

2014

SPECIAL GEOPOLITICAL REPORT

*WHAT CONFLICT IN THE SOUTH CHINA SEA
WOULD MEAN FOR THE FOOTWEAR INDUSTRY*

FDRA
FOOTWEAR DISTRIBUTORS AND RETAILERS OF AMERICA



The prospect of armed conflict in the South China Sea grows daily. While major skirmishes have been avoided thus far, tensions remain high between Southeast Asian nations and China due to territorial disputes in the energy-rich Sea. Footwear executives should be aware of this hot spot as conflict will have major implications for U.S. footwear companies and brands in the form of increased transit costs and supply chain disruptions.

About FDRA — 70 Years of Excellence

Since 1944, the Footwear Distributors Retailers of America (FDRA) has been the footwear industry's voice in Washington, DC. Today, FDRA's voice is stronger and more respected than ever. Over the past year, FDRA has enhanced its member services and support and is now the industry's intelligence hub. FDRA provides its members valuable business intelligence and expertise on a variety of trends and topics including product safety, customs, sourcing strategies, intellectual property and social compliance. It is also the only association able to provide in-depth sales data and analysis for footwear retailers. In short, FDRA boosts its members business. Visit www.fdra.org to learn why over 80% of the U.S. footwear industry belongs to FDRA.

FDRA forecasting seeks to provide the footwear industry with information and critical thought to better prepare it for global challenges and threats that may impact footwear businesses. All views expressed herein should be understood to be solely those of the author.

©2013 by the Footwear Distributors Retailers of America. All rights reserved. Any portion of this report used for any purpose without written consent of FDRA is strictly prohibited.



If you are thinking about leather footwear, there's one distinct leader.

Tata International

Consistent performance is a mark of excellence. Tata International (TIL) has been winning the Top Exporter Awards for Leather and Leather Products from India for the past three decades.

TIL has been supporting major international brands as a strategic partner that offers a complete range of leather footwear solutions ranging from design to production.

State-of-the-art Research Centres: Researchers and designers at TIL's R&D centres work in tandem to craft trendsetting and ergonomic leather products.

Design Intelligence: TIL design studios in Italy, Portugal, Spain and India collaborate with the best international designers and alumni of

premier fashion institutes to stay on top of the latest trends in leather, footwear and garment design.

Product Development: Product development and manufacturing units are equipped with state-of-the-art stitching machines and other equipments that ensure adherence to global standards.

Sustainability: TIL is an SA 8000:2008 Company. Its facilities are ISO certified and comply with LWG Gold standards. All TIL products carry the 'Ecomark'.

Global Support: Global presence gives TIL unprecedented reach and enables it to meet and exceed customer demands, making it an ideal partner for fashion and lifestyle brands.

