Central Banks (Eric Prouzet, Unsplash.com)

# The Pentagon's First Financial War

## How DOD can fight back against China

By Justin Bernier

China's strategy for achieving its global ambitions is driven as much by bankers and bribes as bombs and bullets. The Chinese Communist Party (CCP) continues to take every step imaginable to appropriate dual-use technologies—those with both civil and military applications—from the United States and its allies, while attracting billions of dollars in Western capital used to finance a modernization program for the People's Liberation Army (PLA). The U.S. Department of Defense (DOD) reports that the strategic end state this program supports, if realized, would have serious implications for nothing less than "the security of the international rules-based order."[1] The extent of this threat implies that military tools alone may not prevent an undesirable outcome.

The Pentagon is dutifully preparing for the possibility of a kinetic war with the PLA, but DOD has a role to play on the financial battlefield, too. Defense leaders should consider three policy initiatives to curb the flow of technology and capital to China:

- Encourage compliance on technology transfer laws by rewarding companies and universities with strong export control practices when they compete for federal grants and contracts.
- Discourage investment in China's "bad actor" companies by supporting a government policy to assume custody of shareholder voting rights in certain state-owned enterprises (SOE).
- Track Chinese expansionism through business and financial channels with an all-source intelligence capability designed to provide U.S. officials with strategic warning and policy support.

A bureaucratic purist could paint these initiatives as inconsistent with the Defense Department's core competencies, but this view would be short-sighted. DOD may be the only government agency with the financial leverage, the knowledge base, and the political will to roll back China's strategy of stealing military technology and securing foreign capital for its armed forces buildup against the United States. More certain is the reality that U.S. servicemembers are endangered by ongoing technology and capital flows from the West to the People's Republic of China (PRC). These high stakes give the Pentagon little choice but to fight back

---

Justin Bernier is a Founding Partner of All Source Investment Management, a Connecticut-based wealth advisory firm. He advises clients in twenty states, focusing on portfolio management, alternative investments and risk management for accredited individuals and select nonprofit institutions. Nothing in this article should be construed as financial advice.

against the financial warfare that China is already waging around the world.

## Money Bombs

Economic warfare is the age-old strategy of weakening a state through trade embargoes, tariffs, expropriation, and other sanctions. U.S. economic wars are normally orchestrated by the Treasury and State Departments, with DOD playing a supporting role in the enforcement of embargoes and the denial of defense purchases. Congress has also been an active participant in economic warfare, especially concerning sanctions against Iran, North Korea and Russia. Although a proven tool for policymakers, economic warfare can be politically difficult to manage because of its perceived effect on general populations and global commerce. U.S. tariffs on select Chinese sectors in 2019, for instance, generated frenetic media headlines despite causing only nominal changes in overall trade levels.

A subset of economic warfare—one more targeted and easier to control—is financial warfare; the denial of money or credit to specific entities. Restricting or redirecting capital with precision can maximize pressure on foreign leaders who need hard currency for operating expenses but also minimize the effects on legitimate commercial interests. In the example of Russia, the Small Business and Entrepreneurship Council (SBEC) has lobbied for financial penalties against President Vladimir Putin and other Kremlin insiders rather than broad economic sanctions thought harmful to American companies. Untargeted sanctions on Russia would "cascade down the supply chain," argues SBEC President Karen Kerrigan, hurting U.S. vendors in the aerospace, agribusiness, and energy sectors, while handing Chinese companies an opportunity to capture market share.[2]

Financial warfare is an option for those combatants armed with a large budget, like the Department of Defense, but Pentagon leaders may not realize their own potential. The DOD contract award process could be used to counter Chinese espionage and intellectual property theft by giving preference to companies and universities that safeguard sensitive technologies. Secondly, DOD leaders could discourage portfolio investment in companies within the PLA supply chain—so-called "bad actors"—by backing a plan to relieve shareholders of their voting rights in these state-owned enterprises. Finally, an all-source intelligence capability designed to track China's non-military expansion would support technology and capital control initiatives while helping U.S. officials develop future policies.

There may be fertile ground for proactive policies in Washington, where members of both political parties appear to recognize the present CCP threat. Several months into his administration, President Joe Biden has sustained some initiatives by President Donald J. Trump to strengthen export controls on China. In June 2020, then-National Security Advisor Robert O'Brien catalogued these accomplishments, including measures to stop the PLA from using student visa programs to place its personnel in American universities for the purpose of stealing technology, intellectual property, and sensitive data. Rounding out the list was a decision to "halt the investment of U.S. federal employee retirement funds into PRC companies…"[3]

## The Wall Street Problem

President Trump's senior advisor on national security was referring to a seemingly obscure benefits debate in the first half of 2020, when Chinese stocks nearly became part of the Thrift Savings Plan (TSP), the retirement investment program familiar to Defense Department civilians and servicemembers. Based on financial advice from BlackRock, the Federal Retirement Thrift Investment Board had voted to replace the benchmark for its international fund (a.k.a. the "I Fund"), an index of some 900 companies based in developed markets.[4] The

proposed benchmark, known as the MSCI ex-USA Investable Market Index, would have expanded the I Fund to 6,600 components—almost every publicly traded company outside the United States—to include defense firms at the heart of China's "military-civil fusion" strategy for developing a world-class fighting force.

Aviation Industry Corporation of China (AVIC), with annual defense revenue comparable to Northrop Grumman, is an aircraft manufacturer listed on the Shenzhen exchange. AVIC is developing the PLA Air Force's next-generation Chengdu J-20 and Shenyang FC-31, the latter with technology stolen from the Joint Strike Fighter program.[5] China Shipbuilding Industry Company Limited (CSIC) is a subsidiary of the world's biggest maritime conglomerate, producing warships, weapon launchers and other offensive equipment for the PLA Navy. The Shanghai-listed company has more annual defense revenue than the largest military shipbuilding company in the United States, aircraft carrier builder Huntington Ingalls Industries. These two companies and other Chinese defense firms were part of the MSCI index.

