

S E C O N D L I N E O F D E F E N S E



# STRATEGIC INFLECTION POINTS

THE MALMGREN★LAIRD REPORT

*Focusing on Strategic Change & Discontinuity*



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# Strategic Inflection Points #1

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## The Focus of the Reports

Inflection points are events or situations that can lead to significant change in the development of a company, industry, sector, economy or geopolitical situation. An inflection point can be considered a turning point after which a dramatic change, with either positive or negative results, might well result.

Andy Grove, Intel's co-founder, described a strategic inflection point as "an event that changes the way we think and act."

This month, Second Line of Defense is launching a regular report, which looks at emerging Strategic Inflection Points. The Report is a collaboration of Dr. Harald Malmgren and Dr. Robbin Laird. The report will appear periodically during the year.

The Report will examine events which have just occurred, are occurring or are likely to occur that constitute strategic inflection points which can re-set history. Companies, organizations and nations tend to assume that the past is prologue to the future and often overlook events occurring which will have dramatic impacts on the course of events, and will re-shape the strategic environment.

The Report will focus upon changes in the strategic environment, which are having or are likely to have important impacts on the mid-term situations facing companies and nations.

Some of these events might well be called Gray Swans or "Fat Tail Events. Such events have a significant likelihood of happening, and, if they do, they will have substantial interactive global consequences, which would require major changes in policy and business plans.

The author of *The Black Swan*, Nassim Nicholas Taleb, argued that crucial impediments to learning are that we focus excessively and almost exclusively on what we do know from experience and that we tend to focus on the precise. We are therefore usually not ready for the unexpected. For the author, the rare event equals uncertainty. He argued that planning should begin with extreme events as the starting point in shaping knowledge of the potential range of outcomes that could have large impact. While a flock of white swans is consistent with our experience, the arrival of a black swan is a shock, beyond our experience.

Taleb therefore uses the metaphor of a black swan as a high impact, low probability event that would normally not be part of our routine planning and decision making as it lies outside our "normal" expectations.

In our usage, a “Gray Swan” is a high impact event that is somewhat predictable but usually not included in decision making as major stakeholders avoid contemplation of consequences that can only be approximated and might prove significantly disruptive.

Some analysts would call such an event a “fat tail event,” meaning it falls within the range of foreseeable possibilities, but with such low probability that it may not be “efficient” to incur costs of planning for such an outcome, or it may prove disruptive to “consensus” outlook forecasts by diverting attention from preparation for the most likely outcomes.

In the Strategic Inflection Points Report, we will look at events which have occurred, are occurring or have a decent probability of occurring, and assessing what their impact might well be on the global strategic environment.

In part, we embrace the somewhat predictable events, which could have significant interactive consequences on global power structures. In part, we tease out the meaning of events, which have been noted but not fully focused upon in terms of their consequences for strategic change.

With the world increasingly interactive through advances in communications technologies, the impacts of disruptive events can materialize faster and with greater intensity than might have happened only a decade or two ago. As a result, disruptive events often mark historical inflection points, when high impact shifts the trajectory of political, security, or economic forces.

The Strategic Inflection Points Report looks at such “game changers,” forcing us to consider whether they have set in motion a paradigm shift. In this framework of thinking, we will focus on events and their potential strategic consequences.

We will consider how such events would set in motion interactive consequences, which would likely shape new realities.

In other words, we are looking at events and factors which would dramatically alter plans and pose challenges for which we have been unprepared, often making obsolete the carefully devised plans on which we have become dependent.

In each issue, we will take two to three events and lay out likely scenarios or interactions which would play out from such events. A lead story focusing on an event and its consequences will be combined with 1-2 additional discrete events and consequences.

Malmgren and Laird have worked together collaboratively for more than 30 years at the intersection of political-economic and military-strategic affairs. Unfortunately, the two

disciplines normally exist in silos or stovepipes: political economic analysts ignore the military and security dynamics and military analysts ignore political economic trends and dynamics.

Malmgren and Laird have always believed the two domains are significantly intersecting and have treated them as a Venn Diagram whereby the intersection of the two circles (political economic and military strategic) define the reality of the universe within which global leaders must live and operate.

Dr. Malmgren is a global strategic analyst with a specialty in political economic affairs. He has a global client base ranging across Europe, the United States, and Asia. Well known for thinking outside the box, he is regularly consulted by major public and private stakeholders in the global economy.

Dr. Laird is the co-founder of Second Line of Defense. He has written more than 25 books on military and strategic affairs and has worked at several major think tanks in Washington DC. His work has embraced U.S., European, Latin American, and Asian strategic affairs.

Anticipation, and re-thinking of assumptions concerning the evolution of global affairs is central to looking at the evolution of the decade ahead. Disruption is as likely as continuity, so staying within safe confines will lead to strategic failure.

The Strategic Inflection Points Report is designed to help our readers stay ahead of the curve and to make more informed decisions.

We plan to publish reports once every two months or 6 during a year with occasional special reports built around a significant global event. Each report will be sold separately and sold on the Second Line of Defense Website. All quotations from the report should mention the Report and the where the Report may be purchased.

## Hard Landing and Turbulent Political Transition for China?

The kick-off topic for this first report is upon Chinese developments. We will look first at the prospects of a hard economic landing in China and its political consequences. And then we will look at the impact on defense relationships in Asia from a hard landing.

China's exports of high labor content, low value added manufactures are no longer competitive.

A shift in export orientation to lower labor content, higher value added manufactured exports will take time.

