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MERICS China Security and Risk Tracker



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FOCUS TOPIC

China's hypersonic tests stoke the new arms race

China conducted two hypersonic weapons tests over the summer that showed it has a new weapons capability. According to reports, China launched a rocket that used a fractional orbital bombardment system (FOBS) to propel a nuclear-capable hypersonic glide vehicle (HGV) round the earth for the first time. The tests reportedly caught Western intelligence services and militaries by surprise.¹

Beijing has denied the tests took place, claiming it merely conducted a routine space plane launch in July. Regardless of the precise technical specifications, the tests were highly significant. They showed Beijing has made rapid progress on hypersonic systems, and that it may already have the capabilities to evade the United States' missile defense systems.

Its new capabilities do not indicate a change in China's no-first use doctrine, nor do they dramatically change the dynamics of deterrence between the US and China. Nonetheless, they could have serious implications for strategic stability and the balance of power, not just in the Indo-Pacific but globally. Beijing's tests will accelerate the ongoing arms race and are likely to contribute to the erosion of the existing international arms control architecture.

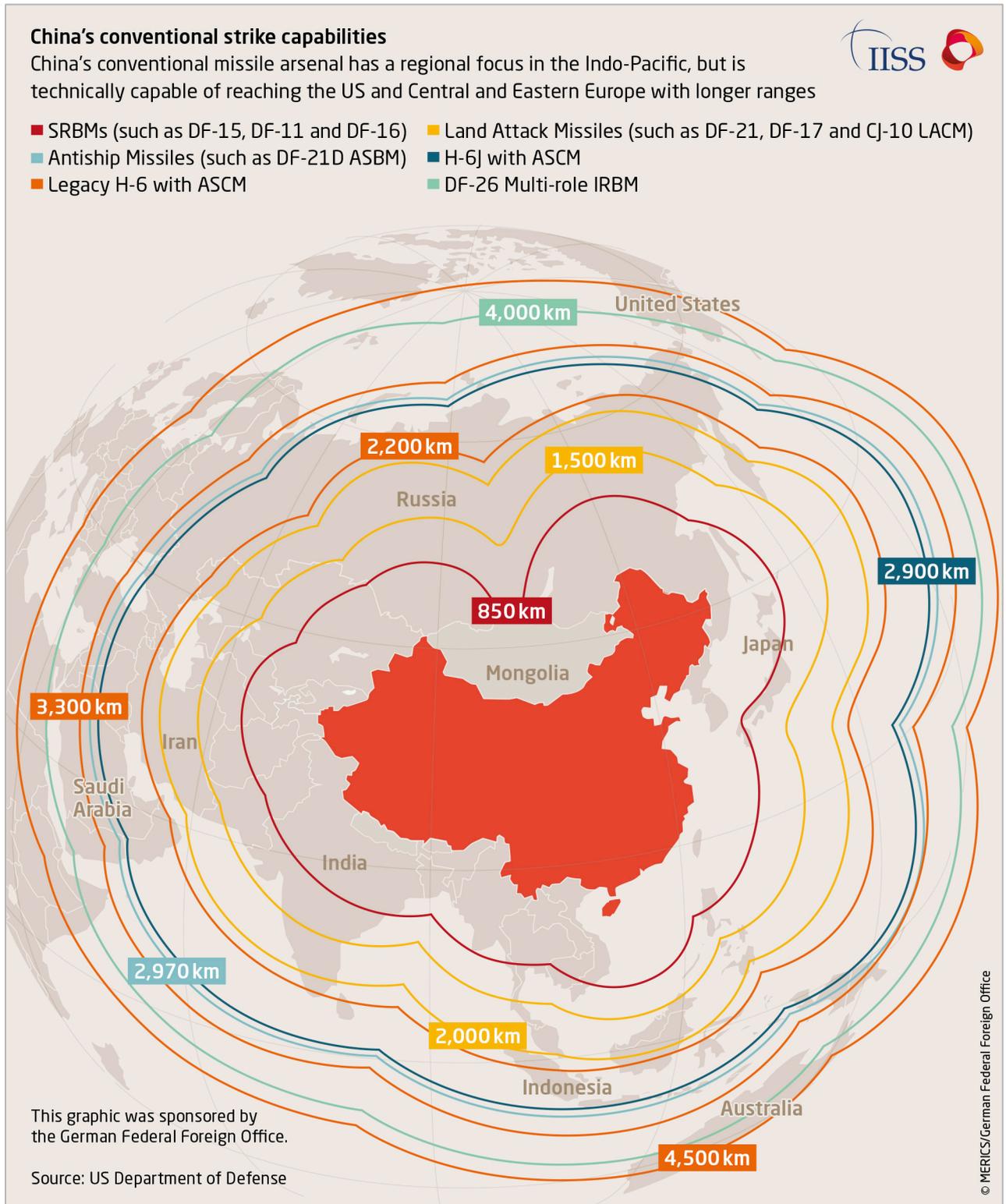
Hypersonic glide vehicles are part of China's search for ways to overcome US missile defense systems

