

**Soft Balancing against the US ‘Pivot to Asia’:  
China’s Geostrategic Rationale for Establishing the AIIB**

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**Abstract**

The existing accounts about the China-led multilateral development bank – the Asian Infrastructure Investment Bank (AIIB) – have focused on the American policy concerns and the economic and commercial reasons for China to establish it. Two deeper questions are left unaddressed: Was there any strategic rationale for China to initiate a new multilateral development bank; and if there were, how effective is China’s strategy? From a neorealist, balance-of-power perspective, this paper argues that China has felt threatened by the Obama administration’s rebalance to the Asia-Pacific strategy. In response, China opts for a soft-balancing policy to carve a regional security space in Eurasia to mitigate the threat coming from its east. China’s material power, premised on the fact that the country is a huge domestic market and flush with cash, has proved irresistible for Asian states, with the exception of Japan, to be enticed away from the US. On the one hand, this paper adds weight to the claim that although the US remains to be the pre-eminent military power in the Asia-Pacific, it has fallen into a relative decline in regional economic governance; on the other, China’s soft balancing has its own limitations in making like-minded partnership with, and offering security guarantee to, AIIB members. A China-led regional order has yet to arrive even with the AIIB.

**Keywords:** Asian Infrastructure Investment Bank (AIIB); Soft-balancing; Eurasia; ‘One Belt, One Road’ (OBOR); US hegemony

# **Soft Balancing against the US 'Pivot to Asia': China's Geostrategic Rationale for Establishing the AIIB**

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China's President Xi Jinping outlined a proposal for building the 'Silk Road Economic Belt' and the '21<sup>st</sup> Century Maritime Silk Road' ('One Belt, One Road' or OBOR), linking China and Eurasia together, during his visit to the Central Asian state of Kazakhstan in September 2013. A month later in Indonesia, Xi proposed the setting up of the Asian Infrastructure Investment Bank (AIIB) to help finance the OBOR initiative. The Chinese government in March 2015 issued an official document, laying out the major principles and priorities for OBOR (National Development and Reform Commission 2015). Three months later, the AIIB was officially launched with 57 founding members, including some of the United States' key allies such as the United Kingdom, France, Germany, and Australia. Membership of the AIIB has further expanded to 70 in March 2017.<sup>1</sup>

Before the establishment of the AIIB, many leaders, particularly those in the West as well as Japan, expressed concern about the transparency and governance of the AIIB. The US government initially 'opposed the AIIB's creation and reportedly urged its allies and partners in Europe and in Asia not to join the AIIB' (Weiss 2017: 5). They were worried that the Bank would be 'a bank of China, by China and for China' (Ito 2015). Similar to the role of the US in the World Bank group, China currently makes the single largest contribution to the Bank, accounting for 33.41% of its capital share and holding 28.79% of the voting rights. This provides China with *de facto* veto power over crucial issues (e.g. its structural reform) that would require a 75% majority. In addition, compared with other multilateral development banks (MDBs), the powers delegated to the AIIB's Board of Directors are substantially modest (Weiss 2017: 9). With a non-resident Board of Directors, it is argued that, the financing operations may tend to reflect the opinions of the AIIB president and executives, which are obviously

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<sup>1</sup> The 13 new members are Afghanistan, Armenia, Belgium, Canada, Ethiopia, Fiji, Hong Kong (China), Hungary, Ireland, Peru, Republic of Sudan, Timor Leste, and Venezuela.

dominated by China (Ito 2016: 4). The Obama administration, in particular, articulated two major concerns over the AIIB. First, it would be an institution designed to compete for clients as well as influence with the existing multilateral development banks: the World Bank and the Asian Development Bank (ADB). Second, there were concerns in Washington that the existing US-dominated Bretton Woods institutions' international influence and clout, particularly on the rule-setting, would be diminished (Ito 2015; Nelson 2015: 17-18). Critics have argued that China would likely apply its rules and standards in project lending, ultimately undermining the liberal norms and rules espoused by the US-dominated Bretton Woods institutions. With these misgivings, Washington had tried to lobby American key allies, especially the UK, against joining the AIIB. The US position on the AIIB showed Washington's hidden reservation about integrating China into the existing liberal international order. Nevertheless, Washington's effort to delegitimize and marginalize the AIIB has 'failed miserably' (Drezner 2015; Feigenbaum 2017). After the UK's unexpected announcement to be the first G7 country to seek the membership of the AIIB in March 2015, which aroused the ire of the Obama administration (Dyer and Parker 2015; Watt et al. 2015), other US allies – Germany, France, Italy, Australia and South Korea – quickly jumped on the bandwagon to join as founding members of this new development bank.

