

The escalating arms race in South East Asia, China and Japan and the impact on rare earths



The perception of a growing Chinese aggression in East Asia is driving local powers to seek closer ties to Washington to counter a widespread perception of Chinese expansionism. The Philippines, which spent the better part of the 90's trying to drive the US away, closing down the largest US base in the Pacific, are trying to lure the American military back to the region. More importantly, as far as the tensions over the Senkaku/Diayou Islands dispute is concerned and the related tensions between China and Japan, even Filipinos who remember the trauma of the violent Japanese occupation during World War II are advocating for greater Japanese rearmament. The Philippines are taking advantage of a recent statement from President Obama, which was largely missed by the media. Indeed, during a visit to Tokyo at the end of April, Obama said that if China were to attack the Senkaku Islands, U.S. forces would counterattack alongside Japanese ones. The Japanese Prime Minister Shinzo Abe was eager to secure this support and the message suggests that the White House is clearly taking a pro-Japanese stance in the Senkaku dispute.

During his visit, President Obama visited a sushi restaurant with the Japanese leader, addressing him by his first name 'Shinzo'. Obama delivered some greetings in Japanese "konnichiwa" and above all he pronounced the magic word most Japanese wanted to hear "Senkaku", avoiding the islands' Chinese name altogether. As far as the Japanese government is concerned, Obama is fluent in their language. Obama stated

that these islands, as historically administered by Tokyo, fall under American protection guaranteed by the bilateral US-Japan security treaty. Obama stressed that this has been the White House's consistent position but Beijing would have surely noted that the pronouncement was made in Tokyo during a meeting that was deliberately choreographed to reinforce the strong bond between the US and Japan. Indeed, China has already reacted, making it clear that it does not recognize the applicability of the Japanese-American defense treaty to the Senkaku/Diayou. The only sour note was the failure of the US and Japan to conclude a framework for bilateral free trade negotiations within the Trans Pacific Partnership. Obama asked Japan to grant greater access to American agricultural products and cars.

Back in Manila, just before President Obama arrived for his visit, the US and the Philippines signed a 10-year military pact (Enhanced Defense Cooperation Agreement) that will allow the US military to gain access to a series of bases while being able to deploy aircraft and warships in various airports and ports. The Agreement and renewed US military presence in the Asia-Pacific region is to ensure "the freedom of navigation" in the eastern seas. Evidently, the "Senkaku" dispute falls into the greater scope of the agreement. Indeed, the Philippines' government wants US support for its own territorial disputes with China, which relate in particular to the Spratly Islands and Scarborough Shoal. In one case, Manila brought the matter before the international arbitration tribunal in The Hague – which Beijing said it would refuse to honor. Meanwhile, The Philippines are the most determined country in South East Asia to thwarting Beijing's ambitions, even at the cost of being forced to endure incurring economic repercussions. Obama said the pact with Manila will help promote regional security, improve the training of the armed forces and improve the response to any natural disaster. China, however, considers this another example of an American desire to contain its ambitions. In February, Philippine

president Benigno Aquino – compared the Chinese to Hitler's aggression against Czechoslovakia in 1938.

China has responded by fostering various agreements with Iran...

Japan will surely take advantage of the Philippines' concern over Chinese hegemonic pretensions to regain prominence in the South China Sea and East Africa within a multinational framework – backed by the United States. This contrasts with the individualistic approach taken on by various countries in the region from South Korea to Australia and others, engaging in random military buildups to confront the common fear of Chinese expansionism and North Korean threats. Japan, rather, wants a more complex approach that combines military expansion with access to economic opportunities, trying to ensure the growth of its business activities abroad, especially through the defense of their trade routes preferred, first of all those who cross the South China Sea and the Straits of Malacca. This policy sharply contrasts with Japan's reliance on Chinese rare earths. It does, however, suggest that Japan will become even more active in promoting new rare earth sources and processing facilities. China, which plans to challenge the World Trade Organization's ruling against its policy of trade restrictions on rare earths, will have more reason to treat these elements as strategic.

Modern weapons from guidance systems to actual hardware fabrication require rare earths and a handful of similar critical metals, the market for which China has been allowed to dominate. In the future, the kind of magnets made using rare earths will be even more important for military applications. Consider the 'railgun'. This is the new type of weapon could be supplied to the U.S. Navy will by 2016. The railgun works on the principle of electro-magnetic force, rather than an explosive charge to propel a projectile. The idea is to take advantage of a difference in electrical potential between two parallel rails in which the electric current flows, whilst inserting between two projectiles. A

railgun deployed on a warship could deliver a lethal blow from a distance of well over 110 nautical miles. It requires several rare earth magnets. In the summer 2013, the U.S. Office of Naval Research awarded BAE Systems a contract to continue development on a high-powered electromagnetic railgun. The railgun is a mere example of the fact that the geopolitical framework in Asia is evolving in the shape of a new arms race, which will have economic and trade repercussions. China's dominance in the production of rare earths will become an even more important incentive for the West and its allies to secure new sources.

Rising tensions in the Pacific suggest China will ignore WTO ruling on rare earths

✘ Whatever bilateral relations improvements were achieved in the past two weeks between Japan and China, they are sure to rise again as the World Trade Organization prepares to rule against Chinese quotas on rare earth exports. The formal decision will be delivered on Monday, March 24 and it will be motivated by the conclusion that China has "given preferential treatment to its domestic industry". The WTO is expected to propose that China limit its own domestic production, should the quotas be motivated by the need to preserve resources. China may appeal the ruling and will have 60 days to do so but this period will likely only serve to heighten tensions with Japan and other neighbors.