The technology that Beijing tested over the summer is not new – China, Russia and the United States have been working on developing similar capabilities for years. FOBS were already developed and deployed by the Soviet Union.² China's first public display of a ballistic missile equipped with a hypersonic glide vehicle (the DF-17) took place at the national day military parade on October 1, 2019.³ However, the relatively successful test of a HGV – the missile reportedly missed its target by about 38 kilometers – was a first, and it constitutes a major step on Beijing's road to fulfilling its geopolitical and military ambitions.

Beijing's threat perceptions, along with its ambition to become a global power by 2049, have always shaped China's development of new missile capabilities. Militarily, Beijing's top priority – and greatest concern – is to establish and maintain control over the area inside the First Island Chain, which includes Taiwan and the South China Sea. This island chain is a natural barrier that, in Beijing's eyes, could be used by foreign forces to contain China and block its access to the Pacific Ocean – or even as a springboard to launch an attack against the Chinese mainland. Controlling this area is the first step Beijing must take on its path to becoming a global power and turning the PLA into a top-tier military that can “fight and win wars” by mid-century.

The main obstacle to these ambitions is the United States, especially its presence in the Indo-Pacific and its missile defense systems. These systems are seen as a major vulnerability by Beijing; they weaken China's strategic deterrent and reduce its ability to launch a second strike in a conflict.

Exhibit 1



Over the last few years Beijing has therefore dedicated considerable resources to developing capabilities that might enable the PLA to target the US's Indo-Pacific-based assets and facilities and evade US missile defenses. The process has accelerated as the US has expanded its defenses in the region. Since 2014, the US has deployed the Terminal

High Altitude Area Defense (THAAD) system in South Korea and Guam. US missile defense systems, however, remained a stumbling block for Beijing, as it lacked ways to evade them.

HGVs like the one that was reportedly tested over the summer could be the solution. HGVs can carry either nuclear or conventional payloads. And although slower than ballistic missiles as they approach target, their greater maneuverability and lower flight path makes them harder to predict and counter. Theoretically, this means they could penetrate missile defense systems.

Beijing's quest to achieve "mutual vulnerability" will accelerate the emerging arms race

China's new HGVs do not represent an entirely new threat to the United States or other countries. Beijing has long had the ability to strike against the US and against US assets in the Indo-Pacific. Nor do they substantially change the deterrence dynamics between the two or indicate a change in Beijing's nuclear doctrine.