The focus of the analysis thus far has been, in the first place, on the American policy concerns and the tug of war between its major allies and it. In explaining why China initiated the AIIB, the existing accounts can be summarized as follows: (1) huge demand for infrastructure investment in various Asian countries that goes beyond the financial capability of the established development banks to meet (Wang 2015); (2) China's needs to export its production overcapacity to arrest its domestic economic slowdown; (3) China's perception of American relative decline during its ascendancy since 2008; (4) China's displeasure at the sluggish pace of institutional reform of the international financial institutions; (5) Xi Jinping's decision to give up Deng's policy dictum of 'keeping a low profile in international affairs' (for accounts of all these arguments, see Chan and Lee 2017; Etzioni 2016; Prasad 2016: 226-34; Ren 2016; Weiss 2017; Yu 2016). A deeper question is, however, left unaddressed: Was there any strategic rationale, apart from economic and commercial reasons, for China to establish a new multilateral development bank?

Few attempts have been made to attribute the Chinese major and path-breaking move to create an MDB by itself to its policy response to an imminent external threat from the US. Throughout the 1990s and early 2000s, China's economy had grown rapidly, enabling it to become the second largest economy in the world since 2010. However, until late 2013, China had never showed its intention to establish a multilateral development bank. Why did China not establish the AIIB under Hu Jintao or earlier? The existing accounts are idiosyncratically inclined to attribute the policy change to Xi's ideology without going into sufficient details of the underlying factors of his policy. To fill this void, this paper provides an alternative account of the rationale for setting up a China-led MDB by resorting to an old neorealist theory, balance of power, and by connecting it to a signature foreign policy of the past Obama administration, namely strategic rebalance to Asia. In the face of that threat, China began to take steps to set up the AIIB and the associated 'One Belt, One Road' project, even if it was about to be swiftly awarded more clout in both the World Bank and the International Monetary Fund.

This paper proceeds in five major steps. First, it will deal with the Obama administration's signature foreign policy, rebalance to Asia, and how China has felt threatened by it. This is to be followed by an account of the theory of soft balancing and its relevance to the study of the establishment of the AIIB. Sections 3 and 4 will respectively discuss the institutional origins of the AIIB and OBOR and their 'separation', and China's 'Marching West' towards Eurasia strategy. An assessment of China's soft-balancing policy will be made in Section 5.

### **The US 'Pivot to Asia' Policy**

In the midst of the first term of the Obama administration, Washington launched a rebalancing foreign policy in the Asia-Pacific through the notion of 'pivot to Asia'. The ultimate goal of this strategy is to maintain the domination and supremacy of the American hegemony in the Asia-Pacific region in the face of 'China's rise'. The US often harbours the view that a rising China will strive to drive it out of the Asia-Pacific, undermining peace and security of the region.

As part of this pivot to Asia policy, the US has expanded its military presence by strengthening the existing alliance structure in the Asia-Pacific. It has deployed more

troops and equipment to Australia and Singapore and further expanded its military cooperation with Japan and the Republic of Korea. Australia is one of the key actors of the Obama Administration's 'Asia pivot'. In 2011 both countries agreed to deploy 2,500 US Marines to Darwin, a northern city of Australia. In addition, Canberra also grants the US access to its Naval Communication Station in Western Australia, including the space surveillance radar system there (Wood 2015: 140). In Singapore, the US also has been allowed to have access to Changi Naval Base, the Port of Singapore Authority's Sembawang Terminal, and the Paya Lebar Air Base (Wood 2015: 143). More US naval forces were deployed to the Pacific Ocean than to the Atlantic Ocean under Obama's Asia-Pacific rebalance (60% versus 40%) (Hang 2016: 298). Overall, although the naval assets only increased by 2% in comparison with the George W. Bush administration, it has been argued, this two-percent increment does make 'a difference in terms of perception, signal of intent and actual capability' (Hang 2016: 298).

In Japan, while the US has tried to reduce its visible 'footprint' by relocating 7,000 Marines from Okinawa to Guam in order to reduce the resentment generated by the presence of US troops among the Japanese public, Washington was simultaneously upgrading the capabilities of American forces based in Japan substantially. Patriot interceptors and powerful X-band radar systems, which are designed to track long-range missiles, have been deployed (Lord and Erickson 2014).

