A PUBLICATION OF HILLSDALE COLLEGE

Imprimis

OVER 4,700,000 READERS MONTHLY
October 2019 · Volume 48, Number 10

Why and How the U.S. Should Stop Financing China's Bad Actors

Roger W. Robinson, Jr.
Chairman, Prague Security Studies Institute

ROGER W. ROBINSON, JR. is president and CEO of RWR Advisory Group and co-founder and chairman of the Prague Security Studies Institute. He earned a B.A. from Duke University and an M.A. from George Washington University. He served as senior director of international economic affairs on President Reagan's National Security Council, where he was the principal architect of the secret economic and financial strategy that proved decisive to the defeat of the Soviet Union. He later served as chairman of the Congressional U.S.-China Economic and Security Review Commission. Prior to his government service, he was a vice president in the international department of the Chase Manhattan Bank.

The following is adapted from a speech delivered at Hillsdale College on September 9, 2019, during a conference on the topic, "Understanding China."

In the early 1980s, I served on President Reagan's National Security Council. Prior to my time at the White House, I was a vice president at Chase Manhattan Bank, in charge of its USSR and Eastern Europe division. It was my job to assess the creditworthiness of the countries in that part of the world, and I had come to realize that the Soviet Union had relatively modest hard currency income—and that what little it had came largely from the West.

In 1982, the Soviets had an empire stretching from Havana to Hanoi, but their hard currency revenue totaled only about $32 billion a year—roughly one-third the annual revenue of General Motors at the time. They were spending about $16 billion more annually than they were making, with the funding gap—the USSR's life support—being financed by Western governments and banks.

President Reagan had long believed that the Soviet Union was economically vulnerable, because he knew it lacked the entrepreneurship, technological dynamism, and freedoms that are the prerequisites of a strong modern economy. And when he learned that we in the West were financing its brutal regime, he committed to slowing, and ultimately terminating, that flow of discretionary cash.

Our European allies had a completely different approach. Their belief in *Ostpolitik*, as the Germans called it, presupposed that commercial bridge-building would lead to geopolitical cooperation. If the West would offer financing and trade with the Soviets, peace and prosperity would result. Meanwhile, the Soviets were using the proceeds of Western loans, hard currency revenue streams, and technological support to build up their military, expand their empire, and engage in anti-Western activities.

The Reagan administration drew the line on a project called the Siberian Gas Pipeline, a 3,600-mile twin-strand pipeline that stretched from Siberia into the Western European gas grid. If completed, not only would it become the centerpiece of the Soviets' hard currency earnings structure, but Western Europe would become dependent on the USSR for over 70 percent of its natural gas, weakening Western Europe's ties to the U.S. and leaving the continent open to Kremlin extortion. Moreover, the pipeline was being financed on taxpayer-subsidized terms, since France and Germany viewed the USSR as a less developed country worthy of below-market interest rates.

Imprimis (im-prī-mis), [Latin]: in the first place

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ISSN 0277-8432

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The U.S. at the time had a monopoly on oil and gas technology that could drill through permafrost—which we had developed for Alaska's North Slope—and we imposed oil and gas equipment sanctions on the USSR and European companies that were helping to build the Siberian pipeline. At one point, despite the strain it placed on relations with our NATO allies, we closed the U.S. market entirely to companies that continued to supply the pipeline project over our objections. Four of the six affected companies went under within six months, and Europeans woke up to the fact that they could do business with us or the Soviets, but not both.

As a result of these efforts we capped Soviet gas deliveries to Western Europe at 30 percent of total supplies, delayed the first strand of the pipeline by years and killed the second strand, and eventually helped dry up the bulk of Western credits to the USSR. In a secret deal, we also persuaded the Saudis to pump an additional two million barrels of oil per day and decontrolled prices at the wellhead in this country, knocking oil prices down to about $10 a barrel—significant because for every dollar decrease in the price of a barrel, the Soviets lost some 500 million to one billion dollars. In short, the Soviet Union never recovered from these economic and financial blows. It defaulted on some $96 billion in Western hard currency debt shortly before the total collapse of the Soviet empire.

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The story with China today has certain similarities, but with one big difference: the U.S. has been

playing the role of the naïve Europeans. Since adopting the Kissinger policy of engaging with China in the 1970s, our government has operated on the assumption that economic and financial relations with China would lead Beijing to liberalize politically. And since 2001, when we backed China's entry into the World Trade Organization, the pace at which we have given China access to our best technology and capital and trade markets has accelerated. Yet China has shown no signs of embracing individual freedoms or the rule of law.