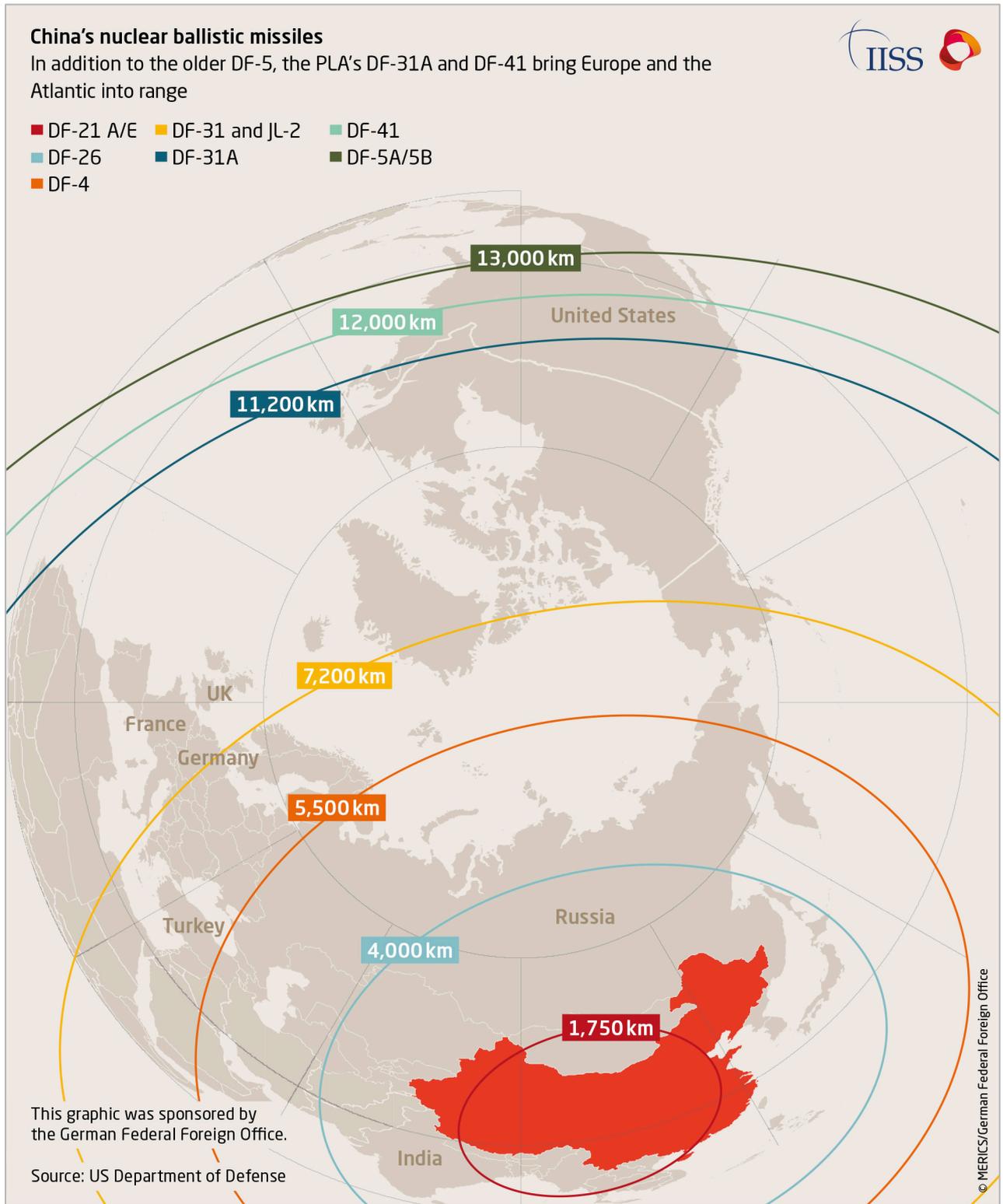
However, China's HGVs are likely to increase tensions in the Indo-Pacific and globally, and may contribute to shifting the balance of power in the region. Just as US expansion of its missile defenses led to Beijing's development of HGVs, China's new capabilities are likely to stoke the already existing arms race, as other countries try to catch up with or surpass the PLA's new capabilities.

China's threat perceptions also continue to rise. Beijing sees an increasingly complex international environment that could thwart its ambitions to reclaim China's position as a global power. China's deteriorating relationship with the US, growing instability in the Indo-Pacific, and Beijing's fears of a Western coalition to confront China and contain its rise will only solidify these concerns.

We should therefore expect the PLA to continue with its military modernization and to expand its conventional and nuclear arsenals. The HGV tests are only the latest step in this process of military buildup. In recent months, satellite images have also shown two new missile silo fields under construction in Western China which could house hundreds of intercontinental ballistic missiles. China's nuclear arsenal is still dwarfed by the United States' (and Russia's),⁴ but the US department of Defense estimates that the PLA may have up to 700 nuclear warheads by 2027 and at least 1,000 by 2030.⁵ In Beijing's eyes, the PLA is simply working to protect its ability to retaliate, which is seen as the key to maintaining US-China strategic stability.