And a shift in export priority to infrastructure projects in the Third World (especially Sub-Saharan Africa and various regions of Asia) is under way.

China's trade account may not be the powerful engine it was in the past, and trade deficits may be experienced.

The Chinese government will need to boost domestic consumption, but this entails higher wages among a wider swathe of the working population, which also threatens inflationary pressure.

Chinese authorities are also faced with a banking system full to the brim with nonperforming loans, exhausted by government demands to lend to whoever came through the door asking for loans during the collapse of China's exports in late 2008 and throughout 2009.

It will not be easy to achieve the government's new target rate of growth of 7.5%.

Investors in the outside world have assumed that the 2012-13 change in China's leaders will be smooth, but among China's growing "investor class" there has been much worry that the transition will not be smooth, and may experience rivalries and competition for political and economic power.

The change in leadership for China's president and for China's Premier are already set, but competition for 7 of the seats in the Standing Committee of the Politburo has just begun. As older leaders retire or are replaced, there will be new membership of the 25 seat Politburo, and then changes in many Communist Party management posts, regional governors, mayors and deputy mayors in major cities, and so on.

Some Chinese believe the changes in the national power structure may reach 3,000 individuals – and in Chinese ways of thinking, each of the incoming families of such individuals will rise, while some of the families of outgoing officials will fall.

If China's economic transition results in a "hard landing" for a few years, will transitional competition for power weaken timely and effective government responses?

Can a new power structure be effective from day one, or will it have to experience a lengthy learning experience, leaving the economy subject to economic turbulence?

Will the consequences of global slowdown and fading world trade momentum be manageable?

## Can China's New Leadership Cope With A Faltering Economy?

During 2012 and 2013 a massive, generational change will take place across most of China's leadership. At the same time, Chinese economic growth is slowing markedly, ending decades of double-digit economic growth.

Under Communist leadership, China's economy was long powered by exports to the rest of the world, but China's international competitiveness has recently been eroded by rising costs of labor, materials and energy.

Foreign demand for China's exports has dramatically weakened as a result of continuing global financial crises set in motion in 2007 and 2008. China's domestic demand is not yet strong enough to pick up the slack from faltering exports.

At home, China's financial bubbles in real estate and commodities are bursting, its banking system is crumbling under the weight of massive misallocated and nonperforming debt, and its peoples are suffering from inflation in food, fuel and daily essentials.

Around the world, investors are now considering whether China's economy will have a hard landing, or just a period of slower economic growth.

The answer depends in part on whether or not the world economy experiences stronger recovery from the financial shocks of the last few years.

But the answer also depends upon how quickly the new leadership can agree on, and implement, new economic policies to address severe stresses on the economy.

This in turn depends upon whether the political transition is smooth, or whether China will experience a lengthy period of turbulent power struggles among the many new leaders who will take over from their predecessors.

## Organizing and Implementing a New Leadership Structure

China is a nation with one flag, but many governments.

With the world's largest population, it is inevitable that decision-making is complex, with multiple layers of authority at the national level and more layers at the regional and local levels. China has many centuries of experience with shifting balance between centralized and decentralized governance.

That delicate balance will continue to be subject to the ways in which local challenges are addressed relatively to national policy objectives, laws, and enforcement mechanisms. Social unrest over "injustices" in treatment of individuals and small businesses by local government officials has been increasing, gradually testing the sensitivities and tolerance of the central government and its complex security apparatus.

The central government closely observed lessons from the Arab Spring and the disruptions enabled by social networks in North Africa.

In response to what I had characterized as "leaderless revolutions" starting in Tunisia and spreading beyond, Chinese central government authorities have taken an even firmer grip on social networks and communications, including texting, Twitter, Facebook, emails, and other digital communications platforms.

Nonetheless, continuing local unrest demonstrates diminishing public confidence in local governments, police and courts, bringing into question the legitimacy and stability of the local foundations on which the Central Committee and its national leadership stands. Occasional evidence of official corruption only confirms widespread perceptions that corruption is rampant.

It is widely believed by ordinary people in China that those who hold public office, and their families, is held to much different standards of ethics and law than the majority of the people.

In the autumn of 2012, the 18th National Party Congress will announce changes in the nation's leadership.

A new President and a new Premier have already been positioned to replace current President Hu Jintao and Premier Wen Jiabao. Western news and media has focused on Xi Jinping, likely to be anointed later this year as General Secretary of the Central Committee of the Communist Party and President of China.

Also much attention has been given to the likelihood that Li Keqiang will be the new Premier.

However, the selection of these two leaders does not automatically establish a top-down decision system seamlessly falling into place.

China's system of government under Mao Zedong may have been monolithic, but the current system has evolved in adaptation to growing complexity of the economy and the increasing national interaction of a huge population. "Leadership" now involves an extremely complex consensus building system involving several hundred Communist Party Central Committee members and an elaborate hierarchy of committees within that framework.

At the top of China's leadership is the Politburo Standing Committee (PSC) of 9 members. The likely new President and new Premier are among the current membership, but at this year's 18th National Party Congress in the autumn all of the other 7 members of the PSC will be replaced. A decision could be made to shrink the membership, or expand it to 11, but most likely it will continue with 9.

Among various other considerations, everyone over the age of 68 will step down, with a new generation taking their place. This age limit will also apply to most subsidiary bodies functioning under Communist Party leadership.

Members of the Politburo Standing Committee make decisions on the basis of consensus, and in public make efforts to speak with one voice.