In South Korea, under the Obama's 'pivot' to Asia policy, the US has substantially boosted its military presence in the Korean peninsula. During the George W. Bush administration, Washington withdrew 40 percent of US troops from South Korea as well as reduced the scale and frequency of military exercises between two countries. However, Obama carried out the 'largest joint military exercises with South Korea since the Korean War' and its troop presence between Seoul and the demilitarized zone that divides North and South Korea has also increased (Ross 2012; 78). In addition, the deployment of the Terminal High Altitude Area Defense (THAAD) missile system from the US to South Korea has incurred China's wrath (as will be discussed more below). Beijing perceives it as a threat to its national security for its role in changing the balance of power in the region.

Apart from a strengthening of the US traditional ‘hub-and-spoke’ alliance system, more detrimental to Chinese interests is that the US has encouraged its Asian allies, especially Japan and Australia, and India to cement military ties among themselves. Since March 2013, the US rebalancing toward Asia-Pacific region has expanded to ‘Indo-Asia-Pacific rebalance’ by bringing India into the fold. These so-called ‘mini-lateral’ or ‘pluri-lateral’ structures can combine the strengths of both bilateralism and multilateralism in developing a network of American allies (Tow and Envall 2011: 62).<sup>2</sup> Obviously, their common target is a rising China.

Economically, Washington has also tried to maintain its dominant position in the regional economic order by pushing ahead with a 12-country Trans-Pacific Partnership (TPP) trade agreement. The TPP was not initiated by the US but by Brunei, Chile, New Zealand and Singapore. The US under George W. Bush decided to join the negotiations in 2008 in the final year of his administration. The succeeding Obama administration included it into its rebalance policy (Christensen 2016: 248-249; Ren 2017: 245). Until January 2017 when the Trump administration declared its withdrawal from it (Williams and Fergusson 2017), it was supposed to be the largest pact governing international commerce, encompassing 40% of the world’s economic output and deemed to be a key economic component of Obama’s ‘pivot’ (Manyin et al. 2012). However, China, the second largest economy, was excluded. Although China had expressed interests in joining the TPP negotiation (Ren 2017: 250), the standards that the Obama administration had set for China on various issues of human rights, transparency, state-owned enterprises and crackdowns on hacking and cyber industrial espionage, ‘are so high as they have effectively precluded [China’s] participation’ (Etzioni 2016: 183). Despite Hanoi’s equally dismal human rights record, Washington invited Vietnam, seen as a strategic counterweight to the rise of China, to join the TPP (Nakamura 2015). The TTP was later pitted against the Regional Comprehensive Economic Partnership (RCEP) in which Australia, China, India, Japan, New Zealand, South Korea and 10 ASEAN states – without the US – were negotiating (Ren 2017: 246). The US also blocked the Chinese move to kick-start the formation of the Free Trade Area of the

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<sup>2</sup> Pluri-lateral or mini-lateral security structures involve three but sometimes four or five states meeting and interacting informally to discuss issues related to mutual security threats. See Tow and Envall 2011: 62.

Asia-Pacific (FTAAP) in November 2014 when China was hosting an APEC Leaders' Meeting (Ren 2017: 247-248).

US executive policy statements often conveyed two self-contradictory aims to two divergent groups of audience. They sought to reassure Beijing that Washington's intentions were benign, and at the same time, to reassure the American public and American allies that the US would not allow a rising China to threaten American hegemonic status (Heritage 2017: 145). Behind the coexistence of various schemes of free trade in the Asia-Pacific was a battle over which country would be leading in writing the rules for regional trade (Christensen 2016: 314-315).<sup>3</sup> The centrality of the TPP project for the Obama Administration was therefore about 'geopolitics, not economics', preventing China from developing a growing sphere of influence in the Asia-Pacific region (Bradsher 2015). As argued by Amitai Etzioni (2016), the US has continued to pursue a multifaceted containment policy, which includes economic and ideational containments targeting China, and precludes China's integration into the liberal international order.

A commentary from the official news agency, Xinhua, denounced the 'pivot to Asia' policy as 'corrosive to the region's peace and stability', and that the US should 'come up with ... an epitaph to the pivot' if Washington sincerely wants a peaceful and prosperous Asia-Pacific (Liu 2016). The resentment against the US rebalancing policy can further be seen from its first 'White Paper on Asia-Pacific Security Cooperation', published by the Ministry of Foreign Affairs in January 2017 (Ministry of Foreign Affairs 2017). The White Paper not only emphasizes the long-term strategy to cement Chinese leadership but also aims to counter the rebalancing policy. The White Paper confronts directly with the Fact Sheet published by the White House in 2015 in relations to Obama's rebalance to Asia and the Pacific. While the US seeks, as pointed out by the US Rebalance Fact Sheet, to 'build a *network of like-minded states* that sustains and strengthens a rules-based regional order' (The White House 2015; emphasis added), the vision of China's White Paper is on 'common security', 'reject[ing] the idea of security