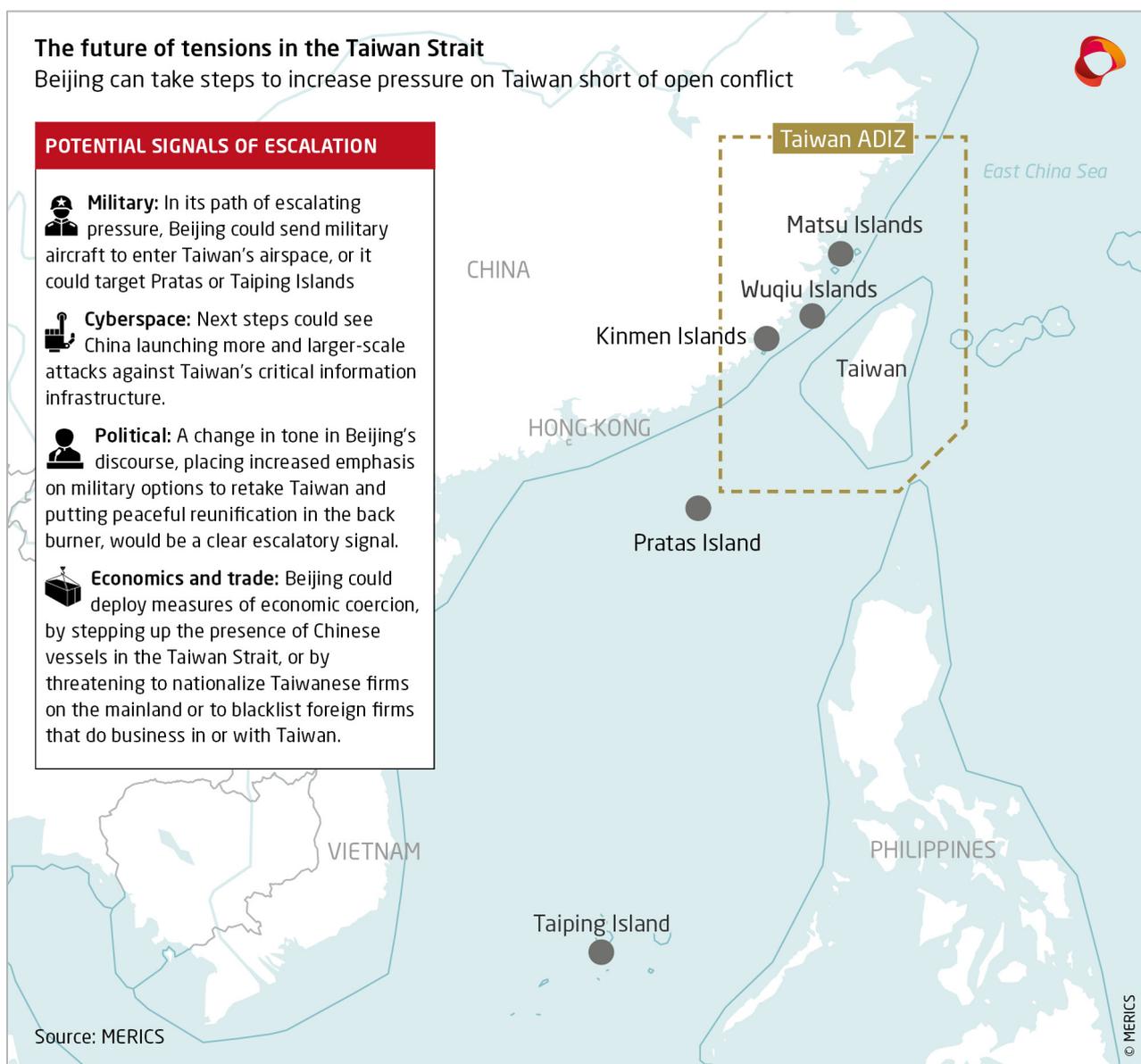
Against the background of rising tensions in the Taiwan Strait, and fears that a conflict may break out in the next few years, Beijing's new capabilities could change the strategic calculations for many countries involved. China's ultimate goal appears to be mutual vulnerability and nuclear stalemate with the US, thus taking nuclear strikes off the table in case of war. The balance of power in such a situation would come down to conventional capabilities. And in that area, especially in a local conflict in the Indo-Pacific, the PLA has a clear geographical advantage. Beijing might then be emboldened to decide to launch military action against Taiwan sooner than expected.

Exhibit 2



The announcement that Presidents Joe Biden and Xi Jinping agreed during their November 15 virtual summit to look into starting discussions on strategic stability may open a window for both sides to reduce risks. But Beijing's ambitions, alongside the deep distrust between the US and China, are likely to turn these discussions into an uphill battle.