Instead, with our support, the Chinese have launched a massive campaign to become the world's leading superpower. We know about the "Belt and Road Initiative," a strategic undertaking to place huge segments of the world under China's influence or outright control. We know about "Made in China 2025," a strategy designed to dominate key technology sectors—from artificial intelligence and quantum computing to hypersonic missiles and 5G. We know about China's practice of forced technology transfers: requiring American companies to share their trade secrets and R&D in order to do business in China. We know about China's predatory trade practices. We know many of these things only because President Trump has brought them to the forefront of national attention, for which he deserves credit. And the ongoing tariff war is a good thing in the sense that we've finally begun to take a stand.

But there is an issue more critical than trade that Americans, by and large, do *not* know about: China has over 700 companies in our stock and bond markets or capital markets. It has about 86 companies listed on the New York Stock Exchange, about 62 in the NASDAQ, and over 500 in the murky, poorly regulated over-the-counter market. Among these companies are some egregious bad actors. Hikvision, for example, is responsible for facial recognition technology that identifies and monitors the movement of ethnic Uyghurs. It also produces the surveillance cameras placed atop the walls of Chinese concentration camps holding as many as two million Uyghurs in Xinjiang. Both its parent company and Hikvision itself are on the U.S. Commerce Department Entity List (what many describe as the "Blacklist").

Do any of us have the financing of concentration camps in mind when we transfer money into our retirement and investment accounts?

This sounds difficult to believe, but it is an empirical fact: the majority of American investors are unwittingly funding Chinese concentration camps, weapons systems for the People's Liberation Army (PLA), and more. This is because the U.S. has no security-minded screening mechanism for our capital markets, which have roughly $35 trillion under management.

When it comes to screening Chinese investments in U.S. companies, we have the Committee on Foreign Investment in the United States, which was recently strengthened with the Foreign Investment Risk Review Modernization Act of 2018. Congress expanded its reach because it was properly worried about China undermining our security and stealing our technology.

Our capital markets, on the other hand, are completely unprotected. There are serial violators of U.S. sanctions in our markets today. There are proliferators to our adversaries of advanced ballistic missiles. There are manufacturers of sophisticated weapons systems for the PLA. There are companies that are militarizing the illegal islands in the South China Sea. There are companies helping maintain the North Korean nuclear threat. There are companies that have been indicted or whose employees have been arrested for espionage as well as known cyber criminals.

Do we find any of these material risk factors in the risk section of our prospectuses? No. Are we hearing about these concerns from our financial planners or fund managers? No.

Nor has there ever once been a hearing on this topic in Congress.

The trade war is hurting China—this is positive and long overdue. But the Chinese can manage it. What would hurt them immeasurably more would be any contraction in their access to our investment dollars. The Chinese are estimated to have attracted nearly two trillion dollars of American investment in equities alone. We do not even know the extent of our real exposure to China, because it has dollar-denominated bonds issued elsewhere in the world that are ending up in Americans' bond portfolios—our investment banks buy them overseas to utilize a loophole in our regulatory structure. But I can tell you that in the next 36 months, if nothing is done, our exposure will be two to three trillion dollars more than it is today. The Chinese are moving as fast as they can into the investment portfolios of the American people because they are in desperate need of our dollars.

A company's stock will likely decline when it becomes known that the company is providing surveillance cameras for concentration camps or producing ICBMs targeting American cities. You would think that demanding this kind of disclosure would be unobjectionable—but then why is it so hard? Is it because China would be offended?

Beyond the need for dollars, consider the fact that roughly 150 to 180 million Americans have investments in our capital markets. What if these scores of millions of Americans wake up one morning and discover that 15, 18, or 22 percent of their retirement accounts are in Chinese securities? That's not far-fetched—indeed, it is almost certain to happen if nothing is done. And if that happens, those scores of millions of Americans will have a vested financial interest in opposing any future sanctions or other penalties against China, irrespective of the severity of China's offenses or the overall threat it poses to America's national security. That's what China is knowingly working towards—and that's called "checkmate."

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The so-called China lobby is large and formidable today—consider how the NBA was recently cowed into silence regarding Chinese repression of the freedom movement in Hong Kong. But it is nothing compared to where things are headed if Americans become more heavily invested in China. And we remain largely blind to this development, just as we were blind—prior to Reagan's election in 1980—to the extensive financing of the Soviet Union by the West. So here we go again—another authoritarian villain waging economic and financial warfare against us and our allies—but this time even more aggressively and capably.

Astoundingly, Americans are even investing in China's sovereign bonds—bonds issued directly by the Chinese government, with the proceeds to be used at its sole discretion. Remember Liberty Bonds during World War II? The U.S. sold Liberty Bonds to finance our war effort. Today Americans are buying Chinese sovereign bonds to finance our own potential destruction—*anti-Liberty Bonds*. The California State Teachers' Retirement System, to cite just one example, owns Chinese sovereign bonds valued at over $4 million. The Prague Security Studies Institute is finding examples like this throughout our state public employee retirement systems.