Changing the I Fund's benchmark would have plowed roughly $10 billion dollars of TSP assets into Chinese listed stocks, including defense firms and other state-owned enterprises (SOE), inflating their prices and signaling financial strength that can help a company grow.[6] Companies with higher-priced shares often borrow at low interest rates for capital expenditures. Higher-priced shares also facilitate equity financing (selling shares to raise capital) and acquisitions through equity deals. In other words, Chinese defense firms would have been propped up with the retirement accounts of American servicemembers who might someday face the PLA weapon systems they produce.

BlackRock recommended the benchmark change ostensibly to give TSP participants exposure to companies outside of developed markets. There are sound reasons to include emerging market stocks in a retirement account. In addition to attractive growth rates, they offer diversification benefits that may improve long-term returns. BlackRock, however, took a scattershot approach that failed to exclude bad actors from the index. Although stock indices can be modified to reflect commonsense public policy concerns, none of the leading indexers—not Vanguard, State Street, or BlackRock—have voluntarily addressed the problem. As a result, millions of Americans are unwitting investors in China's publicly traded defense firms.

A Chinese flag flies outside the New York Stock exchange on May 30, 2013 in New York City. (Anthony Correia)

BlackRock may have had the best interest of TSP participants in mind when it recommended a broader international benchmark, but the asset manager also stood to expand its influence within 6,600 companies and their respective governments, exacerbating troubling—if not illegal—conflicts of interest. *The Wall Street Journal* has revealed systematic pandering by U.S. firms hungry for access to China's tightly controlled financial services market. In August 2020, after siding with Beijing during trade negotiations with Washington, BlackRock became the first non-Chinese firm to receive preliminary approval for a wholly owned mutual fund company on the mainland. Presumably for supporting Beijing in the same talks, J.P. Morgan, Goldman Sachs, and at least two other firms were granted similar entries to China's $17 trillion investment and asset management market. The very decision to include Chinese stocks in the MSCI indices, the newspaper reported, was championed by BlackRock in exchange for state approval of a private fund business in 2017.[7]

The BlackRock recommendation probably would have been adopted with little notice were it not for Roger Robinson, Jr., a past-Chairman of the U.S.-China Economic and Security Review Commission. Earlier in his career, Robinson had coordinated the Reagan Administration's economic war against the Soviet Union from his post at the National Security Council. Upon learning that the TSP intended to buy Chinese equities, Robinson gave a series of speeches and interviews to raise public awareness of the situation. President Trump took notice; he vetoed the benchmark change and then re-nominated three appointees for the investment board to ensure in hopes of better oversight going forward.

Although based on national security concerns, President Trump's decision to axe the new I Fund benchmark made sense from an investing perspective, as well. A study commissioned by the TSP investment board found that using the expanded benchmark would have resulted in similar returns over the last five years and *lower* returns over the last ten years in the target-date funds it tested.[8] The same review projected that swapping indices going forward would improve returns by ten basis points (0.10 percent) per year—just one-tenth of one percent.[9] One reason for the unimpressive returns is that the emerging market small cap index, a major component of the proposed benchmark, has underperformed over the last decade.

In practice, using a benchmark of 6,600 companies may be diversification overkill. Even if expected returns are slightly higher after including equities from China, India, Brazil, and other rapidly growing countries, a benchmark consisting of every global stock is unsuitable for the retirement accounts of most government employees and servicemembers. Many of these positions carry illiquidity risk because they are listed on exchanges with low trading volume and abbreviated hours. Such markets oftentimes have accounting standards beneath those found in developed markets. Beijing's notable refusal to comply with generally accepted accounting principles would expose TSP investors to business risks they may not expect.

In the final months of his term, President Trump issued an executive order banning financial transactions in companies recognized as "directly supporting the efforts of the PRC's military, intelligence, and other security apparatuses."[10] The original directive, E.O. 13959, and its amendment prohibited investment in forty companies traded on Chinese exchanges. The banned stocks and their subsidiaries were to become un-investable to funds inside employee retirement accounts as well as pensions and endowments, forcing indexers to remove the proscribed companies and re-weight their China benchmarks accordingly. "The underlying principle," said then-White House advisor Dr. Peter Navarro, "is that American capital should not be used to finance Chinese militarization, particularly weapons that

are going to be used to kill Americans."[11] The Biden Administration subsequently postponed full implementation following complaints from the financial services industry that the executive orders were too open-ended for Wall Street to comply.[12]

## The Silicon Valley Problem

Self-defeating value transfers to China are not limited to the financial services industry. Silicon Valley companies have knowingly transferred next-generation technology to the People's Liberation Army at the expense of U.S. national security. In 2019, then-Chairman of the Joint Chiefs of Staff General Joseph Dunford testified to the Senate Armed Services Committee that Google was developing artificial intelligence (AI) capabilities for China even as it spurned similar efforts by the Pentagon. "The work that Google is doing in China is indirectly benefiting the Chinese military," said Dunford. "We watch with great concern when industry partners work in China knowing there is that indirect benefit…and frankly, 'indirect' may not be a full characterization of the way it really is; it's more of a direct benefit to the Chinese military."[13]

Venture capitalist Peter Thiel was even less circumspect: "The weird fact, that's indisputable, is that Google is working with communist China but not with the U.S. military on its breakthrough AI technology." The Facebook boardman speculated that Google sided with China because its leadership expected infiltrators to steal the technology otherwise. Nevertheless, said Thiel, Google's decision to abandon work on a set of computer-vision algorithms known as Project Maven—"a Manhattan Project for AI"—in favor of China was possibly treasonous given their dual-use military applications.[14]