However, as in all political bodies throughout the world, political consensus is inevitably the result of some mix of bargaining, persuasion, and coercion. Consensus is sometimes based on the views of a majority inner group and sometimes based upon bargaining among members on a variety of separate, unrelated issues, depending upon their own interests and the interests of the regions or sectors they represent.

During the Presidency of Hu Jintao, he was referred to as "first among equals" in the PSC. In practice, the PSC functions as a collegial body charged with bringing often disparate views into convergence. This process of consensus building often requires consultations with former national leaders and retired Party officials as well as with the broader memberships of the Politburo and the much larger Central Committee.

PSC members are part of a 25-member Politburo of top-ranking Communist Party leaders, which takes its general guidance from the PSC. However, all of the Politburo members have personal power emanating from the regions and the interest groups they represent.

In turn, they are chosen from among the much larger Central Committee of the Communist Party of the Peoples' Republic of China, with its more than 300 members and an

elaborate staff structure. Within each region of China there are regional party chiefs appointed from among the Central Committee and its Politburo. There are also additional layers of regional party chiefs and official leaders, and Mayors and Deputy Mayors of cities. There are also layers of police and security authorities among both national security agencies and local law enforcement entities.

The People's Liberation Army (PLA) operates in an entirely separate framework.

The PLA is supervised by an 11 member Party Central Military Commission (CMC). The CMC is composed of senior generals in effect chosen by the PSC but chaired by the President, or at times by a past President.

The CMC operates in secrecy and without oversight or even consultation with ministries and state agencies.

In other words, the Commander in Chief is whoever holds the title of Chairman of the CMC.

The principal internal security force of the national government of China is the People's Armed Police (PAP), operating within the State Ministry of Public Safety, but in reality the CMC also has authority of this domestic security structure at the national level.

In the background, the Chinese military, or PLA, is characterized by a high degree of localization. Senior officers are rotated around the country, but rank and file members are usually drawn from the local region, and often rely on local dialects for their own routine communication. This regional diversity of military rank and file means that the PLA is often considered to be less reliable as an instrument of the central government in dealing with local and regional disputes.

Therefore the CMC tends to rely on the PAP for dealing with domestic disruptive events such as significant local demonstrations and regional or ethnic disputes.

Thus, the Chinese military and the domestic security enforcement apparatus operate in an independent, parallel government structure, effectively operating under the President and the PSC.

The military is therefore an entirely separate power center, with both domestic and foreign authority derived from the pinnacle of the Chinese leadership structure.

This elaborate leadership structure interacts with a complex economic power structure that encompasses both government managed economic activities and a growing array of diverse private economic activities.

The government “manages” a number of state owned enterprises (SOE’s) and provides direction to national banks. Ministries, various state regulatory agencies, and the central bank execute policies, which are established by the PSC. All of these bodies are part of a “State Council” which includes heads of ministries and supervisory agencies. The President appoints the members of the State Council, and the Premier is responsible for effective functioning of the State Council. In effect, the Premier operates much like a Prime Minister in some European governments.

In this regard, Chinese officials of government ministries and central bankers execute policy, but they do not make policy.

Western press and media have access to officials and central bankers, and sometimes to the Premier, but they do not have significant direct access to deliberations of the Politburo and virtually no access to deliberations of the PSC.

News and media reporting on policy decisions is thus not based on top-level access but rather on interpretations provided by technocrats who may be in charge of implementation, and who operate within a strict framework of instructions.

Operating in parallel with these government entities are private businesses, regional banks, non-bank financial institutions (shadow banks), high net worth investors operating through vast holding companies, and investment funds that are somewhat like the large institutional investment funds that are found in the US and Europe, etc.

Until the Lehman collapse of September 2008, the private sector share of the Chinese economy was growing relative to the public sector. Since that time, the government sector’s share has enlarged as a result of various economic stimulus measures and more vigorous central government direction, with the SOE’s growing relative to private businesses.

Premier Wen Jiabao has recently been calling attention to this growing role of the SOE’s and suggesting possible need to limit their future role in the economy.

In the last few years in China there has emerged an array of autonomous private investors that I refer to as China’s “investor class.” This includes high net worth families and managers of giant investment funds as well as individual entrepreneurial families.

Their individual and collective wealth has growing influence on how China’s economy functions, and therefore on how the political superstructure functions.

The “investor class” has not been given much attention by foreign press, media, academic economists, or market analysts.

One reason may be that the investor class has only in recent years become a significant segment of the Chinese economy, with many of today's asset managers and senior traders relatively young, and the elder high net worth individuals reluctant to operate transparently.

### Smooth or Turbulent Political Transition?

While much of the world expects China's Communist Party to ensure a smooth political transition, many Chinese investors believe it is more likely that China will experience a period of power struggles among families and interest groups from disparate regions and different segments of the economic and social structure of that nation.

Power struggles are expected over differing ideologies, over distribution of wealth, over appropriate policy proposals to assure continued economic growth, and over means of containing or suppressing social unrest.

Direct discussions with many of the Chinese "investor class" families reveal a widespread worry that a troubled transition of leadership will distract attention of the government and impede orderly implementation of new economic and financial policies.

They expect the leadership transition at national and local levels to continue over a prolonged period from the autumn of 2012 to the end of 2013, and perhaps beyond. The investor class points out that there will be generational change, with most current officials replaced with people at least a decade younger -- in many cases with people who are inexperienced in collective decision making and in establishment of personal power and authority.

