

# 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.

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# The geopolitics of missing Malaysian Airlines flight MH 370

✘ The investigation into the disappearance of the Malaysia Airlines Boeing 777, flight MH 370, continues and none of the theories, whether leaning towards foul play or malfunction, have yielded any results. All that is certain is that flight MH370 departed Kuala Lumpur with 239 people on board – two thirds of whom Chinese – took off at 00:41 hrs on March 8. Notions that the pilots, or one of the pilots, deliberately disabled the Boeing's communication systems have not been conclusive; indeed, they have been as inconclusive as all other theories, which, as any internet search will show, include UFO and Bermuda Triangle like plots as well. It is natural and necessary to speculate over what may have happened to MH 370 – this author has his own theory of possible sudden depressurization causing the plane to keep flying with nobody at the controls – nevertheless, only the facts and the evidence will reveal what has become a mystery.

The problem of speculation, however, is that it only raises the hopes of the family members of the passengers and crew of MH 370. The uncertainty and constant barrage of suppositions and assumptions has taken its toll on the families. Furious relatives of the Chinese interrupted a press conference by a minister demanding answers before he was able to utter a word. "They say different things every day. Where is the plane now?" This article does not intend to speculate over that question – there are plenty of others that do that. Rather, there are some actual unintended developments surrounding the missing Boeing. The search has brought together 26 countries, which

have been forced to share some security information, manage adverse interests under chaotic coordination in a region full of geopolitical tensions. Regardless of when or even if the fate of MH 370 is revealed, the region will emerge a little different – perhaps better or perhaps worse.

China and its neighbors compete economically with and among each other as well as strategically over sovereignty of the South China Sea. In the midst of the regional tensions, the United States have made the Asia-Pacific a “pivot” of their geostrategic policy. The search for MH 370 has been especially arduous, particularly in the crucial early days, because of the contradictory information resulting from the various states’ reluctance to share information and observations. In the first 24 hours, the search focused on an area between Malaysia and Vietnam. The next day, without explanation, Malaysia announced that the flight might have changed course after about an hour’s flight towards the west, re-directing the search toward Central Asia and the area south of the Indian Ocean. Malaysia revealed that its military radar had identified the aircraft while explaining that no action had been taken because it did not seem “hostile”. Five days later, Thailand has also implicitly recognized a failure in radar recognition on March 8, excusing it by claiming that “the aircraft was not in Thai airspace and was not a threat to Thailand”.

The tensions in the region have kept countries quiet about their capabilities. It seems they are reluctant to disclose the limits of their technology and military capacity. This has made coordination and disclosure difficult. It has also prompted a ‘pot calling the kettle black’ accusation from China. Indeed, the ever cryptic China has slammed Malaysia for its lack of transparency after the disappearance of flight MH370. Beijing’s indignation contrasts heavily with its well documented tendency to obfuscate disasters on its own territory. For instance, after the 2008 earthquake in Sichuan,

where the collapse of schools had caused the death of thousands of children, activists were asked about the poor quality of school buildings. Those curious citizens were either beaten or arrested. China is definitely one of those countries where curiosity will hurt if not kill the cat.

This small matter has not deterred Chinese Premier Li Keqiang from curtly demanding that his Malaysian counterpart provide information with "punctuality, accuracy and completeness" over MH 370. Chinese state media have even accused Malaysia (a far more democratic and transparent country than the People's Republic) for their lack of transparency. Yet China has hardly been transparent, entirely excluding even the chance that MH 370 entered its airspace. How could they be so sure?

Beijing's silence results from the same sensitive geopolitical character that has delayed important details about radar and other detections from being revealed by all the other countries involved in the search. The search operation by military vessels in the South China Sea have been much like a massive military exercise, revealing the strengths, but even more the vulnerabilities, of those same countries' defense systems.

National self interest has prevailed over the search for MH 370. Malaysia has underlined the importance of outside help in scouring two land and sea corridors equivalent in size to the entire land mass of Australia. Yet, Indonesia was late in granting surveillance clearance to aircraft from Australia, Japan, the United Arab Emirates and Malaysia to overfly its territory, blaming the delay on 'awaiting' instructions from Kuala Lumpur and 'protocol'.

MH 370 has uncovered the lack of cooperation and mistrust that exists in the South China Sea region. Many of the countries involved are not used to such close cooperation as required, given the need to share sensitive radar data. One positive development has come from Japan. Even though, there are no

Japanese citizens aboard MH370 and despite the tensions with China over the Senkaku/Diayou Islands, Japan was not even asked to join the rescue/search operation. But it has. Japan, the one major NATO power in the region also has the most advanced technology and trained personnel in the entire Asia-Pacific region. Japan's collaboration may well help to resolve the deadlock in Sino-Japanese relations, or at least bring the two countries to discuss the Islands dispute, which will have evident economic and business repercussions, not the least of which will concern the rare earths market.

Both China and Japan have increased military spending and military naval exercises; the MH 370 incident may be the catalyst for a respite and possible diplomatic overture. Nevertheless, the heavy presence of Chinese ships in the South China Sea, in an area over which it claims sovereignty at the expense of Malaysia may cause tensions to rise in South East Asia, where many countries have grown more concerned about China's rising power status and ambition. China is Malaysia's largest trading partner. Perhaps, Malaysia will be seeking more opportunities with its equally concerned neighbors. Or, logic will win the day, as the various countries in the region will start to trust each other more in a greater climate of trust. Either way, MH 370 will have much deeper consequences and effects than the fate of its passengers.