Coupled with China's stated objective of becoming the world's first "AI Superpower," Google's behavior intimated a fundamental disagreement between the Pentagon and Silicon Valley. The reality, however, is a close partnership dating back years. In fact, the Department of Defense has awarded information technology companies thousands of contracts that could be leveraged to strengthen export controls against China. Tech Inquiry, a nonprofit organization led by former Google executive Jack Poulson, researched the breadth of these deals in 2020 as part of a broader transparency project. The study revealed how big tech companies are awarded DOD contracts through intermediaries, including traditional defense firms, like Dell and General Dynamics. Data pulled from federal procurement records showed that Microsoft held the largest number of subcontracts (6,680), followed by Amazon (477), Google (384), and Facebook (172). Also listed were graphics specialist NVIDIA (163), Twitter (43), and Palantir (26), a software company specializing in data analytics.[15]

DOD's reliance on big tech companies that also work for the PRC suggests the U.S. export control system will continue to struggle absent structural reforms. After reviewing the responses of seven agencies on illicit transfers, the Senate Permanent Subcommittee on Investigations reported that the federal government has no comprehensive effort to counter Beijing's "strategic plan to acquire knowledge and intellectual property from researchers, scientists, and the U.S. private sector."[16] The subcommittee described a "whole-of-government campaign to recruit talent and foreign experts from around the world" for the purpose of making China the undisputed leader in science and technology by mid-century. The recruitment programs have incentivized thousands of U.S. citizens to transmit knowledge and research to China "in exchange for salaries, research funding, lab space, and other incentives."[17]

The PRC also obtains militarily useful technology through private equity and sovereign investment funds, hundreds of which have operated in the United States with some $600 billion in government-provided capital.[18] In 2014, for example, the Ministry of Finance and China Development Bank

Capital invested $20 billion to launch the National Integrated Circuit Industry Investment Fund with the stated goal of accelerating the semiconductor industry in the PRC.[19] The fund has reportedly invested in about two-dozen semiconductor makers, such as video-display processor Pixelworks and Black Sesame Technologies, an artificial intelligence company focused on autonomous driving and advanced driver-assistance systems.[20] The fund's second round of financing was seemingly unaffected by a recent drop in Chinese venture capital investments, raising $29 billion from an extended list of government entities, state media has announced.[21] The U.S. has stiffened regulations to slow China's acquisition of sensitive technologies, especially those associated with unmanned vehicles, but private equity deals that are potentially harmful to national security continue to be approved.[22]

The situation has been no less challenging in Europe, where Chinese state-owned enterprises have systematically acquired high-tech companies, spending hundreds of billions of dollars against nominal resistance from government regulators. China's European spending spree peaked in 2016, but only because Beijing re-imposed capital controls, concerned that its banking system had become overleveraged by purchasing foreign assets.[23] The three largest targets for Chinese capital—Germany, France, and the United Kingdom—have since improved their oversight of mergers and acquisitions that affect national security, while Brussels has implemented new guidelines to screen foreign direct investment within the greater European Union.[24]

A group of European governments recently rejected Huawei Technologies and ZTE Corporation as 5G equipment providers following a diplomatic row with Washington, which had designated the Chinese telecoms as threats to U.S. national security. Such intermittent progress is welcome news, but there remains much less transatlantic cooperation on export controls than in decades past, when NATO members adopted strict rules governing transfers to the Soviet Union and PRC. China's economy has since matured into a crucial market for European exporters, making technology and capital controls more painful than ever to the international

Structural reforms will be necessary to prevent science and technology transfers from Silicon Valley to the PLA, including Google's work developing AI capabilities for China, from harming U.S. national security. (New America at www.newamerica.org under Creative Commons license.)

business community. In 2020, Germany for the first time exported more goods and services to China than to any single European Union trading partner.[25] By the end of 2021, China could unseat the United States as Germany's largest importer. Other EU powers are less dependent on Chinese demand, but there is no mistaking that multilateral support for an export control regime directed at the second largest market in the world will require the United States and its closest allies to bring significant economic and diplomatic pressure to bear.

## Impact Investing

The problem of technology transfers to China may have a financial solution. The U.S. government has authority to link federal funding to export controls in order to induce compliance across industry and academia. Ironically, the big banks may provide a blueprint for this approach. "Impact investing," J.P. Morgan explains, is a strategy for generating "measurable positive social or environmental impact alongside financial return."[26] Commonly known as "Environmental Social Governance" (ESG), the movement has gained popularity in recent years, with an estimated $30 trillion in assets now managed under some form of impact investing.[27] While the political values behind the ESG movement are not without controversy, the impact investing method itself is transferrable to financial warfare operations.

Impact investing is executed in one of two ways. Under the exclusion method, asset managers invest in only those companies with acceptable ESG scores. Businesses are rated based on a host of criteria, such as the number of females serving on the board of directors or the amount of greenhouse gasses emitted. The ratings determine whether an associated stock or bond is purchased. For example, low ESG scores might cause a portfolio manager to omit oil and mining stocks from a mutual fund in favor of companies that build renewable energy products.

A more direct method of impact investing uses shareholder activism to change or modify corporate behavior. Voting rights allow investors to weigh in on key corporate decisions, such as acquisitions and board elections. Shareholders may use proxy votes to cast a ballot when they are unable to attend meetings in person. Investors in a comingled vehicle—typically a mutual fund or exchange-traded fund—relinquish their voting rights to the asset manager, who can exercise policy preferences through a third-party company or internal governance team.