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<sup>3</sup> Christensen (2016: 315) has argued that the TPP was initially intended to 'encourage further Chinese economic opening and reform by enticing Beijing to join' (see also 2016: 248-249). But China perceived it as an exclusion (Ren 2017: 250).

for some countries while leaving the rest insecure’ and emphasizing that ‘strengthening of military alliances targeted at a third party is not conducive to common security’ (Ministry of Foreign Affairs 2017; Heath 2017). China’s White Paper rejects the concept of the ‘network of alliances’ by calling for all countries to ‘pursue partnerships’ instead of alliances. Beijing explicitly sounds out its opposition to the deployment of THAAD in South Korea, arguing that ‘[f]orming Cold War style military alliances and building global and regional anti-ballistic missile systems will be detrimental to strategic stability and mutual trust, as well as to the development of an inclusive global and regional security framework’ (Ministry of Foreign Affairs 2017).

In addition, a major reason why emerging powers, China in particular, initiated the establishment of the AIIB (and the New Development Bank BRICS) was their shared frustration with existing multilateral financial institutions whose voting structures are stacked against emerging countries (see Chan et al. 2012; Donnan 2015; Dove 2016; Etzioni 2016; Kastner et al. 2016; Ma 2015). In short, the rebalance to the Asia-Pacific which included the exclusion of China from the US-led TPP, and the tardiness in embracing China into international financial institutions were collectively perceived by Chinese leaders as concerted actions to block China’s rise to prominence in Asia (Ratner 2013; Xue 2016; Zhang 2014). China began to shift its policy focus to Eurasia, as a countermeasure, with an aim of leading the vast region economically and politically. The ‘One Belt, One Road’ initiative, linking China and Eurasia together, is part of Beijing’s geo-political strategy to manage Washington’s rebalance policy.

### **Soft Balancing and the AIIB/OBOR**

This paper argues that the AIIB is part of a Chinese soft-balancing strategy to the US strategic rebalance to Asia. In the wake of the Obama’s ‘pivot to Asia’ policy, China creates a Eurasian zone of economic influence in its west in order to offset the imminent threat from the US from the east. OBOR, the Silk Road Fund and the AIIB serve as three major institutions of China’s ‘Great Game’ strategy.

Neorealists argue that balance of power has yet to be a relic of the Cold War even after its end. However, because states in the post-Cold War era are less concerned about existential threats to their sovereign territorial integrity, second-tier major powers have mostly abandoned the traditional military balancing (Paul 2005: 47). Instead, soft



balancing becomes a more rational behavior. Robert Pape states that ‘soft balancing measures do not directly challenge a unipolar leader’s military preponderance, but they can delay, complicate, or increase the costs of using that extraordinary power. Nonmilitary tools, such as international institutions, economic statecraft ... can have a real, if indirect, effect on the military prospects of a unipolar leader’ (Pape 2005: 17). In explaining US use of soft balancing toward China, He and Feng (2008: 393) argue that soft-balancing is ‘the efforts to undermine the relative power of the threatening state through diplomatic coordination and institutional constraints’. They claim that ‘the higher the power disparity and economic dependence, the more likely a state chooses soft balancing to pursue its security’ (He and Feng 2008: 363). States will opt for this policy if they ‘do not choose to bandwagon with an adversary’ while their economic ties are close (He and Feng 2008: 393).

Stephen Walt (2005: 126) defines soft balancing as the ‘conscious coordination of diplomatic action in order to obtain outcomes contrary to U.S. preferences – outcomes that could not be gained if the balancers did not give each other some degree of mutual support.’ States will coordinate with each other if they want to limit the ability of the US to impose its preferences on them or to take unilateral actions. Soft balancing will also increase their bargaining power in global negotiations in various issues by showing that they can be less dependent on US power or protection. Soft balancing is likely to occur when a couple of states have shared preference for checking American power and are confident that their preference is steadfast (Walt 2005: 129-130). States within the same region may likely be more prone to adopting soft balancing than countries across regions. Chaka Ferguson (2012: 200; emphasis added) further conceptualizes soft balancing as a regionalization policy by defining it as ‘nonmilitary alignments of at least two states that are designed to reduce or remove the military presence and external influence of an outside power from a specific *region*’.

