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### CLOSING CASE Tiny Islands, Big Trouble

The South China Sea has long been a critical waterway in international commerce. Stretching from the Straits of Taiwan in the north to Singapore and the Straits of Malacca in the south, its fecund waters yield a tenth of the world's commercial fish catch. It is transited by vessels accounting for half the tonnage of ocean-borne intercontinental trade. Yet squabbling over three small island chains—the Spratly Islands, the Paracel Islands, and the Pinnacle Islands—and two submerged shoals and reefs—the Macclesfield Bank and the Scarborough Shoal—threaten to undermine trade relations and escalate political conflicts among Brunei, China, Japan, Malaysia, Taiwan, the Philippines, and Vietnam, which have staked claims to part or all of these areas (Map 3.2).

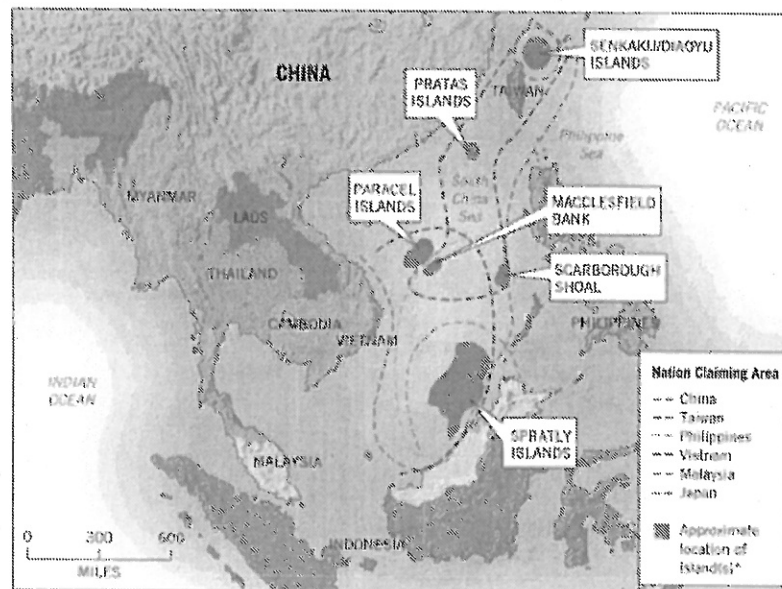
The size of the territory at stake is small: no more than 10 square miles of land spread throughout the 1.4-million-square-mile South China Sea. But the size of the islands underestimates their economic, strategic, and political importance. Under the 1982 United Nations Convention on the Law of the Sea (UNCLOS), a nation's territorial waters consist of those within 12 nautical miles of its coastal shores. These territorial waters are considered to be part of its sovereign territory, although foreign vessels are permitted innocent passage through them. UNCLOS also grants a nation an exclusive economic zone (EEZ) extending a

maximum of 200 nautical miles from its coastal shores. The presence of a continental shelf may also influence the boundaries of an EEZ. Each country controls all economic resources within its EEZ. However, Article 121 (3) of UNCLOS indicates that rocks "which cannot sustain human habitation or economic life of their own shall have no exclusive economic zone." It is not obvious that the island groups in dispute meet this threshold.

The Macclesfield Bank, a series of submerged shoals and reefs, is claimed by Vietnam, China, and Taiwan. (To complicate matters, as we discussed in Chapter 2, China believes that Taiwan is part of its sovereign territory.) The Scarborough Shoal, an underwater formation claimed by China, Taiwan, and the Philippines, has triggered commercial conflicts between China and the Philippines. Incidents involving surveillance of Chinese fishing boats by the Philippine navy have led to boycotts of Chinese goods by Philippine consumers, alleged cyber attacks on Philippine universities by Chinese hackers, stricter regulations on Philippine banana exports to China, and suspension of Chinese tours to the Philippines.

The struggles over the disputed island chains are even more intense than over the two submerged formations. Ownership of the island chains impacts a country's

MAP 3.2  
South China Sea



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# CHAPTER 3 • LEGAL, TECHNOLOGICAL, ACCOUNTING, AND POLITICAL ENVIRONMENTS 81

million Chinese workers are employed in 4,600 Japanese-controlled factories. Should the Chinese market turn hostile to them, Japanese investors could redirect their investments to other parts of Asia, such as Vietnam or the Philippines. Moreover, the United States and Japan have a mutual defense treaty, which would escalate the significance of any armed conflict between China and Japan.