## National Security Governance (NSG)

The Department of Defense can press industry to increase its efforts against Chinese espionage and influence operations by employing impact investing methods in its contract award process. Every company that competes for DOD work could receive an NSG rating that reflects its export control compliance record and its plan for protecting sensitive technology in the future. Under such a merit-based system, contractors that adopt best practices would be rewarded with NSG credits; those that continue to leak dual-use technology would receive debits. Integrating this system into the contract award process so that NSG ratings influence close competitions would strongly incentivize vendors to safeguard technologies from U.S. adversaries.

Educational institutions that apply for DOD research grants should also be rated on their record of protecting sensitive technologies. Many university leaders have neglected to take effective action against Chinese espionage and influence operations despite ample warning from government agencies. Some prestigious American schools have even accepted millions of dollars in unreported payments from China in exchange for access. The Federal Bureau of Investigation recently confirmed that China pays scientists at U.S. universities to steal technology, including "valuable, federally funded research," to the point where American taxpayers are "footing the

bill for China's own technological development."[28] Linking NSG ratings to research funding may prove the best way for DOD to protect its intellectual property on campuses where administrators have shown little interest in export controls.

NSG ratings could be managed by the Defense Technology Security Administration in conjunction with the Bureau of Industry and Security at the Department of Commerce and other agencies within the U.S. export control regime. Vetted service providers with expertise in industrial and cybersecurity policy could calculate NSG grades using the DOD model. Ultimately, the U.S. government could extend NSG ratings beyond defense vendors and grant recipients to include federal contracts of all kinds. American companies and universities that enjoy federal funding would almost certainly take preventative action if they stood to lose millions—even billions—of dollars for not protecting sensitive technologies.

Federal contractors with poor NSG grades would need to be held accountable for the system to work. Under U.S. law, contractors can be debarred or suspended under a variety of circumstances. Statutory debarments and suspensions for violating laws apply across the federal government and are often mandatory punishments with prescribed terms. Congress could also deny DOD research grants and contracts to institutions of learning that do not sustain a proficient NSG rating. One statutory debarment provides precedence by denying defense funds to schools that prohibit military recruiting on campus.[29] More flexibility is found under the Federal Acquisition Regulation (FAR), which authorizes the exclusion of contractors to protect government interests more broadly. The White House could issue executive orders that amend the FAR to exclude contractors—foreign and domestic—that fail the NSG test. As the largest buyer of goods and services in the world, the U.S. government is well positioned to require effective export controls from friends and allies in exchange for its business.

## A New Kind of Proxy War

The National Security Governance framework might also help the Pentagon temper Wall Street's appetite for Chinese stocks. Ironically, the accumulation of shareholder voting rights in Chinese companies by U.S. asset managers offers the Department of Defense an opportunity to reduce technology and capital flows to the CCP's state-owned enterprises. Due to the large amount of proxy votes associated with them, modern index funds have become de facto partners of China's State Council, under which all SOEs are managed and regulated. While the Chinese Communist Party has firm control over the state-owned enterprises, a large percentage of their tradable shares are held by U.S. funds, exposing American investors to real business risk with only the illusion of influence. The power imbalance is made worse by the Chinese government's ability to suspend stock exchange activity at will. If Beijing can halt trading for indefinite periods of time when market conditions are volatile, then it can prevent investors from selling shares during a foreign relations crisis.

Beijing's unquestioned authority over all capital invested in China also raises issues for U.S. firms that possess sensitive technologies. The FBI explains that China uses not only its intelligence services, but also state-owned enterprises and supposed private companies, to steal data and know-how. Cyber intrusions and the corruption of trusted insiders are among the sophisticated techniques the Chinese military use to target individuals.[30] To help American companies avoid these traps stateside, the Department of Defense recently sent to Congress a list of PLA-linked companies operating inside the United States.[31] The next logical step is for DOD to produce a list of such companies operating inside the PRC itself.

The cleanest way to keep bad actors at a safe distance is to create a corporate buffer. U.S. asset managers who insist on holding stock in China's most suspect SOEs should be required to cede their

voting rights in those concerns. The federal government could then manage the proxy votes in trust using third-party fiduciaries who are familiar with the corporate governance rules in the PRC as well as the national security priorities of the United States. Uncle Sam would effectively replace BlackRock, State Street, and Vanguard inside the boardrooms of CCP-controlled companies. Complaints from Beijing over Washington's involvement in Chinese businesses would be expected but easily dismissed, given the PRC's ownership stakes in U.S. companies through state-backed investment funds.

Coercion is another reason for the U.S. government to assume the voting rights of many state-owned enterprises. The CCP has pressured Western investors to toe the party line on key corporate governance votes, research shows, with large mutual funds less likely to oppose reform proposals than smaller shareholders.[32] In 2017, BlackRock and other asset managers reportedly voted to require the boards of two Hong Kong-traded companies—China Petroleum & Chemical Corp and Industrial & Commercial Bank of China—to seek advice from the CCP on important decisions.[33] Boardroom bullying and intimidation tactics of this kind prevents civilian asset managers from acting independently on behalf of their clients, violating fiduciary standards that U.S. regulators expect of mutual funds and other publicly traded investments.

A proxy voting system based on NSG investing principles can be realized using the International Emergency Economic Powers Act (IEEPA), which gives the president broad authority to limit financial transactions in support of national security goals. The federal government has already recognized the PRC as a "foreign adversary," because it is "…engaged in a long-term pattern of serious instances of conduct significantly adverse to the national security of the United States…"[34] Upon determination that China's growing military power represents a national emergency, the executive branch could assume control of the voting rights in select CCP-connected companies. U.S. citizens, companies, and subsidiaries would ideally be covered so that offshore holdings are non-exempt.

Challenges to using IEEPA in this manner—even by powerful institutional investors—would probably be ineffective. Legal precedence is clear that U.S. citizens financially harmed by economic sanctions are not entitled to government compensation.[35] The court of public opinion offers plaintiffs even less promise. Retail investors whose voting rights are already held by asset managers are unlikely to be affected. Equally difficult to imagine is everyday Americans sympathizing with Wall Street executives who are denied access to the boardrooms of China's defense contractors.

