period of elevated friction during the first half of 2018. **President Trump is expected to pivot away from his mainstream economic advisors on China trade policy** (Gary Cohn, Steve Mnuchin, Wilbur Ross) during the first half of 2018 **and embrace the economic nationalist - and unilateralist - recommendations of U.S. Trade Representative (USTR) Robert Lighthizer, which align closely with the president's views.**
- **The upcoming completion of two key China-related investigations will likely provide the platform for a tougher Trump administration stance towards China.** The **Section 301** investigation of Chinese technology transfers, intellectual property rights (IPR) and innovation practices, which is due during the first half – and perhaps first quarter - of 2018, will serve as the key vehicle for this policy shift. Although, USTR has until August 14, 2018 to conclude this 'self-initiated' investigation, **it will be concluded much in advance and, on balance, will likely result in the imposition of unilateral – and perhaps significant - trade enforcement measures against China.**

- The other key investigation – regarding whether steel imports constitute a threat to U.S. national security (**Section 232 investigation**) – **is unlikely to result in the imposition of trade remedy measures.** With the U.S. Department of Defense demanding extensive carveouts from remedy measures that effectively defeat the purpose of the Section 232 investigation, **the administration is instead likely to turn towards ‘self-initiating’ anti-dumping and countervailing duty cases involving Chinese exporters with greater frequency.**
- The Trump administration made a **series of troubling trade policy moves** during the last two months of 2017, which suggest that the groundwork is being laid for a toughened stance on trade with China. When the Section 301 and Section 232 investigations as well as other China-related cases come due, and decisions on enforcement measures are being made, these policy actions will feed into that decision-making process.
- **Currency and foreign inward investment** concerns will remain a second-tier concern in U.S.-China relations during this period. It is worth noting that measures which subject Chinese inward investment and acquisitions proposals to heightened intra-agency scrutiny will, nevertheless, likely advance in the U.S. Congress, and become a first-order issue during the second half of 2018.

The Elevation of Robert Lighthizer within the Trade Policy Debate

The **renegotiation of the North America Free Trade Agreement (NAFTA) will be the Trump administration’s single most pressing trade policy agenda item during the first half of 2018.** In April 2018, Congressionally-delegated Trade Promotion Authority (TPA) will expire - unless reauthorized. In July, Mexico will hold presidential elections and the current frontrunner, Andres Manuel Lopez Obrador, is a populist, left-leaning candidate who has called for NAFTA renegotiations to be suspended until the elections. Unless significant progress is made during the first quarter of 2018 – *and at this time the renegotiations are proceeding poorly*, Donald Trump is expected to issue the required 6-month prior notice of withdrawal from NAFTA. **In any case, the renegotiations will significantly tie-up USTR’s bureaucratic resources during this critical period.**

Unless significant progress is made during the first quarter of 2018 – and at this time the renegotiations are proceeding poorly, Donald Trump is expected to issue the required 6-month prior notice of withdrawal from NAFTA.

Next to the NAFTA renegotiations, U.S.-China trade relations will be the Trump administration’s other most important trade policy agenda item during the first half of 2018. With a large bilateral trade deficit and little to show by way of progress within the U.S.-China Comprehensive Economic Dialogue (CED) process, **bilateral ties are headed for a period of elevated friction during this period.** Bilateral ties were last headed towards a period of tension at this time last year when President-*elect* Trump vowed to get tough on China for its supposedly unfair trade and currency practices, which he claimed had led to a large U.S. trade deficit with China. The tensions were averted following a successful summit at Mar-a-Lago, where President Trump resolved to give his

mainstream economic advisors on China trade policy (Gary Cohn, Steve Mnuchin, Wilbur Ross) an opportunity to rectify the imbalances in the bilateral economic relationship through negotiations, and other, less aggressive means.



These approaches have largely failed, and **President Trump will likely pivot away from the policy recommendations of his mainstream economic advisors** during the first half of 2018. Instead, he will likely adopt **the views, and recommendations, of USTR Robert Lighthizer**.¹ In fact, there are indications, ranging from Lighthizer's prominent role during delegation-level talks during Trump's Asia-Pacific trip to his unique role during the drafting of the administration's recent *National Security Strategy*, that this shift has already occurred.