“China will vigorously defend its sovereignty” warned China’s minister of Foreign Affairs, Wang Yi. He said that there was “no room for compromise “with Japan on the territorial and historical issues. China is engaged in a series of territorial disputes with many of its neighbors but the first and foremost of these is with Japan, over the sovereignty of Tokyo in uninhabited islands in the East China Sea, known as Senkaku to the Japanese and Diayou to the Chinese. The tensions between China and Japan – even if somewhat eased over the past week as Japan has joined the search effort for the missing Malaysian Airlines Boeing 777 (flight MH 370) – are heightened by China’s memory of the invasion by the Japanese military during the Second World War.

Chinese officials have recently demanded that the Japanese leaders to confront “militaristic past” of their country and make amends in the same way as Germany after Nazism. The Japanese Prime Minister Shinzo Abe, meanwhile, warned his country that the territorial dispute over the Senkaku with China evoked the geopolitical tensions that had led, in 1914, to the outbreak of the First World War. He is not altogether wrong; after all there was intense trade between Germany and Britain or between the United States and Germany (among others). Therefore, even lively commercial relations can be trumped by nationalism. In Japan, however, the tensions have had some direct trade effects, especially insofar as rare earth elements are concerned.

Yet the rare earth market situation is somewhat different than it was when the WTO dispute between China and Japan (along with the EU and the United States) came to the fore in 2011-2012. China’s market share in rare earths has decreased noticeably. In 2010, China had a market share of almost 98% – a monopoly – now there is some competition on the way. Tasman Metals (TSXV: TSM | NYSE-MKT: TAS) could be ready to start deliveries of heavy rare earths to Europe and other markets from Sweden in 2017. In North America, such plays as Rare

Element Resources ('RER', TSX: RES | NYSE MKT: REE) could also come on line with heavy rare earths around the same period and all the while, Molycorp and Lynas have been producing and increasing sales of their light rare earths in California and Malaysia. Still, for the time being, China will continue to dominate the production of crucial rare earth products and its enormous market power.

China will become a victim of its own success or market dominance; indeed, the strong rise in rare earth prices in 2011 – in response to the Chinese quotas – has prompted an intense search for sources outside China – and dozens of new deposits have been discovered worldwide. However, China may prompt further demand by stressing the defense and security aspects of rare earths. The continued tensions with Japan will certainly sustain recent Chinese military ambitions. China has announced a new double-digit increase in military spending for the year 2014.

The Chinese Ministry of Finance, in turn, announced on March 4 that a 12.2% increase in the budget of the People's Liberation Army, bringing it to 808.23 billion Yuan or about USD\$ 140 billion. However, the Pentagon, rather concerned about securing reliable sources of critical minerals for itself, claims that the real Chinese military budget is much higher than reported, estimating it to be closer to 240 billion dollars. Most of the funds will be used to upgrade naval and air forces and to develop unspecified "high technology" weapons, presumably, the kind that makes intense use of electronics and therefore, rare earth intense components. Certainly, rare earths and similar critical minerals such as beryllium yttrium and scandium will be used to develop China's 'fifth-generation' stealth aircraft, the J-20 and J-31, the Lijian and experimental glider program called "WU-14". In addition, Beijing is also developing anti-satellite weapons, a supersonic cruise missile and a ballistic anti-ship missile.

Last November, the US- China Economic and Security Review

Commission, established by Congress in 2000, argued that the rapid modernization of the Chinese military was “changing the security balance in the Asia-Pacific” and announced “difficult decades” for US military preeminence in the region. In fact, the Pentagon is concerned that by 2020, Chinese naval and air forces may reach the size and capability of those deployed by the United States in the Asia -Pacific region, which will certainly raise the concerns of its regional allies (including Japan, the Philippines, Indonesia, and South Korea among others) in the region. Chinese military spending will likely translate to more military exercises, many of which may be expected to be planned in and around the disputed Senkaku/Diayou islands, fueling rather than loosening tensions with Japan, which has already responded by increasing its own spending on defense – 5% over the next five years with a total budget of about USD 200 billion for the period 2014-2019. Beijing needs to reduce production to keep production for its own industries and will not hesitate to continue to use its monopoly position to blackmail its neighbors, which will be ever more motivated to find alternative sources.

In this highly charged military and geopolitical context, WTO or not, it is unlikely that China will simply abide by the expected ruling urging an ease of rare earth trade restrictions. At this point, there are serious strategic considerations. China may exploit its intense pollution and environmental degradation to preserve rare earths needed to produce alternative energy sources and to cut back on highly polluting extraction procedures for these materials. Meanwhile, there are no commercially viable processes for recycling rare earths, despite the claims, or alternative materials to rare earths and such metals as dysprosium, which was a mere curiosity until the 1960's, will be in ever greater demand for its use in several military applications not to mention its use in permanent magnets to make ever more popular electric cars.

The rising Chinese nationalism and militarism will only serve to force the West and its allies to diversify their supplies. The Chinese hegemony will last for a few more years until new sources come online – and InvestorIntel has published several articles outlining the most promising of these. The slump in rare earth prices seen in 2013 has not taken into account China's rise as a military power, rather than simply an economic one, or the fact that there just might be another technological revolution around the proverbial corner to cause an immediate increase in demand. Issues of rare earths are economical because they represent a lucrative market, but they are becoming increasingly strategic.