The NSG proxy vote solution would be more effective than delisting all Chinese stocks from U.S. stock exchanges. Companies that fail to meet accounting standards should be expelled, but this gesture will not slow U.S. capital flows to Chinese companies operating in the global marketplace. Samsung Electronics is listed on the Korea Exchange without an American depository receipt that U.S. investors can purchase from home, yet a market capitalization of more than $400 billion makes it one of the world's largest companies.

Another questionable idea—outlawing all Chinese equities—would be politically challenging at home and potentially destabilizing abroad. Bloomberg notes that U.S. residents have amassed roughly $700 billion worth of Chinese stock, but the real figure is likely double that when offshore accounts are included.[36] Even if a ban on Chinese stocks became law, institutional investors have well-established workarounds to trade foreign securities. Chinese debt, for instance, already accounts for an estimated one-third of corporate bond investments made through the Cayman Islands.[37] Rather than tilt at windmills trying to keep dollars from entering Chinese exchanges, the U.S. government

should simply require shareholders of certain state-owned enterprises to relinquish their proxy votes to federal trustees. Such a policy would not end U.S. investment in China, but it would surely discourage ownership of bad actors by large institutions, forcing Beijing to reconsider its pursuit of American capital.

Employees in the United States could benefit from policies that discourage retirement fund managers from buying SOE shares in general. Back-testing shows the WisdomTree China ex-State-Owned Enterprise Index—a benchmark of Chinese stocks less those with at least twenty percent government ownership—dramatically outperforming the MSCI China Index in recent years (see figure 1). While past performance is no guarantee of future results, since inception the China ex-SOE Index has grown twice as fast as the standard China benchmark on an annualized basis, suggesting that average investors might fare better without exposure to companies directly controlled by the PRC.[38]

Similarly, American employees might be well served without the corporate bonds of many state-owned enterprises. Once thought to enjoy government backing, these bonds have exhibited higher default rates since 2018, when provincial authorities and regulators began letting some SOEs miss payments. The CCP's "orderly exit" approach to overleveraged SOEs appears part of a broader strategy to restructure debt at the expense of foreign bondholders. While perhaps orderly today, American investors could be left holding the bag if widescale defaults triggered panic selling out of SOE bonds.

The risk inherent to state-owned enterprises stems from the reality that many lack the controls and motives of conventional businesses. "Chinese regulators are often politically powerless to impose financial discipline on major SOEs," the U.S.-China Economic and Security Review Commission reports, "as officials often pressure banks to grant them favorable interest rates and even loan forbearance."[39] The absence of real accountability means that uncompetitive SOEs may operate as "zombies"—indebted companies that can only repay interest—long after becoming insolvent. On balance, state-owned enterprises are considered less efficient, less innovative, less growth-oriented and more corrupt than privately owned Chinese companies, all but ensuring underperformance over time. Newer state-controlled companies, such as Alibaba, may ultimately improve the performance of SOEs, but

**Figure 1. Hypothetical Growth of $10,000, China ex-SOE Index vs. MSCI China Index, 2015 - 2021**

the underlying risks that make many of these securities unsuitable for average investors will remain.

## Financial Counterattack?

How might the PRC react to stronger technology and capital controls? The American press has speculated that China could dump its U.S. Treasury securities in anger or as part of a strategic plan to de-dollarize the global economy. The idea makes for excitable headlines but is improbable for the basic reason that China buys Treasurys so that America will buy its goods. A PRC selloff of Treasurys would create an excess supply of dollars, increasing the relative value of the Renminbi at the expense of Chinese exporters, who rely on a weak currency to make their products competitive in the U.S. market. Taken to the extreme, a strong Renminbi could devastate China's export-dependent economy. Now officially labelled a "currency manipulator" by Washington, Beijing has all but refused to discuss the issue, an advantageous foreign exchange rate—i.e., a relatively strong U.S. Dollar—being the lynchpin of its economic strategy.

China's financial system also needs the safety and stability of Treasurys. The People's Bank of China might ultimately reduce its reliance on the U.S. Dollar in favor of competing reserve currencies,

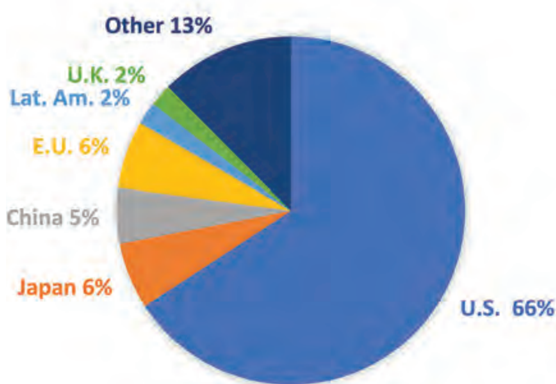


**Figure 2. China holds about 5% of outstanding Treasury securities**[40]

but such a move is unlikely anytime soon. The Chinese economy has never been so leveraged, with a record three-hundred percent debt to gross domestic product, putting its financial institutions in no position to dump dollars used for reserves and international payments.[41] China's central bank more likely worries about losing access to dollars in the event of a crisis. In July 2020, Chinese state lenders reportedly scrambled to secure alternate sources of liquidity after U.S. congressmen threatened financial sanctions on banks serving government officials behind the Hong Kong crackdown.[42]

Even if Beijing ignored the risks of dumping its dollar-denominated debt, the $1 trillion of Treasurys held by China could be absorbed by the $120 trillion global bond market. Treasurys have lower risk and higher yields than comparable sovereign debt instruments, making them attractive to fixed income buyers, including defined benefit plans, insurance companies, and bond funds. The yield on the U.S. ten-year bond hovered around 1.6 percent as of early-May 2021, characteristically higher than its counterparts in Germany (-0.2 percent), Japan (0.1 percent), and the United Kingdom (0.8 percent). A temporary spike in rates caused by Chinese selling would prompt asset managers to swap their corporate bonds for U.S. government debt with similar yields and durations as a way of de-risking portfolios. If the risk arbitrage trade failed to soak up excess Treasurys, the U.S. Federal Reserve, the European Central Bank, and the Bank of Japan could step in to purchase the remaining securities.