GRAPHIC OF THE QUARTER



KEY DEVELOPMENTS OF THE QUARTER

Domestic Stability

The CCP takes action to tackle any threats to stability in the run-up to the Party Congress

The party held the Sixth Plenum of the Central Committee of the CCP from November 8-11, which passed a rare resolution on party history widely seen as paving the way for President Xi to remain head of the party and government for a third term of office. The leadership reshuffle is due to take place at the 20th Party Congress in the Fall of 2022. During the sensitive preparation period, China's leaders will put greater-than-usual emphasis on avoiding domestic instability that might undermine or distract from the

reshuffle and surrounding political messaging. The resolution passed at the plenum paid tribute to Xi's predecessors. But it placed greater emphasis on party achievements made under the leadership of Xi, thereby elevating his status to that above Mao Zedong and Deng Xiaoping.

The main goal for Beijing in the months to come will be to prevent any major instability affecting the preparations for the leadership reshuffle at the next Party Congress. As the first point of business, China's leadership is trying to tackle the economic risks facing the country amid ongoing energy shortages and the crisis engulfing debt-laden real-estate giant Evergrande, which has triggered protests from unpaid employees, suppliers and investors. Financial health checks are to be imposed on major lenders: Zhao Leji, secretary of the Central Commission for Discipline Inspection (CCDI), announced "full-scale disciplinary inspections" to safeguard the healthy development of China's financial sector. The campaign will target 25 organizations, including China's "big four" state owned banks.

MERICS Top Risks
Top risks of the quarter, selected by MERICS experts

DOMESTIC STABILITY RISKS

<p>Evergrande crisis causes protests, threatens China's economic stability Evergrande's near default has caused protests, as the real estate giant partly stopped paying employees and suppliers. There is still a high risk of a full default that would send shockwaves through China's economy.</p> <p> Who is affected? Evergrande employees, investors with liabilities and households who purchased real estate through Evergrande and fear for their savings will be affected. Party and state officials across the country also fear social unrest from a full collapse.</p> <p> When will the risk materialize? 0-6 months</p>	<p>Anti-corruption campaign kicks into gear in run-up to Party Congress In the wake of the Evergrande crisis, and as part of a broader regulatory crackdown, the CCDI launched a new round of disciplinary inspections of financial institutions, including China's "big four" state owned banks.</p> <p> Who is affected? Party officials, private and state-owned firms in a range of industries. Beijing will strive to prevent dissent or instability ahead of the Party Congress in 2022.</p> <p> When will the risk materialize? 0-12 months, until the 20th Party Congress in late 2022</p>
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In September, former Justice Minister Fu Zhenghua became the latest top official to be taken down by the reinvigorated anti-corruption campaign. The CCDI announced that Fu – said to be a member of President Xi Jinping's faction within the CCP – is under investigation on suspicion of "serious disciplinary violations". Fu was a sitting member of the party's elite Central Committee and an influential figure who oversaw the judiciary and police. He was behind major corruption investigations and persecutions of high-ranking officials, human rights activists and lawyers. The campaign's other recent targets include former Vice Minister of State Security Sun Lijun, former chairman of state-owned China North Industries Group Yin Jiaxu, and Hangzhou party secretary Zhou Jiangyong.

The reasons for this new string of investigations are unclear; it is likely they are intended to smooth President Xi's path to retaining power at the Party Congress.

Civil society organizations in Hong Kong – both foreign and domestic – are likely to be the next targets of the party's efforts to strengthen control over any potential threats to the system's stability. The Ministry of Foreign Affairs has published a list of over 100 pro-democracy events in Hong Kong that it alleged were instigated by the United States. The list emerged as Hong Kong announced plans to pass Article 23 of the city's Basic Law in the first half of next year. Article 23 stipulates that the Hong Kong government "shall enact laws on its own to prohibit any act of treason, secession, sedition or subversion against the central government." It will expand the authorities' ability to target foreign civil society organizations involved in political activities in Hong Kong.

Security and Defense

Tensions in China's neighborhood set to rise even further

China continues to ratchet up pressure on Taiwan. Beginning on China's October 1 National Day, Beijing sent over 150 planes into Taiwan's air-defense identification zone (ADIZ) over five consecutive days. Chiu Kuo-cheng, Taiwan's Minister of Defense, noted on October 6 that Beijing would be militarily capable of taking the island by 2025, prompting close attention to President Xi's speech on October 9 commemorating the anniversary of the 1911 Xinhai Revolution. The speech was carefully parsed for any references to an official shift in China's policy towards Taiwan. However, Beijing's official position remains unchanged. President Xi said that he wants reunification to happen, but there is no sign that he is ready to resort to military force and provoke a conflict with the US. Open conflict is highly unlikely in 2022, as instability must be avoided ahead of the 20th Party Congress. During 2022, Beijing is likely to continue pressure on Taiwan through grey zone tactics, while staying below the threshold of conflict. However, the risk that Beijing may decide to provoke a conflict in the medium-term continues to increase.