They expect rivalries between the "Princelings" and their privileged families who derive their status from their revolutionary forebears in the leadership of China since Mao, and they expect rivalries between these privileged groups and more populist Party figures that represent ordinary peoples of the varied regions and cities of China.

Moreover, there is much fear among the investor class that the new power structure will include many new leaders and officials that bring with them new family ambitions to gather wealth, potentially at the expense of current members of the investor class. There is worry that if Chinese economic performance in the next few years proves disappointing, incoming leaders will blame outgoing leaders for poor management and corruption, opening opportunities for wealth transfer from the ancien regime to the new leaders and their associated families.

## A Hard Landing for China's Economy?

At this time much of the investor class, with their own wealth at stake, visualizes a much weaker outlook for China's economy than expectations of most foreign analysts. Much of the investor class inside China is skeptical about the reliability of official Chinese government statistics that suggest continued strong growth.

Doubts about official measures of GDP growth, manufacturing activity, and trade grew dramatically after the collapse of Lehman Brothers in September 2008. At that time, world trade began its longest and deepest contraction since the Great Depression of the 1930's, continuing through all of 2009.

Chinese who were involved in exporting or who were invested in export enterprises could see that Chinese exports collapsed in late 2008 and remained depressed through most of 2009, yet official figures presented a much more positive picture.

Although world trade picked up momentum in 2010, it began to weaken again during 2011, and Chinese investors could see that the export engine of China's economy is again faltering.

Concerns mounted among investors about growing stockpiles of raw materials inside China that were often accumulating alongside ports without being utilized in manufacturing. Chinese investors understood that Chinese banks had been mandated to expand lending dramatically in 2009 as a means of propping up the economy, but that the consequence subsequently has been accumulation of vast amounts of nonperforming debt.

To Chinese investors, it is evident that many banks have become insolvent, yet government reports fail to highlight the extent of nonperforming debt. Bad debt is now simply ignored in official statistics, essentially placed "off balance sheet." Many Chinese investors understand that government officials have strong incentive to present upbeat data because Chinese public confidence in the government rests on assurance of continued robust economic growth. Admitting that economic performance was seriously disappointing might encourage greater public criticism China's leaders.

Thus, many of the investor class in China are far more cautious about economic growth this year than government reports would suggest. There is private worry about the real possibility of a hard landing, and that a hard landing might be prolonged for a couple of years or even more.

The investor class believes that Chinese manufacturing, in which they are invested or directly involved, is no longer internationally competitive in high labor content manu-

factures, because of rising wages, costs of materials and energy, and global transportation costs. They believe that raising the domestic rate of economic growth will take several years.

In the meantime, many of these investors expect very slow economic growth, as exports weaken relative to the economy as a whole, and while growth of domestic consumption increases only very slowly. In essence, it is a common view among Chinese investors that the real rate of growth will be well below the government's new target of 7.5% annualized rate of growth of GDP.

Some Chinese investors believe that China can partially reorient its external sales of goods and services by focusing on provision of infrastructure projects in emerging markets, particularly in neighboring countries, and in Sub-Saharan Africa, Latin America, and parts of the Middle East.

In particular, they expect the Chinese government to assist in promoting the building of railways, power plants, water turbines, and other such infrastructure in such emerging markets.

Reflecting on changing competitive circumstances, some investor class participants expect Japan, and sometimes Germany, to be the principal competitors of China in infrastructure exports.

They express the hope that the Chinese government will invest in Japanese Government Bonds so as to keep the Yen strong relative to the Chinese Renminbi. They worry about potential weakening of the Euro in the future as the Eurozone undergoes prolonged recession, as a weaker Euro would not only weaken demand for Chinese exports but also enhance European competitiveness against Chinese exports to emerging market economies.

The investor class also hopes to build an internationally competitive automotive industry with initial focus on emerging market economies, competing directly with Japan, South Korea, and India. The investor class hopes eventually to shift manufacturing focus away from high labor content manufactures to low labor content, high value added products, following the path of Taiwan and South Korea.

However, they believe that such a transition will take many years.

Thus, many Chinese who have their own wealth at stake in China's economy express the belief that the Chinese economy will suffer a lengthy transitional period of very slow, low single-digit growth for the next few years.

They also point out that the overall population has begun to contract. They observe that demographics will result in decline in the labor force required to support a growing aged population.

In direct conversations, they explain that in past years it was relatively easy to invest profitably in virtually any asset in China, whether in real estate, commodities, or companies, but this is no longer a one-way bet.

Instead, bubbles are bursting in real estate, key commodities look poised to decline as Chinese growth slows, and the Chinese stock market has been the world's worst performing stock market for a prolonged period.

In regard to the stock market's poor performance, they believe the market would have been even weaker but for occasional propping up of stocks by government purchasing on behalf of pensions and other public accounts.

Among the investor class, declining confidence in domestic growth is spurring increased attention to investment in other markets around the world, not only in developing supplies of raw materials, energy, and food for China but also in penetrating ownership of foreign infrastructure and foreign production facilities.

The investor class is becoming cognizant of, and active in the exploitation of, globalization of production and of markets.

This process of engagement with the world at large is quite natural, but it poses a new question for China's leadership about the outlook for capital flows:

- How will China's government deal with the evident desire of the investor class to allocate an increasing share of their wealth to investment outside China?
- Could China experience a period of capital flight as the domestic economy slows?
- Will foreign investment in China taper off, with foreigners seeking greater repatriation of past gains inside China?