A more likely scenario is that China would strategically default on debt held by American investors. A decade-long credit expansion has left Chinese banks overextended. Rather than restructure non-performing loans at the expense of local banks, Beijing has propped up failing state-owned enterprises with foreign capital amounting to a managed opening of its financial market. The U.S.-China Economic and Security Review

Commission summarized the situation in its 2020 report to Congress:

> *"After years of unbridled lending, China's financial system is facing mounting problems. Local governments have recorded significant revenue shortfalls, banks remain undercapitalized, and an aging population threatens persistent current account deficits. The Chinese government seeks to attract large volumes of new foreign investment to meet these capital shortfalls. These circumstances provide the key context for the entry of foreign capital and expertise into the country's financial system."*[43]

Western asset managers in search of returns have accommodated the staged opening of China's financial market by stepping up their purchases of debt instruments. In late 2019, the Ministry of Finance issued the PRC's first Euro-denominated bonds in fifteen years, attracting €4 billion ($4.5 billion) from institutional investors, such as pension funds and insurance companies.[44] In 2020, U.S. private credit interests began moving into the Chinese market to buy up distressed debt instruments trading at a discount. Due to its total control over capital invested in China, the PRC could strategically default on debt issues disproportionately owned by foreign investors. Even while targeting the United States in this fashion, the PRC could continue holding Treasury securities, confident that Washington would not intentionally default.

A key lesson of the U.S.-China trade war is that the PRC has few economic weapons it can use against the United States without hurting itself. China's export-driven economy relies on the U.S. consumer for demand; its financial system depends on U.S. dollars for liquidity; its state-controlled businesses increasingly need U.S. capital. Shortly after President Trump raised sanctions in 2019, cracks emerged in the Chinese economy, its second quarter growth dropping by half. Within weeks, manufacturers based in China began offshoring operations to countries with better U.S. relations. Throughout the standoff, China's Treasury holdings remained stable, indicating that Beijing does not view debt dumping as a practical tool.[45] This finding should prompt the U.S. Intelligence Community to assess what financial weapons the CCP might consider using in the future.

## Show me the Renminbi

Financial warfare requires financial intelligence. The defense intelligence community tracks the PLA's military capabilities around the world, but these efforts alone may not create enough understanding of China's asymmetric expansion strategy. Foreign policy analysts have warned that Chinese expansionism differs dramatically from the Soviet way. Although it has secured military outposts in several countries, the PRC's main approach is to ensnare governments economically and financially, oftentimes by compromising local elites. After flooding a state with strategic investments, loan packages and bribes, political resistance eventually fades away, leaving Beijing with the upper hand on national security matters.

"Debt trap diplomacy" appears central to Beijing's expansionist strategy across the African, Asian, and South American areas where China has become a dominant lender. By overextending credit to financially unstable countries, the PRC positions itself to extract political and economic concessions if repayment becomes difficult. Most of China's loan contracts have confidentiality clauses, but the terms that are observable usually prohibit debt restructuring, even in the event of financial distress.[46] Whether the PRC is consciously structuring loans to influence foreign capitals or simply practicing aggressive underwriting, indebtedness creates a power imbalance in favor of the creditor. Given its past efforts to diplomatically isolate

Taiwan through economic pressure, U.S. defense leaders may reasonably assume that China will pursue its national security interests by exploiting the financial weakness of its borrowers should opportunities arise.

The U.S. Intelligence Community is aware of the PRC's financial intrusions overseas, but there is no centralized effort to map this influence across multiple factors. The Defense Intelligence Agency (DIA) could fill this void by leading an interagency effort to understand the true state of Chinese expansionism. Civilian agencies and contractors are well suited to follow China's financial and business interests overseas. DIA, however, is most incentivized to understand the threat they pose to U.S. regional security commitments.

Africa Command, Central Command, Indo-Pacific Command, and Southern Command have a vested interest in knowing what national and commercial interests the PLA can impact within their respective areas of responsibility. Intelligence on seaports, airports, toll roads, and utilities controlled by the PRC is relevant to the combatant commands. Also salient is intelligence on Chinese state-owned enterprises active in the regions—especially those providing essential service and those involving local elites. Much of this information is obtainable through open source intelligence, but there is a role for other government agencies that can clarify informal business relationships.

## Money Mindset

The U.S. government has a range of options to tighten technology and capital controls on China. This article has recommended that the Department of Defense spearhead three initiatives to: (1) promote compliance with export controls by leveraging federal grants and contracts; (2) discourage U.S. investment in certain state-owned enterprises by assuming custody of shareholder voting rights; and (3) develop an intelligence capability that can track Chinese expansionism through business and financial channels as well as traditional military metrics. Some financial warfare concepts may be unfamiliar to a DOD that has relied on other departments to manage the economic power of the United States. The U.S. military, however, is versatile enough to integrate financial warfare operations into its broader strategy for countering the China threat.