Or look at university endowments. The University of Michigan has 44 percent of its $12.2 billion in assets in private equity and venture capital; of the venture capital portion, one-third of the investments are Chinese. This is not to single out or excoriate the

University of Michigan. Its investment portfolio is quite typical of what we're finding elsewhere.

Where is the disclosure related to these Chinese investments? Where is the due diligence on the part of fund managers and index providers? There are all kinds of investment policies and standards that prohibit the financing of concentration camps, human rights abuses, the PLA, organizations engaged in espionage, and violators of U.S. sanctions—but it's happening anyway. State legislatures need to take this up as a matter of urgent concern.

So far, we've talked mostly about private capital. What about our tax dollars? The Federal Thrift Savings Plan (TSP)—the retirement system for all federal employees—totals roughly $578 billion. It is the largest retirement fund in the country, with 5.7 million enrollees—including U.S. military personnel. For a long time, TSP managers were using a specific index for TSP's $50 billion international portfolio. Morgan Stanley Capital Investment (MSCI) has a whole range of indexes, and TSP was using an index containing only companies in developed countries—largely industrialized democracies. But in November 2017, the TSP Board had the idea of changing its index to capture yields from emerging markets. A Wall Street consulting firm introduced them to the MSCI All Country World Index, which includes China. Indeed, it includes companies such as AVIC, which makes fighter aircraft for the PLA and is China's largest producer of ballistic missiles, and China Mobile, which has been barred from U.S. government procurement for national security reasons.

The decision was made to begin moving the TSP international fund to this MSCI All Country World Index beginning next year.

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So what's to be done? The first urgent matter is to reverse the TSP Board decision before it is implemented. This should not be a partisan issue. Even leaving aside China's brutal repression of its own people, does anyone in America, Democrat or Republican, want to fund the production of weapons designed to kill American soldiers, sailors, and marines? Does any American want to underwrite the Chinese militarization of the South China Sea? Or finance U.S. sanctions violators, benefiting Iran and North Korea? Do Americans want to finance the destruction of their own liberty and the ruin of everything they hold dear? I think most Americans would react with outrage, if they knew the facts.

Next, it is urgent that Chinese bad actors be excluded from accessing U.S. capital markets—or at least be forced to disclose their malevolent past activities because of the material risks involved. To be candid, when it comes to China, there is a question whether one can even speak of *good* actors. Article 7 of the National Intelligence Law of China allows every commercial entity to be instantly weaponized—to commit espionage, technology theft, or whatever else is deemed to be in China's national interest—by simple order of the government. That's a matter of public record. In other words, for some fund managers who wish to eliminate bad actors from their portfolios, one solution is simply to eliminate Chinese enterprises. For others, careful, security-minded diligence is required.

Some detractors of this initiative will object that it is detrimental to the free flow of global capital—that it contracts the investable universe of fund managers, narrowing what they can buy in seeking a better yield. "Don't politicize the markets," will be a popular refrain. It's an unfortunate fact that you can't appeal to Wall Street on the basis of patriotism, doing the right thing, and safeguarding America's security interests. You'll generally get a big yawn.

So instead we need to speak to them in market terms: "Where's the prudent risk management? Where's the required disclosure of material risks? Where's the good corporate governance? Where's the

continued on page 6

concern over share value, corporate reputation, and brand?" That's Wall Street's lingo. It's much more difficult for them to ignore. Failure to disclose material risks is illegal. And although the SEC apparently doesn't consider egregious corporate human rights and national security abuses as material risks, the kind of material risk I am talking about is based on the idea that a company's stock will likely decline when it becomes known that the company is providing, for example, surveillance cameras for concentration camps or producing ICBMs targeting American cities. You would think that this kind of disclosure would be unobjectionable—but then why is it so hard? Is it because China would be offended?

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The good news is that we can win this economic and financial war. America dominates the global economic and financial domain—period. Our capital markets are roughly the size of the rest of the world's combined, and we hold about 60 percent of the world's liquidity. Wall Street might argue that if we safeguard our capital markets, China will just go to another international exchange, in which case our country will be the one hurt. The problem with that argument is that no other country has anywhere near the depth and volume of our markets. China's need for dollars is so voracious that it would likely use up the volume of a Frankfurt or London in months, not years. There is nowhere else for a player the size of China to go. Just as in the early 1980s, when we had a monopoly on oil and gas equipment and technology for Arctic-like conditions, we have most of the world's money today—and the leverage that goes with it.

The bottom line is clear. The Chinese are waging economic and financial warfare against us every day. We are in a position to prevail. The problem is that we've not seriously taken the field. In terms of our capital markets, we're not even at the stadium. It's time to mobilize our national assets and declare, "Not on my watch." After all, it's our money. ■

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