Some of these multiple fears have recently been manifested in some official Chinese data, particularly in China's dips into trade deficits and shrinking current account surpluses. When the Chinese government recently decided to widen the exchange rate "band" many foreign economic and financial analysts concluded that China's April decision to widen the exchange rate "band" as a sign that Chinese leadership was confident in economic recovery and expectation of currency appreciation.

However, many of the Chinese investor class take a different view, that widening of the bank allows the Chinese currency not only to strengthen, but also to weaken, against

other currencies. It opens the way for more market-oriented determination of the exchange rate, which may well result in a decline in the Renminbi if China's export competitiveness continues to weaken.

Thus, many of the investor class believe that China's exports will continue to falter and that trade deficits will become more frequent. They also expect the pace of foreign investment into China will slow in a context of global economic slowdown.

## Convergence of Weakening Economy with Establishment of New Power Structure

Very broad, generational turnover of leadership is taking place at the same time as the Chinese economic engine is faltering. There are widespread fears among China's investor class that political power struggles may interfere with timely economic policy decisions in response to domestic and global slowdown.

Power struggles may distract the most senior levels of government, especially during a period of transition when a "learning curve" will prevail as new leaders experience interaction with each other and with each other's power base.

Such fears have already been given validity by the events following the fall of Chongqing's Communist Party leader and Politburo member Bo Xilai, and questions about his wife's involvement in businesses and conflicts with foreigners, and allegations of involvement in murder of a foreign business partner.

Allegations of corruption at such a high level of governance have highlighted public concerns about disparities in treatment of powerful families in contrast with treatment of ordinary citizens before the law. Making matters even more complex, one of the principal political supporters of Bo Xilai has been Zhou Yongkang, one of the 9 members of the Politburo Standing Committee, whose personal responsibility is to oversee the security and law enforcement apparatus of the entire nation. If his authority were to come into question, the credibility of the nation's laws and law enforcement would also come into question.

Moreover, this role as overseer of security and law enforcement implicitly encompasses extensive awareness of the extent of corruption and aggregation of wealth – including wealth that may have been positioned outside China. If the overseer of such information is perceived as favoring or shielding privileged members of the power structure at either national or local levels, this could open a chain reaction of yet additional power struggles not only among leaders but among the wider populace.

In response to the erupting controversies surrounding Bo Xilai, the PSC and the Central Committee have issued a series of statements that “no one is above the law” and that all Chinese people must be treated equally under the law. These newly publicized rhetorical declarations are designed to restore credibility of the Communist Party leadership, and the laws it promulgates. However, this rhetoric may have broad repercussions in the future, as pressures rise to rooting out corruption throughout the economy. Such a process could threaten many members of the incoming leadership who already hold relatively high positions in the hierarchy of the Communist Party Central Committee and Politburo, and who may have previously acted in a manner, which might be viewed, as exploitive of privilege or corruption.

In a context of widely felt grievances over “unfairness” and favoritism in the application of law enforcement, the new theme of “no one is above the law” opens the way for allegations of incompetence or corruption to be utilized in inevitable power struggles as top level job changes encompass hundreds, and eventually thousands, of national and local leaders.

Since the Tiananmen Square events, the Chinese Communist Party has been able to minimize transparency of its internal differences.

However, during the last year there were already public signs of profound differences about whether incremental economic and social policy change was a better path, or whether a return to a harsher “cultural revolution” might be needed to help China revitalize.

Bo Xilai’s strong support for bold action through a “red revival,” reminiscent of the Cultural Revolution, was already questioned by former leader Zhu Rongji in various statements he issued in past months. It was publicly known last year that differences between Bo Xilai and Premier Wen Jiabao had become polarized. Popular opinion had been that Premier Wen was eloquent and knowledgeable about the economy, but not politically powerful enough to confront such a next generation populist leader as exemplified by Bo Xilai.

In a surprising move, it was Wen who was the first official to denounce Bo Xilai publicly after Bo’s chief of security, Wang Lijun, sought sanctity at a US Consulate out of fear for his personal safety. During the 30 hours Wang was in the US Consulate, Bo’s Chongqing police and a detachment of Chongqing paramilitary security personnel surrounded the Consulate, demanding that Wang be turned over to them, only to be forced to withdraw when a Vice Minister from Beijing arrived with a detachment of internal security forces to override local police and take Wang into national government custody.

This public drama was amplified when scandals broke over Bo's wife's alleged involvement in corrupt business transactions with a foreigner but also in the murder of that foreigner, with allegations of moving capital out of China illegally.

The extraordinary downfall of Bo Xilai and the implicit power struggle behind pose acute embarrassment for both the outgoing and the incoming Chinese leadership, because it raises questions about the moral authority and "legitimacy" of the central government and of the Central Committee of the Communist Party.

Eventually, as the debate continues about Bo's bold "red revival" and the alternative of incremental relaxation of central control, it is likely that questions will arise about the relative effectiveness of such alternatives. Greater public controversy can also be expected about the extent to which corruption is implicit in the harsh selection of winners and losers in the "red revival" scenario.

### The Dual Challenge to Consolidate Authority While Revitalizing a Faltering Economy

Thus, it is highly likely that lengthy power struggles will take place at a time when the Chinese economy is facing critical challenges in several domains.

These challenges come:

- From a slowing world trade,
- A weakening of Chinese biggest foreign markets,
- An erosion of Chinese international competitiveness,
- Inflation at home,
- Collapsing bubbles in real estate and commodities,
- Insolvency of banks,

And social unrest over "injustices" in treatment of smaller businesses and individuals by state-owned enterprises and local government officials.