The Pentagon should view financial intelligence as a potential force multiplier against the People's Liberation Army rather than a subject "outside its lane." DOD, in fact, has more access to financial expertise than defense leaders may appreciate. The reserve component of the U.S. Armed Forces includes servicemembers with backgrounds in capital markets and international business. DOD contractors include Fortune 100 companies that can analyze the financial battlefield as expertly as any government agency. Agile firms, like Roger Robinson's RWR Advisory Group, are already tracking China's overseas business relationships through open source methods. Networking these resources into a formal structure would enable DIA to develop an early warning system for China's financial warfare activities.

U.S. policymakers for decades have assumed economic dominance when contemplating America's instruments of national power. This luxury of wealth encouraged the Department of Defense to outsource most non-military policy issues. Unfortunately, the federal government has largely failed to protect financial and economic interests central to the DOD mission of national defense. The unpleasant truth is that American-made technology sits at the heart of China's defense modernization program while American capital has fueled the growth of China's state-owned enterprises. Every passing year leaves U.S. servicemembers with a narrower advantage over a People's Liberation Army that sees no daylight between the economic and military objectives of the PRC. Following a military-civil fusion strategy is not an

option for a free-market United States, but neither is allowing China's financial warfare operations to go unchecked. PRISM

## Notes

*This article contains general discussion of the financial markets provided by All Source Investment Management ("All Source"). The information and opinions are theirs, but the accuracy and completeness cannot be guaranteed. Throughout the article, All Source may generally discuss different investments and historical events regarding the financial markets and various types of investments; however, nothing in the article should be construed as a recommendation to buy or sell any financial vehicle, nor should it be used to make decisions today about your financial situation. Please understand that All Source cannot make any promises or guarantees that you will accomplish such goals. All investments are subject to risk including the potential loss of principal. The purpose of the article is to provide general information on the subjects covered. The author of this article as well as the information presented in the article is not related to, endorsed by, nor connected with and not approved by any government agency or organization. Despite efforts to be accurate and current, this article may contain out-of-date information; the author is under no obligation to advise you of any subsequent changes related to the topics discussed in this article.*

[1] Office of the Secretary of Defense, "Military and Security Developments Involving the People's Republic of China: Annual Report to Congress," 2002, p. ii.

[2] Karen Kerrigan, "Russia Sanctions Bill Hurts U.S. Small Businesses, Not Vladimir Putin," *Issues & Insights*, March 12, 2020, accessed November 25, 2020, https://www.effectivesanctions.org/category/news/, ; Small Business & Entrepreneurship Council, "Fact Sheet: DASKA targets U.S. companies, not the Kremlin," January 20, 2020, accessed November 25, 2020, https://www.effectivesanctions.org/fact-sheet-daska-targets-u-s-companies-not-the-kremlin/

[3] The White House, "The Chinese Communist Party's Ideology and Global Ambitions," June 26, 2020, https://www.whitehouse.gov/briefings-statements/chinese-communist-partys-ideology-global-ambitions/

[4] BlackRock Institutional Trust Company, N.A. (BlackRock) manages the I Fund as well as the F, C and S Funds.

[5] Bill Gertz, "NSA Details Chinese Cyber Theft of F-35, Military Secrets," *The Washington Free Beacon*, January 22, 2015; Siobhan Gorman, August Cole and Yochi Dreazen, "Computer Spies Breach Fighter-Jet Project," *The Wall Street Journal*, April 21, 2009.

[6] $10 billion estimate is based on recent TSP fund values and a 12% country weighting to Chinese stocks in the MSCI ACWI ex USA IMI Index (USD).

[7] Lingling Wei, Bob Davis and Dawn Lim, "China Has a Friend In Wall Street," *The Wall Street Journal*, December 3, 2020.

[8] Aon Hewitt Investment Consulting, Inc., Report to Federal Retirement Thrift Investment Board, "I Fund Benchmark Study," October 2019, p. 5, accessed November 25, 2020, https://www.frtib.gov/ReadingRoom/InvBMarks/2019_Oct_Benchmark_Evaluation_Report.pdf.

[9] *Ibid*, Aon.

[10] The White House, "Executive Order on Addressing the Threat from Securities Investments that Finance Communist Chinese Military Companies," November 12, 2020; Humeyra Pamuk, Alexandra Alper and Idrees Ali, "Trump bans U.S. investments in companies linked to Chinese military," *Reuters*, November 13, 2020.

[11] Audrey Conklin, "Navarro: Trump admin 'tackling Chinese companies that mean to do America harm,'" *FOXBusiness.com*, accessed November 25, 2020, https://www.foxbusiness.com/markets/navarro-trump-chinese-companies

[12] Saleha Mohsin, "U.S. Extends Period for Investors Coping With China Stock Ban," *Bloomberg*, January 27, 2021, accessed April 30, 2021, https://www.msn.com/en-us/money/markets/us-extends-period-for-investors-coping-with-china-stock-ban/ar-BB1d8HkD

[13] Harper Neidig, "Top Pentagon officials say Google work is 'benefiting the Chinese military," *The Hill*, March 14, 2019, accessed November 25, 2020, https://thehill.com/policy/technology/434064-top-pentagon-officials-say-google-work-is-benefiting-the-chinese-military

[14] Suzanne O'Halloran, "Google working with China but not US military is 'peculiar': Peter Thiel," *FOXBusiness.com*, July 15, 2019, accessed November 25, 2020, https://www.foxbusiness.com/technology/google-working-with-china-but-not-us-military-is-peculiar

[15] Jack Poulson, "Reports of a Silicon Valley/Military Divide Have Been Greatly Exaggerated," *Tech Inquiry*, July 7, 2020, accessed November 25, 2020 https://techinquiry.org/SiliconValley-Military/#conclusions

[16] U.S. Senate Committee on Homeland Security and Government Affairs, Permanent Subcommittee on Investigations, "Threats to the U.S. Research Enterprise: China's Talent Recruitment Plans, November 19, 2019, accessed November 25, 2020, https://www.hsgac.senate.gov/imo/media/doc/2019-11-18%20PSI%20Staff%20Report%20-%20China's%20Talent%20Recruitment%20Plans%20Updated.pdf

[17] *Ibid*, U.S. Senate, p. 1.

