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White Paper

GEOIntelligence

This GEOIntelligence White Paper is part of a series designed to equip leaders with methods to enhance strategy development and execution. It integrates military and business analysis models to provide strategic assessment, planning, and risk management. There will be future reports on other international challenges in the coming months.

This report is a continuation from last month's White Paper on China's Strategic Positioning. Please see: Bancroft GEOIntelligence White Paper on China's Strategic Positioning.

Most analysts agree China's fundamental aim is to supplant U.S. ideological, economic, and political dominance; first regionally, and eventually globally. Many of President Xi's endeavors confront U.S. ideological, economic, and political dominance simultaneously, to attempt to diminish the U.S. "brand," while enhancing that of China. Already a significant regional military power, China's economic growth has enabled it to become an expanding power.

In this vein, with China as a major player in the global economy, there is both opportunity and threat. The key takeaway is to have an informed mindset and approach on how to invest, sell, and manage business relationships in the market, consistent with risk appetite.

This report provides a framework for corporate leaders to assess China. As mentioned last month, there are four relevant tools or approaches that intersect for senior leaders to use when considering how to navigate strategic challenges regarding China; the four methods are:

- Political, military, economic, social, information, infrastructure, physical space, and time (PMESII-PT).
- Porters 5 Forces: supply power, buyer power, competitive rivalry, new entrants, and substitutes.
- Organizational Risk Frameworks that use criteria specific to business and industry.
- SWOT, or Strengths, Weaknesses, Opportunities, and Threats analysis.

This follow-on report deep dives into the four models as it relates to last month's paper on China Positioning.

PMESII-PT Model:

This lens looks at the interaction of the elements of national power and operational "systems of systems" in which stakeholders (governments, companies, associations, alliances, partners, individual actors) conduct business and consider their strategic and operational interests in decision making. Examples of PMESII-PT considerations include:

- **Political:** The People's Republic of China (PRC) continues its aggressive and coercive pressure in the South China Sea and on several nations, companies, and individuals. Additionally, China's recently enacted national security laws require its citizens and government-owned enterprises to provide the PRC any data to which they have access. This law poses a political, economic, social threat to the sovereignty of nations and proprietary business intelligence. Additionally, it creates infrastructure, physical, and social networks that provides direct and indirect access to the PRC that would violate national sovereignty and legal privacy rights that are normal expectations of free market and democratic societies. There are also examples where the PRC uses this practice to limit access of foreign entities even under conditions that would be considered due diligence activities.

- **Military:** China continues to invest heavily in its military with its expansion in maritime, space, cyber, and nuclear capabilities. This includes heightened air, naval, and coast guard activities aimed at intimidating Taiwan and the Philippines, and disrupting freedom of navigation in international waters of the South China Sea that it believes are within its illegal territorial boundaries.

- **Economic:** China's economic environment draws investors due to the low cost of labor, growing middle class demand for goods and services, and limited environmental regulations. President XI's domestic strategy is to produce and consume goods and services within China while continuing to support China's interest in gathering natural resources and data from external sources for domestic consumption and exercise of power. This trend is a high-risk threat to foreign investors who desire to maintain ownership of their intellectual property in domestic and global markets.

- **Social:** The PRC has managed to impose a strong sense of compliance throughout its population along with silencing Uyghurs Tibetans, and other ethnic groups who have suffered through oppression and "re-education" programs of the PRC government. Education and commitment to innovation for the state versus the individual or group is incorporated into the values and beliefs of the society and exercised through stringent state controls.

- **Information:** The information domain plays a central role in the PRC quest for domestic, regional, and global dominance. Xi regards data as a "factor of production" similar to oil, energy, and other commodities. The PRC leadership perceives information as a domain of struggle and competition and use it as a strategic, operational, and tactical weapon. This approach erases the distinction between government and private sector, targeting both foreign and domestic entities and information sources. As a result, doing business with China presents an increasing risk, invoking the principal of "Caveat Emptor" (buyer beware).

- **Infrastructure:** The PRC is reducing foreign-owned entities to lessen their influence in China. At the same time, China continues to exercise its influence through Belt and Road Initiative infrastructure investments and ownership of overseas property. Property rights by the PRC are viewed as something in the purview of the state. The PRC has the right to own property, and its citizens and corporations can own property to the degree allowed by the state, but in support of the PRC national goals and interests. By extension, this "everything belongs to the state" perspective even applies to the justification for the purchase of overseas property and the theft of intellectual property. Rule of law can be overlooked if it is in support of increasing the power of the state (the PRC).