Lighthizer's economic nationalist, and unilateralist, views align closely with President Trump's own leanings - and Candidate Trump's campaign promises - on the need to impose punitive trade enforcement measures on China to address the bilateral deficit. Lighthizer's trade policy objectives vis-a-vis China revolve entirely around protectionism: strengthening trade remedies laws; providing safeguards relief to industry; treating China as a non-market economy for anti-dumping purposes; and bringing additional cases against China at the World Trade Organization (WTO). **Alarmingly, Lighthizer has strongly suggested that the United States might ignore a WTO ruling if it were to favor Beijing in a China-related 'non-market economy' and/or anti-dumping case.**² His recommendations following the Section 301 investigation on China's IPR practices will likely reflect these unilateralist and protectionist beliefs.

Key On-Going Enforcement-related Investigations

SECTION 301 IPR Investigation: On August 14, 2017, USTR Lighthizer 'self-initiated' an investigation of Chinese technology transfers, intellectual property rights (IPR) and innovation practices under Section 301 of the Trade Act of 1974.³ **Under the statute's timeline, USTR has until August 14, 2018 to submit its report.** Although it has been less than 150 days since the investigation was launched, there are already signs that the administration could release its conclusions and move into the remedy phase of the probe during the first half – or even first quarter – of 2018. **A draft report has been completed which is now being shared within the interagency committee overseeing the investigation.**

The speed with which the investigation appears to have moved ahead is not surprising. USTR releases a **'Special 301 Report' on an annual basis**, and the 2017 edition had a 10-page section devoted to China. China is a 'Priority Watch List' country, according to USTR's global classification of countries' IPR practices. China's IPR practices are also routinely surveyed – and criticized – in the **annual National Trade Estimate Report on foreign trade barriers**. Hence, compiling the Section 301 draft so quickly is not unexpected.

Since the late-1990s, USTR has interpreted Section 301 to require that any alleged violations of U.S. rights first be taken up within the WTO's dispute settlement mechanism. As such, USTR has not imposed unilateral sanctions under Section 301 authority since the late-1990s. Instead it has taken its case to the WTO Dispute Settlement Body (DSB). It remains to be seen if USTR Lighthizer will follow this precedent. **The prevailing consensus is that he will do exactly the opposite and propose harsh unilateral Section 301 trade enforcement measures against China.** These remedies *might* be announced as early as the end of the first quarter of 2018 and will likely be heavy-handed. If so, it will almost certainly elicit a retaliatory Chinese response.

If USTR Lighthizer does follow precedent (which is not likely) and initiates an IPR-related Section 301-based case at the WTO's DSB, USTR could argue that as per China's accession commitments 'enforcement is supposed to mean enforcement' and China – by tolerating the wide infringement of IPR laws that exist on the books – is failing to meet its positive WTO enforcement-related obligations. Another basis for challenge is that China, by coercing foreigners out of their IPR rights, is failing to administer its laws and regulations in an "impartial" and "reasonable" manner, as required by the WTO. **It remains to be seen if USTR can construct a credible case, and it is by no means certain that it can. If it could, it would have brought a slew of cases much earlier on.** For instance, in related areas where it had a robust case, such as electronic payments, USTR did not hesitate to bring its case to the WTO, and proceeded to win a favorable award.

SECTION 232 Steel Investigation: On April 20, 2017, the Trump administration initiated a sweeping investigation to determine whether Chinese steel imports threaten American national security.⁴ **Under the Section 232 timeline, the U.S. Commerce Department has until January 14, 2018 to submit its report with recommendations to the president.** The operating assumption in Washington is that Secretary Wilbur Ross at Commerce has waited to release the report until *after* tax reform legislation was passed. With Republicans holding a razor-thin majority in the U.S. Senate, the Trump administration did not want to lose any Republican votes arising from China's retaliatory threat of action in case Trump imposed remedies on imported Chinese steel.