For business queries please contact TIL at n.mohan@tatainternational.com

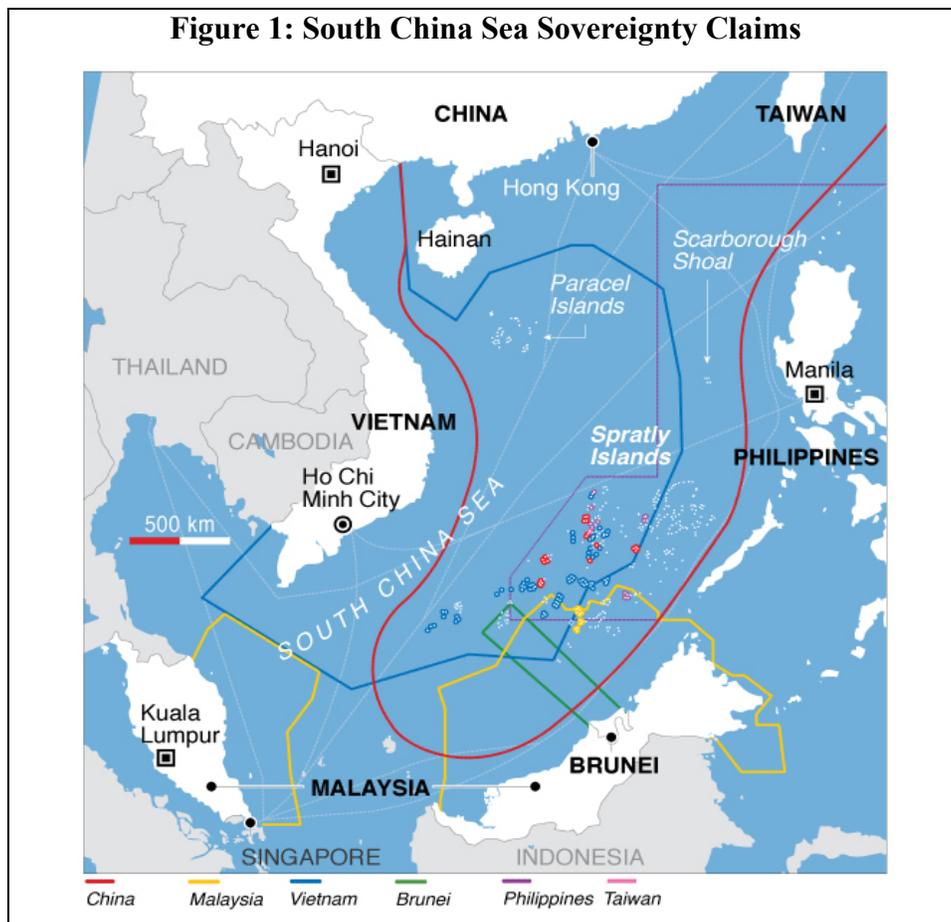


TATA INTERNATIONAL

Trent House, G Block, C-60 Bandra-Kurla Complex, Bandra (East), Mumbai - 400 051, India
www.tatainternational.com

Background

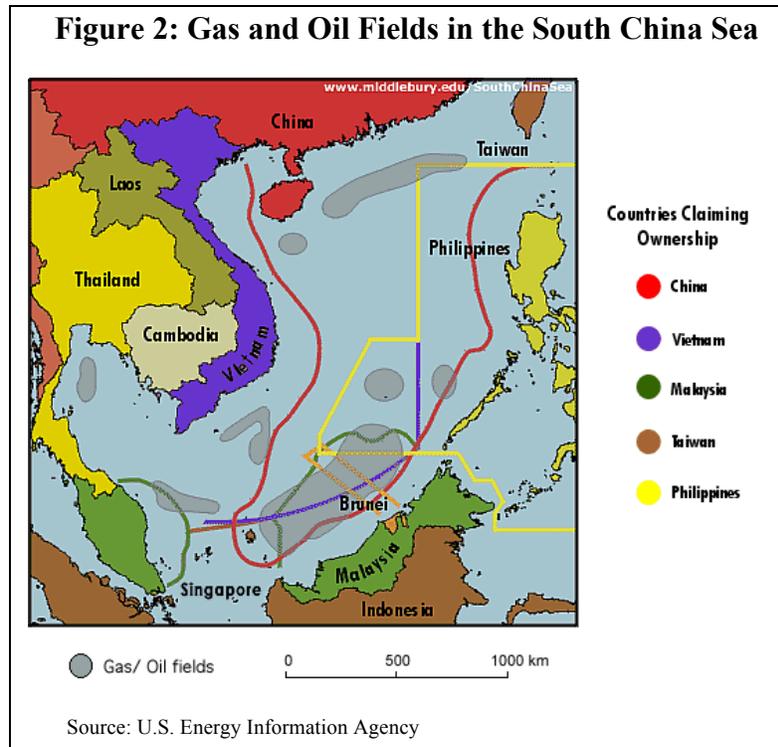
The South China Sea is encircled by six nations including China, Indonesia, Malaysia, Vietnam, the Philippines, and Brunei. Each lay claim to parts of the Sea near their shorelines, while China now claims rights over nearly the entire Sea (See Figure 1). The Sea is of great geo-strategic importance regionally and globally. For example, 90% of China's trade goes through the Sea, as does the overwhelming majority of oil imports for Asia from Africa and the Middle East.¹ The White House states \$5.3 trillion in trade flows through the South China Sea each year, 23 percent being U.S. trade. FDRA estimates 95 percent of U.S. footwear flows through, or adjacent, to the Sea.



There are also large energy reserves in the Sea, coveted by growing Asian economies. The U.S. Energy Information Agency notes that Chinese estimates put upwards of 213

¹ Zhang, Wenmu. (2006). Sea power and China's strategic choices. *China Security* (Summer), 22.

billion barrels of oil in the South China Sea, while a 1993/94 U.S. Geological Survey puts the oil reserves at 28 billion barrels.² (See Figure 2)



Sovereignty debates over the Sea have occurred for centuries, but hostilities have increased over the past decade and are reaching a tipping point due to the now needed energy and mineral resources.