Resolving these territorial disputes will be complex. National pride may need to be balanced against the economic benefits of peaceful resolution. Philippine leaders have proposed that Association of Southeast Nations (ASEAN, discussed in more detail in Chapter 10) and China negotiate a binding code of conduct that would regulate commercial activities in the region. Others experts propose that the squabbling nations agree to binding arbitration under the aegis of the UNCLOS. China has rejected arbitration, preferring to engage in bilateral negotiations over the disputed areas. Cynics suggest that given the unequal economic and military power of China vis-à-vis its neighbors, bilateral negotiations will inevitably favor China.

## Case Questions

- 3-22. Pick one of the island chains (Paracel, Spratly, Pinnacle/Senkaku/Diaoyu/Tiaoyutai) under dispute. Research the claims of the parties asserting ownership of the island chain. Prepare a short memo

summarizing the ownership claims, the basis of those claims, and a possible solution to the dispute. Are bilateral negotiations, arbitration under UNCLOS, or a region-wide code of conduct the best way to resolve the conflicts? What are the advantages and disadvantages of each approach?

- 3-23. Suppose you are an executive for Forum Energy PLC, which was granted exploration rights in the Spratlys by the Philippines. What political risks do you face? What can you do to lessen these political risks?
- 3-24. Suppose you are an executive for Toyota, which has extensive FDI in China and has targeted the Chinese market as critical to the company's future growth. What political risks do you face? What can you do to lessen these political risks?

Sources: Based on "In South China Sea, a dispute over energy," *Washington Post*, January 25, 2013; "Senkaku row raises militarization fears," *Financial Times*, February 6, 2013; "Dangerous shoals," *The Economist*, January 19, 2013; "China Dispute Casts Pall Over Japan Growth," *Wall Street Journal*, October 14, 2012; "Japanese car sales down in China," *Japan Times*, October 14, 2012; "Rolling the waters," *The Economist*, July 7, 2012; "Vietnam Protests CNOOC's Plans in Disputed South China Sea," *Wall Street Journal Asia*, March 16, 2012; "Beijing in Fresh Sea Row with Hanoi," *Wall Street Journal*, March 1, 2012; "The devil in the deep blue detail," *The Economist*, February 4, 2012; "Carp among the Spratlys," *The Economist*, March 10, 2011; U.S. Energy Information Administration report on the South China Sea, accessible at <http://www.eia.gov/countries/regions-topics.cfm?fips=SCS>.

## MyManagementLab®

Go to [mymanagementlab.com](http://mymanagementlab.com) for Auto-graded writing questions as well as the following Assisted-graded writing questions:

- 3-25. Discuss the differences in accounting systems and procedures adopted by countries. What are the primary influences on a country's accounting system?
- 3-26. What is political risk? How can companies protect themselves from political risk?
- 3-27. Mymanagementlab Only—comprehensive writing assignment for this chapter.

## Endnotes

1. "Apple in Brazil trademark dispute," *Financial Times*, February 14, 2013; "Apple Feels Heat in Brazil Over iPhone Brand," *Wall Street Journal*, December 19, 2012, p. B6; "Now, Apple in trademark dispute over iPhone in China," *Press Trust of India*, February 20, 2012; "Apple has 'trademark weakness'," *China Daily*, February 20, 2012.
2. "How to Cut a Job in Italy? Wait, and Wait Some More," *Wall Street Journal*, May 21, 2013, p. B1; "Brink's retreat in Belgium backfires," *Wall Street Journal*, December 21, 2010, p. B8.
3. "The Hindu rate of self-depreciation," *The Economist*, April 23, 2011, p. 47.
4. "U.K. lawmakers call for end to libel tourism," *Wall Street Journal*, February 24, 2010.
5. "Mining executives woo rebels with billion-dollar mineral deals," *Houston Chronicle*, April 17, 1997, p. A20; "As Zaire's war wages, foreign businesses scramble for inroads," *Wall Street Journal*, April 14, 1997, p. A1.
6. Office of the U.S. Trade Representative, *National Trade Estimate Report on Foreign Trade Barriers 2002*, p. 70.

territorial waters and its EEZ, making ownership of these otherwise insignificant islands extremely valuable. The three island chains are blessed with abundant fish stocks. Moreover, geologists and petroleum engineers believe significant oil and gas reserves lie under the waters of the three chains. Estimated reserves vary widely, however. The Energy Information Administration, the statistical branch of the U.S. Department of Energy, believes the South China Sea contains 11 billion barrels of oil and 190 trillion cubic feet of natural gas; the Chinese National Offshore Oil Company's (CNOOC) estimates are much higher, 125 billion barrels of oil and 500 trillion cubic feet of natural gas.