Regional tensions are likely to be increased by the AUKUS trilateral security pact that Australia, the US and the UK, announced in September to provide Australia with US nuclear-powered submarine technology. The AUKUS coalition will raise Beijing's threat perceptions, prompting it to double down on military build-up and modernization. We can expect Beijing to invest further in expanding its nuclear arsenal and anti-submarine warfare capabilities.

Meanwhile, there are signs the situation in Afghanistan may be starting to deteriorate, which could shift Beijing's posture and relations with the Taliban. Islamic State (IS) suicide bombers killed almost 100 people and wounded dozens more in two attacks against mosques in Kunduz and Kandahar on October 8 and 15. IS claimed the Kunduz bomber was a Uyghur militant and that the attack targeted both the Taliban and Shiite Muslims for their willingness to expel Uyghurs from Afghanistan to please China. The Taliban has named China as their "principal partner." From Beijing's point of view, the

attack suggests the Taliban may prove unable to prevent militant groups from launching attacks on China from Afghan territory. In a sign of Beijing’s growing concern over how the Afghan situation is evolving, Tajikistan has reportedly offered to transfer control of a preexisting military base to Beijing in exchange for military aid from China. Beijing is likely to further expand its military footprint in Central Asia to keep a close eye on Afghanistan and to prevent terrorism and instability from spilling into its territory.

MERICS Top Risks

Top risks of the quarter, selected by MERICS experts



SECURITY AND DEFENSE RISKS

AUKUS will speed up China’s military build-up

The new US-Australia-UK security pact has raised Beijing’s threat perceptions. A new arms race can be expected from the greater regional presence of the US and British militaries, coupled with Australia’s acquisition of nuclear-powered submarines.

Who is affected? Countries in the Indo-Pacific region (especially those with territorial disputes with Beijing), along with those with a military presence there. They will need to grapple with the gradual shift in the regional balance of power and with increased tensions and belligerence.

When will the risk materialize?

From 12-24 months

Repeated PLA incursions into Taiwan’s ADIZ increase the risk of accidental escalation

Increased PLA incursions into Taiwan’s ADIZ are stoking tensions. The US and others have stepped up their own presence in response, and added other types of support for Taiwan. This heightens the risk of accidental escalation and may push Beijing to escalate its activities further. Potential next steps could include PLA aircraft entering Taiwan’s airspace or targeting Pratas or Itu Aba islands.

Who is affected? Taiwan is affected most, but other countries with a stake in maintaining the status quo in the Taiwan Strait will also feel the pressure.

When will the risk materialize?

From 12-24 months

Source: MERICS

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Geopolitical Competition

Inward-looking Beijing seeks to reduce risks in its relationship with the West

The US and China are taking steps to reduce the risks in their relationship. On November 15, Presidents Xi and Biden held a virtual summit in an attempt to introduce “guardrails” into the relationship and prevent the escalation of tensions. No major deliverables emerged from the meeting, though the tone was friendlier than at previous meetings between the two administrations, signaling the desire to at least resume communication and some degree of practical cooperation. A similar dynamic was noticeable during the October 6 six-hour meeting between US National Security Adviser Jake Sullivan met Politburo member Yang Jiechi on October 6 in Zurich.

US prosecutors also reached a deal with Huawei CFO Meng Wanzhou that allowed her to return to China instead of being extradited to the US. Beijing responded by releasing

Canadians Michael Kovrig and Michael Spavor after almost three years in detention. While it is premature to speak of a thaw in US-China ties, these moves were an attempt to reopen the lines of communication between Washington and Beijing. Better communication channels can help to manage competition and to prevent accidental escalation of current tensions, particularly over Taiwan. Meanwhile, Beijing sees an opportunity to bring ties with Europe back on track after a few tense months. China seems sure to look for benefits from the transitional period following Germany's September elections and France's dissatisfaction at the AUKUS announcement.