Military ships from the surrounding nations regularly come into contact, and harass, fishing and other commercial vessels of other countries. With China’s fast-growing naval power, it has become the most aggressive nation in the region, crashing into ships and using water cannons to clear ships from its “territory.”

For example, in 2011 Chinese ships came into conflict with vessels from both Vietnam and the Philippines in the South China Sea. Afterwards, one of China’s state-owned media outlets increased tensions when it ran an article titled, “Don’t Take Peaceful

² U.S. Energy Information Agency. (March 2008). *South China Sea Background Paper*. <<http://www.eia.gov/countries/regions-topics.cfm?fips=SCS>>

Approach for Granted.”³ The article warned Asian states to give up their claim to the Sea, stating, “If these countries don't want to change their ways with China, they will need to prepare for the sounds of cannons.”⁴ In 2012, among several incidents, China and the Philippines had vessels engaged in a major standoff over the Scarborough Shoal in the South China Sea.⁵

Within the past year, China has grown even more aggressive. Its military approved plans to start garrisoning part of the Parcel Islands and has begun to hold major combat drills with its entire fleet in the Sea. China has also initiated deep-water drilling, started in May 2013, and it recently awarded additional drilling rights to oil companies, despite the fact that no international body has settled regional claims.

To understand such heavy action by China, it is necessary to understand that China’s claims to the South China Sea are based not solely on economics but also on security. As trade and energy imports have increased via sea-lanes, China has been looking to increase its “security boundary, which is a nation’s security concerns over all of its national interests, including those beyond its own borders.”⁶ China has fear that terrorists, pirates, or even America could disrupt their sea supply chain in and around the South China Sea, which would devastate their economy and directly threaten the Communist party’s rule. A growing number of military and geopolitical strategists in China also believe that weakness at sea was one of the results of Japan defeating and occupying China prior to WWII.⁷ Therefore, China believes it needs to extend its maritime borders over the South China Sea to better protect its economic security as well as its mainland.

Whatever the reason, as Chinese claims to the South China Sea have become more aggressive, including progressively using ‘gunboat diplomacy,’ its relations with

³ China Global Times. (2011, October 25). Don't take peaceful approach for granted, *The Global Times*, <<http://www.globaltimes.cn/NEWS/tabid/99/ID/680694/Dont-take-peaceful-approach-for-granted.aspx>>

⁴ Ibid.

⁵ CNN. (2011, April 11). China, Philippines locked in naval standoff, *CNN*. <<http://edition.cnn.com/2012/04/11/world/asia/philippines-china-naval-standoff/index.html>>

⁶ Zhang, Wenmu. p. 21

⁷ Ross, Robert S. (2009). China’s naval nationalism: Sources, prospects and the US response. *International Security*, 67.

Southeast Asian nations have become complicated. These nations fear Beijing intends to establish the South China Sea as a “Chinese lake.”⁸ Such domination over the Sea, they believe, would allow China more political, economic, and military power in the region; power which would diminish their sovereignty and ability to push back against what they see as an increasingly hostile and hegemonic China.⁹

“We are strongly committed to safeguarding the country's sovereignty and security, and defending our territorial integrity.”

~ Chinese President Xi Jinping

Today, Southeast Asian nations are trying to walk a tightrope with China. On one hand, they want access to Chinese goods and to sell their products to China, yet the security dilemma they face over China’s growing and aggressive navy means they are increasingly trying to pull in outside powers, like the United States, Japan, and India, as a way to balance a rising China.¹⁰ This comes at the same time as America is increasing its military presence and diplomatic outreach to the region.

In an effort to better ensure stability, as well as help American businesses better access growing markets, President Obama announced that America would refocus on the Asian-Pacific after a decade of intense focus on the Middle East. This “Asian pivot” includes forging new economic and diplomatic ties with states in Asia such as Burma and stronger ties with states such as the Philippines, as seen through the Trans-Pacific Partnership (TPP). The U.S. military is also working to create new pacts with Southeast Asia

⁸ Hyer, Eric. (68/1). The South China Sea Disputes: Implications of China's Earlier Territorial Settlements. *Pacific Affairs*. p. 36

⁹ Ibid, p. 36

¹⁰ Roy, Denny. (2005). Southeast Asia and China: Balancing or Bandwagoning? *Contemporary Southeast Asia*. p. 310

militaries including accessing ports and basing troops in the region. Thanks to China's perceived aggression in the region, these new efforts and policies are being met with success.