In fact, the Section 232 investigation appears to have run into trouble within the U.S. inter-agency vetting process. **The main objection has been put forward by the U.S. Department of Defense (DoD). DoD's main objection is that the trade restrictions proposed by the Commerce Department in the draft report would contravene defense sector agreements that the United States has with many of its allies and would unnecessarily damage these alliances.** These agreements aim to promote standardization in both countries' procurement of defense equipment by waiving U.S. restrictions on imported inputs and goods from that ally which are used in military applications - thus easing their access to the U.S. defense market.

As such, DoD has asked for significant carveouts for its allies, and the **Commerce Department is currently considering remedy exceptions for Australia, Mexico, Canada, the United Kingdom, Japan and South Korea.** However, **these carveouts will defeat the very purpose of the Section 232 investigation.** China only provides three percent of all U.S. steel imports. In fact, China did not even break into the top 10 sources of U.S. steel imports in the first half of 2017. Of the top 10 steel exporters to the United States, half are countries with which the United States has mutual defense agreements. Canada

provides 17 percent of U.S. steel imports, and Germany, South Korea, Taiwan and Japan are all bigger suppliers than China.

If the Section 232 steel investigation ultimately turns out to be a flop, **the Trump administration will most likely turn towards ‘self-initiating’ anti-dumping and countervailing duty (AD/CVD) cases against non-allied foreign exporters, including China, with greater regularity.** Both Robert Lighthizer (in the Section 301 instance) and Wilbur Ross (in the aluminum alloy sheets anti-dumping instance – *see next section*) have shown that they are not shy to self-initiate cases. Categories of domestic steel products that are under the greatest import pressure will be provided temporary protection through AD/CVD duties. Government procurement (Buy American) laws could also be passed requiring DoD to purchase steel-based products from manufacturers that are part of America’s technology and industrial base.

Hardening Trade Policy Actions

During the last two months of 2017, the Trump administration took a number of troubling China-related trade policy steps – some of which will feed into the decision-making process when the Section 301 and Section 232 investigations come due and decisions on enforcement measures are made.

On November 28, the U.S. Commerce Department announced a **‘self-initiated’ anti-dumping investigation into imports of common aluminum alloy sheets from China. This is the first such self-initiated case in 25 years.**⁵ The Commerce Department will treat China as a ‘non-market economy,’ while computing production costs to determine fair market value for the (supposedly) dumped products. Using the ‘non-market economy’ methodology in anti-dumping cases after December 11, 2016 (the 15-year anniversary of China joining the World Trade Organization) is contrary to the U.S.’ WTO obligations. **The ‘self-initiated’ investigation will most-likely be the first of many such ‘self-initiated’ anti-dumping and countervailing duty (AD/CVD) investigations by the Commerce Department.**



During the last week of November 2017, USTR laid out a detailed legal argument for continuing to treat China as a ‘non-market economy.’⁶ The legal justification was laid out in a third-party submission that sided with the European Union (EU) in a WTO case that was brought against the latter by China. **The essence of USTR’s argument is that Article VI of the *General Agreement on Tariffs and Trade (GATT)* – and not *China’s WTO Protocol of Accession* – provides the authority to reject home market prices and costs in anti-dumping cases if those data are not determined under market economy conditions. In USTR’s view, expiration of Section 15(a)(ii) of China’s WTO Accession Protocol only requires the defendant**

country (in this case, the EU) to bear the burden of providing the evidence that the Chinese industry in question does not operate on market principles. This interpretation will almost-certainly be challenged at the WTO.

On October 26, 2017, the Commerce Department laid out a **200-page memo titled “China’s Status as a Non-Market Economy” (NME), arguing that China is not a market economy under U.S. law for anti-dumping purposes.**⁷ Commerce conducted a six-factor analysis of key aspects of China’s economic structure to support its case: of China’s currency convertibility regime; its wage determination regime; foreign inward investment regime; SOE regime; industrial policy regime; and legal system. **The purpose of this memo is to provide that burden of proof regarding China’s NME status, consistent with USTR’s interpretation of Section 15(a)(ii) of China’s WTO Accession Protocol.** When China files a case against the United States at the WTO in 2018 against the latter’s non-compliant use of the NME methodology in the context of an anti-dumping-related legal challenge, USTR will use this memo as a basis to construct its legal argument.