MERICS Top Risks
Top risks of the quarter, selected by MERICS experts 

 GEOPOLITICAL RISKS	
<p>Meng Wanzhou deal increases risk that Beijing will resort to hostage diplomacy again China released Canadian citizens Michael Kovrig and Michael Spavor just hours after Huawei CFO Meng reached an agreement with US judicial authorities that allowed her to return to China. The deal confirmed the obvious links between the two cases.</p> <p> Who is affected? Citizens of countries that have legal or geopolitical disputes with China, and who are physically in China, may be detained and used as bargaining chips.</p> <p> When will the risk materialize? From 12-24 months</p>	<p>Inward-focused China places global exchanges at risk The CCP is preparing for the next Party Congress by focusing on internal stability issues. Coupled with Beijing's zero-Covid strategy, this means China is likely to remain closed for the foreseeable future. Top officials will stay away from international discussions on global issues. The 2022 Beijing Winter Olympics may worsen this trend if the Games are linked to Covid outbreaks.</p> <p> Who is affected? Foreign governments hoping for productive exchanges with China or to extract concessions from Beijing on global issues. Business representatives unable to travel to China will also be impacted.</p> <p> When will the risk materialize? 0-12 months, running at least until the 20th Party Congress in 2022</p>

Source: MERICS © MERICS

Berlin's voice is certain to be less present in EU debates on China policy until the new coalition government is formed and settles its approach to China relations. Meanwhile, the EU's ongoing rethink of its approach to China may receive a stronger imprint from Paris at the beginning of 2022. France still feels betrayed by the surprise announcement of AUKUS, despite efforts to smooth tensions at President Emmanuel Macron's meeting with President Biden and a separate call with Australian Prime Minister Scott Morrison. Up until the April presidential elections in France, President Macron will continue to call for increased European strategic autonomy and will push for the fast implementation of the EU's new Indo-Pacific strategy under the upcoming French presidency of the European Council. Such an outcome would be largely positive for Beijing, which does not see the EU's partnership-focused Indo-Pacific strategy as a major threat to its interests. Most analysts in China are highly skeptical of the EU's ability to muster the financial and

military means needed for the strategy to succeed. Moreover, Beijing strongly favors European strategic autonomy – especially if it means Europe distances itself from Washington’s confrontational approach to China. As a result, the last few weeks have seen a flurry of high-level meetings meant to bring EU-China relations back on track, including the 11th EU-China Strategic Dialogue between HR/VP Josep Borrell and Wang Yi, and a call between President Xi and European Council President Charles Michel.

Engagement with China, however, will remain difficult, as top party and state leaders have prioritized their internal focus over diplomacy and decided not to travel out of China for any major summits thus far, including the G20 summit in Rome or the COP26 conference in Glasgow. The trend is likely to continue into next year.

Economic and Tech Security

Real estate deleveraging efforts risk popping the bubble they aim to manage

Evergrande, China's second biggest real estate developer, has managed to avoid default with last-minute payments on October 22 and 29 and November 11. The company, however, remains heavily indebted and at risk of collapse. Beijing remains fearful of the situation spreading to the rest of China’s economy or even globally.

MERICS Top Risks

Top risks of the quarter, selected by MERICS experts



ECONOMIC AND TECH SECURITY RISKS

Power shortages repeatedly disrupt production in China

Power rationing and spontaneous shutdowns of production have become commonplace in China’s industrial centers. Manufacturing growth will be harmed and disruptions will impact global value chains.

Who is affected? Energy intensive industries, including both foreign and domestic companies, in China will be most impacted. Knock-on effects are expected downstream in China and across the world.

When will the risk materialize?
0-6 months, so through the winter at the least.

China continues to expand data regulation

Beijing has issued guidance concerning the definition and management of “important data” and “core data,” categories which are subject under Chinese law to enhanced regulation and penalties for non-compliance. This will increase the regulatory compliance burden for foreign businesses operating in China, but it may also bring greater predictability.

Who is affected? All foreign entities operating in China or generating significant quantities of data there.

When will the risk materialize?
0-6 months

Source: MERICS

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The bad practices driving Evergrande's fall are widespread in China, though Evergrande seems to be an acute example. Another major real estate player, Fantasia, failed to make bond payments of over USD 200 million by the October 4 deadline. The risk of the real estate bubble popping is real, though fears of global contagion may be somewhat overplayed.