- **Physical Space:** The PRC map, already problematic, "9 dash line" recently expanded to its "10 dash line" version and highlights the PRC view of its presumptuous and ever-expanding geographical boundaries throughout the Pacific. PRC-drawn national boundary maps dismiss international norms while empowering self-approved legitimacy to intimidate its neighbors such as the Philippines in the Spratly Islands, Vietnam in the Parcel Islands, India in the Aksai Chin, and the Arunachal Pradesh regions.

- **Time:** The PRC has a very long-range strategy focused on years and decades that is inclined to be discounted or dismissed by free market leaders, who are generally more focused on the short term. The Chinese look at time as being on their side and will reap strong dividends in the future.

Porter's 5 Forces:

From a business strategy perspective, the classical strategic model of Porter's 5 Forces shows how China's power has been on the rise over the past decades.

- **Supplier Power:** China has been the top exporter to the United States with $300 billion to $350 billion net annual export trade imbalance over the past several years (per the U.S. Census Bureau). China's labor markets and overall lower cost to produce has driven significant demand and dependence by U.S. and free market nation companies across multiple sectors. The COVID-19 pandemic, with its supply chain disruptions, emphasized risk concentration. Industries from technology, healthcare, apparel, and machinery were impacted by supply chain disruption. The risks are especially pronounced in technology, with the supply of rare minerals necessary for information technology components controlled by the Chinese, and China's proximity to countries that produce a significant volume of microchips, including Taiwan and the Republic of Korea. This risk with China inspired the U.S. Chips Act to incentivize U.S. production of microchips in the United States.
- **Buyer Power:** Lower cost products have been in high demand by free market public and private sectors during the pandemic and post-COVID 19 recovery period causing a subsequent inflationary period across the globe. This demand increase, coupled with Chinese supplier power, increased risk concentration. China's pricing strategies to drive global prices down through supply and demand forces caused the U.S. to enact tariffs in certain product categories to protect the U.S. markets through presidential executive orders. The executive orders were focused on solar and Electric Vehicle products that point to longer-term strategic areas and not just temporal supply and demand imbalances.
- **Competitive Rivalry:** U.S. and free market nation companies have tried to leverage the cost arbitrage of Chinese production to remain price competitive through their end products or component parts. Pandemic supply disruptions and recent government sanctions designed to protect U.S. manufacturers have presented significant headwinds to their low-cost strategies during the current inflationary period. The offshore concentration for many companies has caused them to consider alternative supply chains including on-shoring, near-shoring, and other alternative lower labor cost countries to mitigate and augment production risk. These strategies take time to implement and include start up investments and higher overall operating costs. Additionally, depending on the targeted country and its relationship or proximity to China, the mitigation may only be temporal.
- **New Entrants and Substitutes:** Given the scope and magnitude of China's production imbalance there are limited potential new entrants and substitutes to supply chains in the near term. Businesses have looked to Mexico, Vietnam, and the Philippines as potentially strong low-cost alternatives. However, China's shadow over the Asia Pacific Region and its $100 billion trade surplus (per the Statista Research Department) with Mexico may be difficult to avoid without transformative actions like onshoring or developing other alternatives across the globe. For example, Reuters reported last June that in addition to the U.S. Chips Act, which has already enabled investment in Texas starting this year, Apollo Global Management has announced a joint investment with Intel for a chip fabrication factory in Ireland.

In summary, China's strategy in responding to international pressure seems to be the "deny everything, admit nothing, and launch counter accusations" approach to diplomacy. Therefore, de-risking in the South China Sea may be best characterized by looking for new production capacity elsewhere. China is treating current investments as a sunk cost to maintain access in its domestic markets, while securing production and expanding markets to neighboring nations such as India and the ASEAN nations.

The U.S. and its allies have multiple tools to lever in its national security interests relative to China led by economic tools that will impact business strategy for companies. Depending on a company's exposure, the impacts on business strategy and investments may be significant.

Organizational Risk Frameworks:

Corporate Boards and C-suite leaders will have criteria specific to their organization, industries, and stakeholder priorities that inform their risk tolerance, decision making, and policy development. A notional example of organizational risks associated with doing business with the PRC include:

- **Operational:** Disruption of supply chains is a risk due to PRC decisions to curtail or slow supplies of processed rare earth elements necessary to produce computer chips and industrial magnets.
- **Legal:** Theft of intellectual property by a PRC state-owned company is a norm as they rebrand, repackage, and bring to market for sale, as if it was an original product of a domestic PRC organization or network.
- Third Party: Outsourcing production and services to a third-party vendor that uses products or services of a PRC state-owned company provides the PRC government access to proprietary data and intellectual property.
- **Cyber:** Networks face both direct and indirect threats due to interdependencies of financial data that is accessible to the PRC. Despite sophisticated firewalls and enterprise risk controls; espionage, firewall breakthroughs, and direct cyber-attacks originating from the PRC and government-owned company proxies are a norm in most industries.
- **Reputation:** Any entity doing business with the PRC puts their market-trust reputation at risk when investing in and doing business with the PRC, its government-owned companies, and PRC expatriates subject to national security laws about access to data outside national boundaries.