Growing U.S.-Philippine relations is an example of how America's new policies are taking root. Expert Leszek Buszynski explains, "After finding that it was too militarily weak to defend its South China Sea claims against China and that it could not rely on Asia-Pacific multilateralism to defend Philippine interests, Manila sought to strengthen its position against China by balancing with the United States."¹¹ Indonesia, who has disputes with China over the Natuna Islands, also has been looking to the U.S. to help balance against China.¹² China's posture has caused Indonesia to warm to an increase in U.S. regional influence despite the fact it has traditionally seen America as a threat to its goal of hegemony in Southeast Asia. It has changed its attitude and is growing closer to America because, between the two, they see China as the graver threat.¹³

As American naval presence increases in the region to help curb aggression in the South China Sea, and as new agreements are formed between U.S.-ASEAN nations, tensions between the U.S. and China have risen. This has been reflected in both official government statements and in Chinese media.

An example was on August 3, 2012 when the U.S. State Department issued a statement admonishing China's aggression in the South China Sea, including plans to build a military garrison in Sansha City.¹⁴ China's Foreign Ministry reacted, stating the U.S. Asian pivot was causing regional tensions to rise rather than creating peace, and reaffirmed its "indisputable sovereignty over the South China Sea Islands and adjacent waters."¹⁵ Another example was in late August 2012 when then Secretary of State

¹¹ Ibid p. 314

¹² Ibid, p. 317

¹³ Ibid, p. 317

¹⁴ Ventrell, Patrick. (2012, August 3). Statement on the South China Sea. *US Department of State*, <<http://www.state.gov/r/pa/prs/ps/2012/08/196022.htm>>

¹⁵ Gang, Qin. (2012, August 30). Statement on the US State Department issuing a so-called press statement on the South China Sea. *The Ministry of Foreign Affairs of China*, <<http://www.fmprc.gov.cn/eng/xwfw/s2510/t958226.htm>>

Hillary Clinton attended a Southeast Asian regional forum to discuss America's new commitment to the region and its goal of helping peacefully resolve the South China Sea dispute. The Chinese media responded critically to Clinton's trip and comments regarding the South China Sea. State-run papers said her remarks and U.S. policies focused on the Sea were inappropriate and unwelcome and said America's "saber-rattling is disturbing a tranquil region."¹⁶

All of this has led global policymakers to view an increasingly frightening situation where conflict among many Asia nations and China in the South China Sea could shut down shipping lanes and trade in one area of the world still seeing robust growth and producing important goods.

The South China Sea issue is not just about competing claims; it's about peace and stability in the region.

~ ASEAN Secretary General Le Luong Minh

International bodies like the U.N. and ASEAN have held forums to discuss and resolve territorial disputes peacefully but have not slowed displays of military force in the Sea. In fact, a new naval arms race has begun with smaller countries in the region building new combat ships and subs, and purchasing defense weapons, equipment, and military platforms from European defense firms eager to export to new customers.

The prospects of a full-fledged war in the next 5 years are low. However, what is more likely is that regional conflict will reveal itself as a "lukewarm" war - one part standoffs, and one part heated but constrained conflict via continued water cannon usage, direct

¹⁶ LA Times. (2012, August 30). China's media criticize Clinton's visit to Cook Islands. *LA Times*, <http://latimesblogs.latimes.com/world_now/2012/08/china-hillary-clinton-south-pacific-cook-islands.html>

physical engagement between vessels, and use of combat ships and subs as a display of force to intimidate. Such conflict can be managed, but only for so long; small skirmishes can harm national prides and often lead to war when it is least expected.

Some in business will disagree, citing the fact that these nations are economically interdependent and conflict would disrupt their economies and social orders.

Unfortunately, economic interdependence theory may not apply in this instance because it does not take into account the rising nationalism in Asia.



China's New Passports (2013) now display islands in The South China Sea as part of their territories. This is an effort to reinforce its claims in the minds of Chinese citizens, especially younger generations, as well as force other nations to stamp the booklets in a crafty effort to force them to acknowledge their South China Sea claims.