Firstly, China has tools that were unavailable to market economies during the 2008 financial crisis. For example, China can pressure other companies into purchasing toxic assets to reallocate risk. State-owned firms have already purchased several Evergrande assets, effectively providing a soft bailout. However, a full bailout seems to have been ruled out, as state media has repeatedly described Evergrande as "not too big to fail".

Second, China's financial markets are far less integrated with global markets than US markets were in 2008. If China fails to overcome this challenge, the ensuing economic pain will be acute in China but more muted elsewhere.

Nevertheless, the risk of crisis and contagion within China is strong in the short and medium term. Deleveraging in the real estate sector is likely to slow investment and construction activity, while manufacturing and exports will suffer from power supply shortfalls and supply chain shortages. A fully-fledged crisis in China, or even just a significant slowdown, would undercut global markets and growth.

China in Europe's crises: the Belarus border crisis

The crisis at the border between Belarus and the EU continues to evolve. Belarusian leader Alexander Lukashenko has been accused of trying to destabilize the Baltic states and Poland by facilitating the crossing of refugees into their territories. The refugee crisis at the Belarussian border is seen as revenge for Europe's imposition of sanctions after Belarus forced a plane flying over its territory in May to land so police could arrest a well-known dissident – a claim that President Lukashenko has denied.

Russia and China are Belarus' only notable diplomatic partners, and among the few countries with influence over the Lukashenko regime. Minsk would most likely change course rapidly if Moscow or Beijing exerted pressure.

Beijing is currently trying to bring relations with Europe back on track. Using its leverage over Minsk to bring some stability to the border would certainly create some goodwill across the EU. However, China is standing firm by Belarus, framing it as a "victim" of Europe's well-known illegal immigration problem. The main reason behind this is that China's leadership defers to Moscow over Belarus to avoid offending President Vladimir Putin by impinging on Russia's sphere of influence. Additionally, the situation at the border also plays into Beijing's wish to retaliate against Lithuania for allowing the establishment of a Taiwan Representative Office in the country.

China's semiconductor sector continues to struggle amid efforts to reduce dependencies

Beijing remains focused on reducing China's dependencies on global supply chains in strategic sectors, such as semiconductors. President Xi has identified China's external dependencies in "core technologies" as the country's greatest hidden danger.

Against the background of global shortages in semiconductors, US-China tensions and the Covid-19 pandemic, Beijing is making great efforts to raise the competitiveness of the domestic semiconductor industry.

China remains a long way from self-sufficiency in semiconductors, however, with less than 10 percent of semiconductor demand within China met by production from Chinese firms. A recent report by a leading Chinese investment bank also found that China's semiconductor industry spends less on R&D as a proportion of revenue than counterparts in Europe or the US. As China's semiconductor firms already have smaller revenues than global industry leaders, their lower R&D spending will impede catch up.

However, Chinese industry should be able to gradually close the gap with the global technological frontier in many fields in the medium term. Chinese universities are creating new departments to develop skilled labor for the semiconductor sector, and China's big private firms like Xiaomi and Huawei are investing in semiconductor related companies. China's state-linked investment fund for development of the integrated circuit industry is also targeting its activities in order to mitigate national supply chain vulnerabilities and catalyze domestic industry on a large scale.

LOOKING FORWARD: WHAT TO WATCH IN THE MONTHS AHEAD

- **November-December:** EU Council President Michel and President Xi reportedly agreed on their phone call to hold the next EU-China Summit soon, and diplomatic sources indicate it will happen before the end of the year. The political mood in Europe on China has become more polarized over the last few months; the summit will give an indication of the direction that EU-China ties may take in 2022.
- **Dates unknown:** The US Trade Representative Katherine Kai is currently reviewing tariffs and other measures directed at China after her October 4 speech unveiling the administration's China trade policy. The decision on which measures are changed or unchanged will have an impact on business confidence and will probably set the stage for US-China economic relations during the Biden Administration.

ENDNOTES

¹ <https://www.ft.com/content/c7139a23-1271-43ae-975b-9b632330130b>

² <https://nuke.fas.org/guide/russia/icbm/r-36o.htm>

³ http://eng.chinamil.com.cn/view/2019-10/01/content_9642091.htm

⁴ Today, China holds an estimated 200-250 nuclear warheads, compared to the roughly 3,800 possessed by the US, and 4,300 by Russia.

⁵ <https://www.defense.gov/News/Releases/Release/Article/2831819/dod-releases-2021-report-on-military-and-security-developments-involving-the-pe/>

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