This volatile mix of challenges poses core questions about Chinese development and its global impact.

- Can new leadership made up of hundreds – and eventually thousands -- of new national and regional officials cope effectively with upheaval and change in the economy during a period of prolonged power struggle?

- Can China avoid an economic hard landing if most of its leaders are preoccupied with fending off rivals and gathering personal power and authority?
- Or will we see China's leadership undergoing a prolonged period of political paralysis as the new leaders experience the time consuming "learning curve" which tends to characterize the formation of most new governments throughout the world?

Looking ahead, wide disparities between cities and rural life, between geographically and ethnically diverse regions, between public and private economic enterprises, and between income groups will coincide with ideological differences about greater central control of the economy or alternatively greater relaxation of central management and further encouragement to privately driven economic growth.

The potential for chain reactions to local social unrest and heavy-handed repression is evident. In past years, when economic growth remained robust, average people could retain expectations for a greater future for themselves and their progeny.

In the future, tolerance for "injustice" is likely to diminish if weak economic prospects suggest the need for lowering expectations for the wellbeing of future generations.

China's "collective leadership" will change along with generational change in the next few years.

- Will internal strains be manageable if the economy's performance proves disappointing to the people of China?
- Within China, will there be a reversion to previous hard line Cultural Revolution dictates or will China's decision system continue its recent path towards collective leadership in support of an increasingly diversified, entrepreneurial, innovative society?
- Externally, if the Communist Party leadership finds itself paralyzed by faltering economic growth and domestic controversies over unfairness and injustice, will it need to divert attention of the wider public to conflicts with other nations, particularly with neighboring nations such as India, Vietnam, and Japan?
- Will the PLA lay claim to a greater share of national wealth to enable itself to project power beyond China's neighborhood, ostensibly to protect China's supply lines with Africa and the Middle East, and even beyond?
- Will China's leadership be able to exercise multilateral leadership on a global scale, supported by its vast accumulation of foreign currency reserves, or will those reserves have to be drawn down to help levitate a failing domestic economy?

Ultimately, the rest of the world not only awaits the outcome of this major transition in China's leadership, but its impact on the global economy.

Can China's new leadership think global, or will it be forced by daunting domestic challenges to remain focused on domestic survival for the next several years?

by Harald Malmgren

## The Impact on Asian Security

The current transition in the PRC is unprecedented in modern times in Asia. A major lynchpin of the global economy and an ascendant power in Asia will face significant political uncertainty in an authoritarian power structure. The rules will be scripted as part of the power struggle; not the other way around.

Another aspect of the transition is equally significant: this will be the first major political transition in the PRC in which money and power are not held by the same elite. For the first time, there is an investor or moneyed class separate from the political elite contesting for power in the PRC.

This means that reading the tea leaves will be complicated for outside powers and policy-makers. This means as well that key Asian powers will be reading each other's reading of the situation as well, and any efforts by key states to enhance their advantage to leverage any perceived power vacuums created by the transition.

And at the heart of the transition is the problem of losing the global advantage of relatively cheap labor and seeking to transition to higher value more advanced technological production.

The other Asian powers will seek leverage both ways; states like Vietnam and Malaysia will seek to further dislodge China from the lower end of the production market and Japan and Korea will seek to deflect China from displacing their positions in the global economy in the higher end of the production market.

All of this suggests that the probability of significant conflicts over policies and perceptions of intentions underlying those policies are high. And the significant lack of transparency in the PRC normally will only exacerbate transparency issues.

At the same time, the regional conflicts among the Chinese political class will almost certainly be enhanced in the transition. The temptation for the Army to enter into the

effort to consolidate national power or to be relied upon by key regional factions will be significant.

The possibility of leveraging external efforts to protect perceived Chinese interests to enhance a factions political standing will be increased as well.

The fear which key Asian states will have of the spillover from a hard landing in China due to economic as well as security dynamics will be a significant political factor over the next 2-3 years during this transition.

The absence or presence of an active stabilizing role of the United States during this period will be a key factor shaping the probability of crises spinning out of control, and cutting more deeply into regional tensions. But if the US does not nor can not play this role, the probability of key regional players seeking to enhance their defense capabilities against a China which might become more intrusive in Asian affairs to augment the power position domestically of rising Chinese leaders will be significantly enhanced.

The most likely states to be at the vortex of this situation will be North and South Korea. South Korea is already expanding its global presence in both economic and defense terms. South Korea is seeking through its weapons acquisition programs and enhanced capacity to import high technology capabilities and to export global defense products. The incentive to do so will be increased as the threat of the impact of a Chinese power struggle is enhanced.

At the same time, the already significantly isolated North Korea will look at the Chinese dynamic and perhaps see an opportunity to play on Chinese fears and concerns during a political transition.

The relative turbulence within China will leave North Korea freer to meet short-term needs by brandishing their defense threat against South Korea and Japan. If the United States is not an effective counter balance, the North Korean factor could reinforce the political tensions within China, accelerating both North Korean assertiveness and Chinese sense of vulnerability. This would be an explosive cocktail.

Vietnam has been looking with growing concern at its regional position and their capability to defend their interest against China. The Vietnamese are in the midst of a modest defense build up designed to enhance their capacity to defend themselves against Chinese claims in common territorial waters. The Vietnamese might well see Chinese

preoccupation with internal affairs as a good time to assert their claims and expand their control over contested territorial waters and resources in the region.