The sentiment against Chinese acquisitions in the United States is on the rise, and China-related inward investment concerns will become a first-order issue during the latter half of 2018.

On November 30th, the 33 countries participating within the G20-initiated **Global Forum on Steel Excess Capacity** issued their final report in Berlin, which outlined six guiding principles to reduce overcapacity in the sector. **The United States expressed disappointment regarding the results** and, on December 12th along with the EU and Japan, **announced a new trilateral cooperative front to challenge overcapacity in China’s steel sector, as well as the state financing and subsidies that fuel it.** America’s unfavorable view of the deliverables coming out of the G20s Global Forum on Steel Excess Capacity will have a significant impact on on-going and future steel trade remedy cases, including the Section 232 steel investigation.

On October 17th, the U.S. Treasury Department released its most recent semi-annual currency report.⁸ **No country was listed as a ‘currency manipulator,’ although five countries, including China, were placed on the Monitoring List.** China should never have been placed on this list for the simple reason that China did not meet two of three criteria to be placed on the list. It was nevertheless listed because the size of the bilateral goods trade deficit continues to be disproportionately large. **This pattern of being placed on the Monitoring List, but not being declared a ‘currency manipulator’ is expected to remain unchanged during the next semi-annual cycle in Spring 2018.**

On November 8th, the **Foreign Investment Risk Review Modernization Act - a bill to review, upgrade and expand the scope of CFIUS (Committee on Foreign Investment in the United States) was introduced in Congress.**⁹ The bill aims to markedly augment the oversight of, both, inward investment and acquisitions of U.S. companies by Chinese entities, as well as restrict China-destined *outward* investment and technology transactions by U.S. firms. Both Defense Secretary Jim Mattis and Treasury Secretary Mnuchin, the nominal head of CFIUS, have endorsed this legislation. The legislation is currently being deliberated on and is facing scrutiny regarding its overly-expansive mandate envisioned for CFIUS. In its current form, it is unlikely to become law. **This having been said, the sentiment against Chinese acquisitions in the United States is on the rise, and China-related inward investment concerns will**

become a first-order issue during the latter half of 2018. Chinese companies' bids for U.S. firms that are currently on CFIUS' radar are expected to remain on hold or be rejected in the interim.

The Trump administration did not file any WTO cases against China in 2017, despite his campaign promise to "bring trade cases against China both in this country and at the WTO." By contrast, the Obama administration had launched four cases against China during its final year in office. The Trump administration did initiate 82 anti-dumping and countervailing duty (AD/CVD) investigations during its first year, a sharp increase from 2016, and the most in at least a decade. A number of those AD/CVD cases were directed against Chinese exporters, including the first 'self-initiated' probe in 25 years.

Conclusions

U.S.-China trade and investment ties are re-entering an elevated phase of friction. As early as mid-January, the remedies that President Trump will impose in a **Section 201 Safeguards case related to solar cells and modules** is expected to be announced.¹⁰ Already, the ground is being cleared for a defense of the expected remedy and the subsequent Chinese case challenging the remedies at the WTO. On December 27, 2017, the U.S. International Trade Commission (USITC) laid out legal reasonings alleging China's state-driven subsidization and alleged non-compliance with WTO obligations as an "unforeseen development" that contributed to the surge in solar imports and subsequent injury to U.S. industry. Separately, in late-December, **a bid by Ant Financial Services Group, an affiliate of the Chinese tech giant Alibaba Group, to acquire the U.S. financial services firm, MoneyGram, was called off** due to inability to satisfy national security-related concerns put forth by CFIUS.

The sheer volume of these and other aggressive trade and investment policy actions in advance of the completion of the various China-focused investigations do not bode well for the bilateral relationship. Robert Lighthizer's recently upgraded role in the Trump administration is a particularly ominous sign of things to come. Although nothing is set in stone, the first half of 2018 will likely witness a period of elevated friction in U.S.-China bilateral economic relations.

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