SWOT (Strengths, Weaknesses, Opportunities, and Threats):

Using a Geo-Intel Dynamic Risk Assessment model enables Board Directors and C-Suite leaders to ask the informed questions necessary to make more effective risk-informed strategic decisions.

The following is a brief example of how to apply a SWOT analysis to China that considers the interdependencies of the PMESII-PT, Porter 5 Forces, and Organizational Risk frameworks.

Strengths:

- Dependency by the world for China's products, components, and rare minerals.
- Data accumulation associated with global exports and financial transactions.
- Demand from Russia, Iran, and North Korea for its products.
- Proximity to Asia Pacific supply chain alternatives.
- Military capability to disrupt throughout the South China Sea and broader Pacific.
- Potential to control Taiwan and threaten South Korea through North Korea.
- Military and economic policies are integrated and coordinated.

Weaknesses:

- Intellectual property and innovation led by the free market societies.
- China's wealth and stability is dependent to free market nations.
- Alliances with Russia, North Korea, and Iran are less stable.
- Lack of parity with free market alliances.
- Distrust of PRC - disregard for rule of law and property rights.

Opportunities:

- Reorder global power by taking advantage of current global instability and flashpoints.
- Strengthen its global power through access to and amassing of data and IP.

Threats:

- Military and economic aggression limits participation in global financial markets, innovation, and research.

Implications and Forecast:

- China's strategy is to reorder world influence through its current strengths in next generation technologies such as rare minerals, proximity to microchip production, and low-cost labor.
- China's military and economic strategies are aligned; its aggression toward Taiwan and its developing relationship with North Korea provide insight to its focus on technology hubs.
- China's laws regarding data access highlights the importance of data in training AI models.
- U.S. and its free-market governments and private sector organizations already have large investments and dependency in China, which limits their flexibility in the near to mid-term.
- China is dependent on the U.S. and its allies for sales of its goods, financial resources, and IP.
- The U.S. and its allies need to be aware and intentional about their strategies for dealing with China and its companies.
- Derisking options from China can be evaluated through the dynamic Geo-Intelligence (e.g. PMESII-PT, Porter, Organizational Risk Frameworks, and/or SWOT) models to enable risk informed decisions about supply chains, near-term and long-lead investments in raw materials, property, plant, equipment, and access to labor to stay competitive in current markets and shape the landscape for competing effectively in emerging markets.

Economic Perspectives:

China's global power aspirations pose a major national security and global economic risk for the U.S. and free-market economies. The PRC's military aggression to control the South China Sea, threats to Taiwan, intimidation of the Philippines, and supporting North Korea, which is placing pressure on the Republic of Korea, are all threats to free-market countries and supply chains. In addition, the PRC has been supporting Russia in its war with Ukraine.

China's strategic position as a key supplier to global markets for low-cost finished consumer goods, critical components and rare minerals in the technology, machinery, and healthcare sectors provides significant global influence.

China's increasing aggression in the Asia Pacific Region, home to the largest global concentration of micro-chip foundries in Taiwan and Republic of Korea, poses a long-term risk for the technology sector.
China is the second largest economy in the world, which is an attractive market for free-market nation companies to sell to and invest in. China's strategy and disregard for property rights, IP, and data privacy must be considered in the decision making by free-nation companies.

The strategic conundrum for foreign investment in China lies in balancing the market attractiveness with apprehension regarding regulatory and business practices. Many large free-market nation companies are already invested in China with financial assets or operations. De-risking methods range from establishing physical, virtual, and legal firewalls to protect current interests and shift investments outside of China and its intrusive policies.

Companies are encouraged to map supply chains, product elements, financial investors, as well as information technology interfaces to assess the overall risk. This situation analysis can then provide the basis for strategic options and feasibility of strategic pivots.

China is a major player in the global economy. It provides both opportunity and threat. The key takeaway is to have an informed mindset and strategy on how to invest, sell, and manage business relationships in the market, consistent with risk appetite.