The Vietnamese and North Korean dynamics, in turn, could well intersect in turn with internal Chinese power struggles. Contesting Vietnamese and North Korean assertiveness might well be seen by aspiring Chinese leaders as a good canvas upon which to paint their own rise to power.

In other words, there is a virtual certainty that the internal dynamics of Chinese power transition accompanied by a continuing Chinese investor class's engagement in the global economy will lead to turbulence in Asia.

And turbulence, in turn, will create a situation in which other Asian powers will seek to mark their place and to either protect or advance their interests.

It will be a very fluid and dynamic situation in which the capability for small events to spin out of control could be high indeed.

by Robbin Laird

## Anticipating a Nuclear Iran

The Black Swan of the Arab Spring in 2011 whose effects are still unfolding coupled with the Gray Swan of an abrupt entry of Iran as a nuclear power will create a very fluid situation for the Middle East in 2012.

Preparing to constrain, contain and attack anticipated Iranian actions outside of Iran – empowered by becoming a nuclear power – will fuel many activities of the Arab states and Israel. And their activity interacting with the efforts of Iran to complete the nuclear weapons process and to shape a proactive foreign policy accordingly will shape a very explosive security situation in the Middle East.

According to several Middle Eastern actors interviewed for this Strategic Inflection Points Report, the states who could set the Iranian effort back on nuclear weapons are not likely to do so. Therefore, major actors in the region on moving forward to provide for their own security and ability to constrain Iranian activism.

The US under Obama and in an election year is not viewed as a key player in shaping the policies this year in the region. The passivism of the USAF leadership has been noted, and the insertion of the F-22 as a key element to constrain Iran is not anticipated. And the Washington games to slow down production of the F-35 are also noted by key players in the region.

As a result, most players in the region will seek their own solutions and acquisition policies outside of the United States to shape more effective capabilities and hope that in 2013 they will have a more favorable audience inside Washington. It is not so much that President Obama is disliked; he and his Administration are seen as withdrawing from the region.

The result will be a significant shift to conventional and counter-terrorism containment of Iran in the region, and preparing a stronger capability for existential deterrence against Iran when it has nuclear weapons. 2012 will see a clear effort by players in the region to augment these capabilities – both for containment and existential deterrence.

At the heart of the response is the underlying tension between Sunnis and Shi'ites. The Saudis and other Sunni societies are not looking at the prospects of a nuclear-armed Shi'ite power with favor. As a result, the Sunni powers are shaping a response to such a prospect, and the response is becoming a fact even before the reality.

## The UAE

In many ways, the UAE is the key state in shaping a comprehensive policy. UAE policy makers have been acquiring a number of key air and naval assets to deal with a more active Iran and the possible emergence of a nuclear Iran. Air defense systems, new naval systems, F-16 Block 60s and related equipment have been procured but remain more stove piped than integrated. This is why building an air operations center – which really is a combat integration center – is central to dealing with the new Iran.

There is also less tolerance for any Western or Russian arms vendors who are not willing to supply parts, help maintain products and to be prepared to fight along side the UAE against Iran. The UAE will look to enhance local supply capabilities but also to ensure security of supply.

There will be a concerted effort to better integrate the equipment they have and to set in motion acquisition efforts which can bear fruit as Iran becomes a nuclear power.

Trying to get the US committed to selling F-35s and deploying F-22s in the interim will be a key objective for the UAE leadership as a new Administration comes to power. The UAE is likely to animate its system of influence in the US, including many former USAF officers, to try to ensure a favorable hearing at the earliest moment in Washington in 2013.

Failing this, new missiles need to be acquired for older aircraft. Here the European missile house MBDA could form a key source of support for systems such as Meteor and other systems. According to a senior UAE official, “we are very happy with the Storm Shadow and want more of them and we will seek ways to co-develop new missiles to deal with our threat environment.”

The failure of Dassault to sell Rafale to the UAE to replace the Mirages opens the distinct possibility of a new combat aircraft being purchased in the near term. Alternatively, the prospects of an Indian-Brazilian Rafale might tempt the UAE back to buy the Rafale and to see this as part of a consortium of support outside of the Middle East for UAE policies.

The Saudis have purchased both the F-15s and the Eurofighter in the past two years. The UAE barring any real demonstration that 5<sup>th</sup> generation aircraft will be dedicated to the Arab cause against Iran will move in the European direction. The Eurofighter is attractive in part because of the flexibility of missiles which it can carry. “We like the weapons load which the plane can carry and the flexibility in shaping software solutions for new weapons, of the sort we think we might need for deep strike into Iran.”

A continued absence of an assertive, credible US policy in 2012 towards the UAE will open the possibility that not only will Europeans benefit, but Russians as well. The UAE understands the key role of Russia in Iran. “If we build a significant arms relationship with Russia, perhaps we can convince them to reduce dramatically their relationship with Iran and help the Iranians listen to reason.”

## Saudi Arabia

The Saudis are in the throes of increasingly their long range strike capabilities against Iran. The Saudi Air Force is adding both F-15s and Eurofighters. This may at first seem illogical but is rooted in weaponization and supplies. As a senior Saudi AF leader commented: “The dual acquisition broadens our supplies to both Europe and the United States and to deal with Iran we will need access to some new longer range missiles as well. Cruise missiles are essential as shown by recent NATO operations in Libya, and Europe is a more reliable supplier in this area.”

The Saudis will step up efforts to add sea-based missile defense and sea-based operational capabilities to deal with Iran capabilities to disrupt shipping, with mines, mini-submarines or fast attack boats.