[18] Mercedes Ruehl, James Kynge and Kiran Stacey, "Chinese state-backed funds invest in US tech despite Washington curbs," *The Financial Times*, December 2, 2020

[19] Wei Sheng, "China's second chip-focused 'Big Fund' raises $29 billion," *technode.com*, October 28, 2019, accessed on December 5, 2020, https://technode.com/2019/10/28/chinas-new-chip-focused-big-fund-raises-rmb-204-billion/

[20] *Ibid*, Ruehl, Kynge and Stacey; Charles Qi, "Black Sesame Technologies: Ensuring Safety in Innovation," *CIOReview.com*, 2019, accessed December 5, 2020, https://automotive.cioreview.com/vendor/2019/black_sesame_technologies

[21] *Ibid*, Sheng.

[22] Cassie Gao, Adam Lysenko, Mark Witzke, Thilo Hanemann, and Daniel H. Rosen, "Two Way Street – US-China Investment Trends – 1H 2020 Update," Rhodium Group Report, September 17, 2020.

[23] Thilo Hanemann, Mikko Huotari and Agatha Kratz, "Chinese FDI in Europe: 2018 trends and impact of new screening policies," *MERICS*, March 6, 2019, accessed November 25, 2020, https://merics.org/en/report/chinese-fdi-europe-2018-trends-and-impact-new-screening-policies

[24] *Ibid*, Hanemann, Huotari and Kratz.

[25] Federal Statistical Office (Germany), "Foreign Trade," November 2020, accessed November 25, 2020, https://www.destatis.de/DE/Themen/Wirtschaft/Aussenhandel/Tabellen/aussenhandel-detaildaten.pdf?__blob=publicationFile

[26] J.P. Morgan Private Bank, "Impact investing," accessed November 11, 2020, https://privatebank.jpmorgan.com/gl/en/services/investing/sustainable-investing/impact-investing

[27] Jacqueline Poh, "Conflicting ESG Ratings Are Confusing Sustainable Investors," *Bloomberg*, December 11, 2019, accessed November 25, 2020, https://www.bloomberg.com/news/articles/2019-12-11/conflicting-esg-ratings-are-confusing-sustainable-investors

[28] Christopher Wray, "The Threat Posed by the Chinese Government and the Chinese Communist Party to the Economic and National Security of the United States," Hudson Institute, Video Event: China's Attempt to Influence U.S. Institutions, July 7, 2020, accessed November 25, 2020, https://www.fbi.gov/news/speeches/the-threat-posed-by-the-chinese-government-and-the-chinese-communist-party-to-the-economic-and-national-security-of-the-united-states

[29] Congressional Research Service, "Debarment and Suspension of Government Contractors: An Overview of the Law Including Recently Enacted and Proposed Amendments," (RL34753), November 19, 2008.

[30] *Ibid*, Wray.

[31] *Ibid*, White House.

[32] Shunlin Song, "Shareholder voting in China: The role of large shareholders and institutional investors," *Corporate Governance*, Volume 28, Issue 1, January 2020, pp. 69-87, accessed November 25, 2020, https://www.onlinelibrary.wiley.com/doi/10.1111/corg.12303

[33] *Ibid*, Wei, Davis and Lim.

[34] Executive Order 13920, "Securing the United States Bulk-Power System," May 1, 2020.

[35] Congressional Research Service, "The International Emergency Economic Powers Act: Origins, Evolution, and Use," (R45618), July 14, 2020.

[36] Shuli Ren, "Treasury Has $541 Billion of Dirty Little Secrets," *Bloomberg*, September 21, 2020, accessed November 25, 2020, https://www.bloomberg.com/opinion/articles/2020-09-21/u-s-keeps-investing-in-china-as-value-investing-dies; Antonio Coppola, Matteo Maggiori, Brent Neiman and Jesse Schreger, "Redrawing the Map of Global Capital Flows: The Role of Cross-Border Financing and Tax Havens," July 2020, accessed November 25, 2020, https://globalcapitalallocation.s3.us-east-2.amazonaws.com/CMNS-Paper.pdf.

[37] *Ibid*, Coppola, Maggiori, Neiman and Schreger, p. 13.

[38] Index Performance Attribution: CHXSOE vs MXCN, 3/31/2015 - 3/31/2021, Bloomberg.

[39] U.S.-China Economic and Security Review Commission, 2020 Report to Congress of the U.S.-China Economic and Security Review Commission, (U.S. Government Printing Office, Washington): 2020, p. 240.

[40] U.S. Department of Treasury, "U.S. Liabilities to Foreigners from Holdings of U.S. Securities," accessed December 5, 2020, https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/shlreports.aspx

[41] Chetan Ahya, Derrick Kam, Nora Wassermann, Julian Richers and Frank Zhao, "Global Debt Factbook," *Morgan Stanley Research*, July 22, 2020.

[42] Cheng Leng, Julie Zhu and Engen Tham, "Exclusive: Chinese banks prepare contingency plans over threat of U.S. sanctions, sources say," *Reuters*, July 9, 2020.

[43] *Ibid*, U.S.-China Commission, p. 10.

[44] Frances Yoon, "China Sells First Euro Bonds Since 2004," *The Wall Street Journal*, November 5, 2019.

[45] U.S. Department of Treasury, "Major Foreign Holders of Treasury Securities," October 21, 2020.

[46] Anna Gelpern, Sebastian Horn, Scott Morris, Brad Parks and Christoph Trebesch, How China Lends: A Rare Look into 100 Debt Contracts with Foreign Governments, *Center for Global Development*, March 2021, p. 45.