Vietnam, China, and Taiwan claim sovereignty over the Paracel Islands, which are roughly equidistant from Vietnam and China. French naval forces administered the area as part of France's colony of Indochina. After France ceded control of its colony in 1954, the Paracels were administered by South Vietnam. In 1974, the Chinese navy ousted South Vietnam's troops and took control of the Paracels. In 2012, the National Assembly of Vietnam reiterated the country's claim over both the Paracel and Spratly Islands. China dismissed this action, asserting it has "indisputable sovereignty" over the islands. The diplomatic squabbles between Vietnam and China heated up in September 2012, when Vietnam charged that Chinese forces robbed and assaulted Vietnamese fishermen who sought refuge on a Paracel island during a violent storm. Vietnam has also protested plans by CNOOC, one of China's state-owned oil companies, to call for bids for firms to drill for oil and gas on 19 blocks one mile from the Paracel Island chain.

The struggle over the Spratlys is equally contentious. By some estimates, the Spratlys' oil and gas reserves are larger than those of Kuwait. Forum Energy PLC, a UK company, is exploring for oil in the region under rights granted by the Philippines. ONGC Videsh, a subsidiary of India's state owned oil company, has been granted similar drilling rights by Vietnam. Excepting Brunei, all of the claimant countries garrison portions of the Spratlys, although one must pity the poor soldiers stationed there because many of the garrisoned islands are described as "naturally above water only at low tide." To counteract the growing naval assertiveness of China, Vietnam and the Philippines have strengthened their military ties with the United States. The United States has also provided two former Coast Guard cutters to the Philippine navy.

But the hottest dispute is over five small islands and three barren rocks labeled on nineteenth-century British naval charts as the Pinnacle Islands. Totalling less than three square miles, the island group is known in Japan as the Senkaku Islands; the Chinese government declares them to be the Diaoyu Islands. The Taiwanese government prefers Taioyutai as their name. Both China and Taiwan agree that the Pinnacles belong to Taiwan; they disagree, of course,

whether Taiwan is an independent nation, a territory of the People's Republic of China, or the sovereign of mainland China. Conversely Japan believes that the Pinnacles are an extension of the Ryukyu Islands, which is an integral component of Japan.

Although technically located in the East China Sea, rather than the South China Sea, the problems surrounding the Pinnacles are similar to those involving the Paracel and the Spratly groups, except that they are more intense and more dangerous. Both Chinese and Japanese politicians have used the Pinnacle dispute to promote their domestic political agendas. The latest contretemps began in September 2012, when Yoshihiko Noda, Japan's prime minister at the time, nationalized three of the islands for domestic political reasons. The Chinese media denounced the move as an insult to China's dignity. Beijing refused to send its officials to International Monetary Fund (IMF) and World Bank meetings in Tokyo. Anti-Japanese riots quickly spread throughout China, causing damage to Japanese-owned property. For instance, Japanese retailer Aeon's store in Qingdao suffered \$9 million in damages. Chinese consumers also boycotted Japanese goods, particularly Japanese automobiles. Toyota's September sales in China dropped by nearly a half, while those of Honda, Nissan, and Mazda fell by a third. Chinese businesspersons and tourists cancelled visits and vacations in Japan, hurting Japanese airlines and hotels. All Nippon Airlines suffered 46,000 seat cancellations, costing an estimated 10 billion yen in lost sales. Chinese factories shifted their orders for component parts from Japanese companies to their South Korean competitors. Japan's GDP is estimated to have shrunk by 0.5 percent as a result of the boycotts.

China's response was not limited to economic boycotts. The Chinese Communist Party was in the midst of a transfer of power, and wished to show no weakness to the world. Accordingly, the Chinese government intensified its presence in the waters surrounding the Pinnacle Islands, thereby reasserting its claims to the islands. Japan too was undergoing a political change, and Shinzo Abe, Noda's successor, boosted Japan's military budget and increased Japanese naval patrols around the Pinnacles. Chinese fishing boats in the area alleged harassment by the Japanese Coast Guard. In November 2012, Japan claimed that a Chinese frigate locked its fire-control radar on a Japanese destroyer, which is a first step to exchanging fire. The conflict then turned rhetorical: the *China Daily* declared that Japan is a "real danger and threat to the world." Japanese Prime Minister Abe denounced China's actions as "a unilateral, provocative act and extremely regrettable."

The danger and threat to the world and the world economy will indeed be significant if cooler heads fail to prevail. The economic damage to the carefully calibrated supply chains created by multinational corporations would be significant, as would the damage to the Chinese economy, one of the main engines of world economic growth. About 1.5