As a Saudi official put it: "As the Iranians become more self confident, they are likely to be more aggressive on the sea, on the ground and in the air. We need capabilities to constrain their activities and influence their thinking."

A major consideration for the Saudis will be to move more rapidly forward on homeland security measures. As a Saudi put it: "We have several programs to provide for enhanced homeland security but these measures are incomplete and poorly integrated. The Iranians are most likely to come at us with terrorist means, and with the Arab Spring unfinished view us as vulnerable to domestic disruption."

The Saudis are likely to be in the more market to upgrade and augment their homeland security efforts in a major way in 2012.

Another aspect of the Saudi response could well revolve around Egypt. The government of Egypt is virtually bankrupt and needs outside funding and support. The Saudis have indicated their willingness to do so in exchange for the evolution of a more favorable Muslim regime, which would be fundamentalist in character. Egypt could then join in the encirclement of Iran effort.

## Iraq

The inability of the Administration to forge a Status of Forces agreement has left a power vacuum in Iraq. This is true both with regard to the ability of Iraq to defend itself directly against Iran, and to curtail incursions from Iran aimed at shaping the evolving power structure in Iraq.

Iraq could from the Iranian point of view be the new Lebanon. The costs of intervention are low from the geopolitical point of view, and strengthening a toe hold in Iraq significant in shaping Iranian influence in the region.

According to a European expert on Iraq and Iran, "the old animosity is stronger than ever. Now the withdrawal of American troops with NO prospect of them coming back to help in an emergency which a status of forces agreement would have allowed will allow the larger country to consider ways to shape an Iraq acquiescent to Iranian influence."

The USAF effort to sell F-16s to Iraq in this environment will prove interesting. Are the US F-16s a strike force against Iran to be used as whatever force commands the Iraqi aircraft or are they instruments of a US policy which is self-constrained? Need the Iranians fear them or is the veto power of a US unlikely to do anything the reality, which Iranian policy makers will consider?

## Israel

Senior Israeli defense leaders believe that they have lost the kind of air superiority that gives them a clear strategic edge. As one senior leader put it: “With the Arab Spring, now new leaders have access to American and European aircraft in their inventories which we would now need possibly to confront as opposed to the past when we were able to shape a counter-Soviet air strategy. And where we were able to count on the Turks and Egyptians as de facto allies in air operations over the Mediterranean and the Gulf, we can not now make this assumption.”

The Israelis could decide for any number of reasons to roll the dice and try to start the process of eliminating Iran nuclear capabilities. They might assume that they could force Obama’s hand in an election year, or what to shape a new Republican Administration’s strategy. In any case, they would seek F-22s for themselves or deployed to the region as well as an acceleration of F-35 deliveries. The Israelis are one of a number of US allies who want the plane now and simply view the machinations of the Obama Administration and Congress over the plane as a delaying tactic. Unlike the USAF leadership, the Israelis have a sense of urgency about fielding new capabilities.

There is a significant worry about the Iranians stepping up their activities in Lebanon and elsewhere to augment the capacity of the Hezbollah and other radicals to be able to attack Israel. As one Israeli decision maker put it:

We have relied on our ability to strike the homeland of our adversaries when they have used surrogates near our borders. Our strategy towards Syria is an example. We have made it clear to the Syrian leadership that attacks launched from Lebanon could well be met with direct strikes on Syrian territory.

As the Iranians obtain nuclear weapons, this option is much more complicated, and perhaps off of the table. This means that our ability to defend our own territory and to sweep the areas closest to us of threats will become SIGNIFICANTLY more important.

## The Intersection with the Arab Spring

Events in Egypt and Syria and beyond associated with the Arab Spring elevate significantly the willingness of players in the region to act early to protect their interests and to make miscalculations about those interests. As concern about countering Iranian assertiveness goes up, and the instability within Egypt and Syria remain, a very explosive situation is possible.

Dealing with the behavior of a nuclear-enabled Iran is not an isolated event; it is part of a bundle of events associated with political instability in the region.

And all of these players are neighbors of Israel. The next US Administration as well as Europe, Russia and China will become key players in what happens next in this increasingly explosive region.

## The Broader Consequences

The security of energy exports will be increasingly exposed in the period ahead. Who will take responsibility for the flow of oil and natural gas from the Middle East? Who will take the risk to confront a nuclear Iran? Will the Saudi, UAE, Egyptian and Israeli Air Forces be able to provide de facto security?

As one senior European officer put it: “We have relied for a significant period of time on the Egyptian Air Force to provide for the security of many of our naval forces. With that now uncertain, what is Plan B?”

The acceleration of instability in the region and the growing probability of security and military conflict will have a significant impact on energy transport and production in the Middle East. With a global economy already teetering on the verge of a significant downturn, such instability will accelerate that downturn.

## The Israeli Nuclear Joker

The Israelis are very reluctant to use their air power to do a strike on Iran, but the tactical nuclear option is increasingly looked upon as the core response. Given that Iran is building its weapons in a relatively isolated location in Iran, the Israelis perceive that they do have an option: use their submarines armed with missiles and tipped with tactical nuclear weapons in a swift decisive strike.

The lack of support by the United States for a comprehensive air strike, and the perceived unwillingness to take the Iranian nuclear option off of the table, has re-enforced Israeli decision makers belief that they have a tactical nuclear option.

And given the evolution of Arab policy in the region, if correctly executed, such a strike would de-facto be supported by Sunni regimes.

By Robbin Laird