Today, popular nationalism inside China has steadily increased as China has grown into an economic power. Students are being taught the nationalist ideas of a “Middle Kingdom” where China historically ruled over much of Southeast Asia, including the South China Sea, and China is merely trying to rightfully recover its lost territories.¹⁷ Hence the reason why China’s education system has redrawn maps of Asia several times in recent decades, each time teaching its students that its boundaries extend further and

¹⁷ Buszynski, Leszek. (2005). ASEAN, the Declaration on Conduct, and the South China Sea. *Contemporary Southeast Asia*. p. 344

further beyond its recognized maritime claims. Rising nationalist sentiment can be seen in books and in state-owned media, as well as in calls on the government by Chinese citizens to develop a blue water navy to help recover their rightful territories and protect its economic interests. Such ‘geopolitik nationalism’ is not just seen in China but in Vietnam, Japan, Indonesia, and other states in Southeast Asia.¹⁸ This nationalistic fervor can push states to act irrationally; rather than a focus on economic growth, disputes become a zero-sum game based on security and survival.

Analysis: What this means for footwear

Considering more than 95% of all footwear shipped to the U.S. flows through the South China Sea, continued tensions and small skirmishes in the South China Sea have major implications for the footwear industry in terms of speed to market and transit costs.

For now, insurance costs for sea-bound cargo have not seen dramatic increases thanks to America’s increased presence in the Sea, ensuring a balance of power. However, as nationalism grows along with regional navies, any increase in conflict in the Sea – especially if water cannon usage increases or even turns to traditional weaponry – could see sea-bound rates skyrocket due to increased risks. The effect on the industry and consumers is especially harmful considering that any additional costs are added to the product before tariffs are applied at the border, magnifying the overall cost impact.

Furthermore, conflict in the Sea could have major effects on speed to market for footwear. Footwear from southern China would have less trouble with ocean bound shipping considering it has no direct land barriers to the open Pacific. However, if shipping lanes are impacted in the southern areas of the South China Sea it could

¹⁸ Hughes, Christopher R. (2011). Reclassifying Chinese nationalism: The ‘Geopolitik’ Turn. *Journal of Contemporary China*, (71), 602.

impact China's ability to obtain the oil cargo ships needed. Even slight scarcity of oil could cause disruptions.

For nations like Vietnam and other surrounding countries that produce footwear and ship through the Sea to get to the Pacific, it means a great deal. War would prevent ships from transiting the Sea altogether, but, absent war, hostilities could still do harm. Though China could never attempt a naval blockade with U.S. presence, should relations reach all time lows, it could harass ships from Vietnam and other nations trying to reach the Pacific in an effort to harm these nations economically. Such an act – boarding ships to ask for papers or holding up ships and making them port – would significantly decrease transit times. Likewise, trying to sail alternative routes to avoid such harassment, such as through the Sunda Strait, would also increase transit time.

This is a critical time in the history of global footwear production and sourcing. China continues to dominate as the number one supplier of footwear to the U.S. market at 84 percent of overall imports.¹⁹ Even with such dominance, both Vietnam and Indonesia are dramatically increasing their exports to the U.S. at pace of 21 and 29 percent respectively. With the continued reshuffling of footwear sourcing throughout the region, conflict in the Sea, both large and small, could have a substantial impact on costs, delivery, and quality.

¹⁹ Footwear Distributors and Retailers of America. (2013). *Footwear Sourcing Forecast*. <<http://fdra.org/wp-content/uploads/2013/08/FDRA-Footwear-Forecast-Report-2013.pdf>>

About the Author

Andy Polk is FDRA's Vice President. He oversees FDRA's communications, marketing, and assists with member services, education and outreach. Prior to FDRA he earned his Masters in International Relations from the London School of Economics and Political Science (LSE). While at LSE, Polk was the director of the London office for the Langley Intelligence Group Network (LIGNET) - a firm providing global intelligence and forecasting from former CIA, U.S. intelligence and national security officers, including former CIA and NSA director Michael Hayden. From 2008 to 2011, Polk served as the director of the bipartisan Congressional Anti-Terrorism Caucus, advising over 100 members of Congress on national security and counter-terrorism policy, and as Foreign Policy and National Security Advisor to House Intelligence Committee member U.S. Representative Sue Myrick. Polk also served as Myrick's Director of Communications and Public Affairs from 2003 to 2008.



FOOTWEAR DISTRIBUTORS AND RETAILERS OF AMERICA

1319 F Street, NW, Suite 700

Washington, DC 20002

202.737-5660

(F) 202.638.2615

info@fdra.org

www.fdra.org