Can the AIIB be accordingly understood as part of China’s regional strategy designed to form and strengthen its regional sphere of influence (Ferguson 2012: 206, 207)? Or, as counter-argued by Brooks and Wohlforth (2005), there is no balance of power today and what remain are simply policy disputes between the two powers. This paper claims that international politics has had a role to play in China’s decision to establish the AIIB and that, together with OBOR, it is part of a soft-balancing strategy to counter US

‘containment’ policy in the region. Externally the AIIB serves to fulfil China’s grand strategy of regional order-(re)building, which aims to undermine the hegemony of the US. An issue, which is to be further explored below, is whether China’s regional partners in the soft-balancing strategy hold steadfast preference with China in constraining US power.

### **From the AIIB/OBOR to the AIIB and OBOR**

Although China has been participating in multilateral institutions for decades and has increased its engagement with them since the 1990s, the AIIB is one of the few multilateral institutions that Beijing initiated and plays a leadership role. During the early stage of the establishment of the AIIB, Chinese officials often linked the AIIB and the OBOR together, indicating that the creation of the AIIB (as well as the Silk Road Fund) would be to help implementation of the OBOR initiative (Lou 2016: 46; Sun 2015; Weiss 2017). In November 2014, Xi Jinping even bluntly stated that “China’s inception and joint establishment of the AIIB with some countries is aimed at providing financial support for infrastructure development in countries along the ‘One Belt, One Road’ and promoting economic cooperation” (cited in Sun 2015: 30). However, this official expression on the linkage between the AIIB and OBOR has been toned down when international concerns over whether the Bank would be a Chinese-dominated bank were growing. In order to allay those concerns, Chinese officials differentiated the AIIB from OBOR, emphasizing instead that the AIIB would conform to the international standards. During a meeting with global executives from 15 companies in mid-2016, Jin Lique, president of the AIIB, further clarified that the Bank was not created exclusively for OBOR, and that it ‘would finance infrastructure projects in all emerging market economies even though they don’t belong to the Belt and Road Initiative’ (cited in Zhong and Cai 2016). Nevertheless, the 13 projects that the AIIB financed in 2016 and 2017 (all joint projects with other MDBs except loans to Bangladesh and Oman), totaling over \$2 billion, have links with, albeit not integral to, China’s OBOR.<sup>4</sup> It is hard to deny that the two initiatives are not inter-related. Some even speculate that the Bank’s co-financing with other MDBs in its initial projects is a

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<sup>4</sup> The recipients of these 13 projects include Pakistan (2 projects, totaling \$400 million), Tajikistan (\$27.5 million), Indonesia (3 projects, totaling \$441.5 million), Bangladesh (2 projects, totaling \$225 million), Myanmar (\$20 million), Oman (2 projects, totaling \$301 million), Azerbaijan (\$600 million), and India (\$160 million). All are in US dollars. For details, see Chan and Lee 2017 and the AIIB official website.

design to try to separate the AIIB projects from China's other foreign assistance projects (Weiss 2017: 6).

After 'delinking' the AIIB from OBOR in official parlance, Beijing wished the US and Japan to join the AIIB in order to enhance the legitimacy of the Bank as well as to enlarge its financial clout. However, even with American and Japanese membership, the geographic foci of its lending on Eurasia would not be changed to benefit American interests. That partly explains why Donald Trump, who is opposed to many Obama's foreign policy initiatives ranging from TPP to the Paris Agreement, has not taken another dramatic U-turn by joining the AIIB. Furthermore, his administration initially only planned to send Eric Branstad, a rank-and-file official in the Department of Commerce as well as the son of US incoming ambassador to China Terry Branstad, to the OBOR forum. Only after China reached a trade agreement with it on buying more American beef in time, did it decide to upgrade the representation of the American delegation to the level of the senior director for Asia at the National Security Council (but yet up to the secretary level) (Lopez 2017; Perlez and Huang 2017). Overall, the US, under both the Obama and Trump administrations, has been sceptical about joining both the AIIB and OBOR, which are perceived as China-led projects to offset American global influence.

### **A Rebalancing of China's Geostrategy**

In 2015 China and Pakistan signed an agreement to commence building a \$46-billion China-Pakistan Economic Corridor (CPEC). CPEC has since then become the flagship project of OBOR and is seen as a countervailing measure to the American 'pivot'. CPEC can date back to 2006 when Islamabad proposed to Beijing a 'Trade and Energy Corridor' (TEC) that would include the development of the Gwadar port, upgrading the Karakorum Highway (KKH), building railways and pipelines to connect Pakistan with Western China for trade and transport energy purposes (Fazal-ur-Rahman 2007). Before Washington's 'pivot to Asia', despite Islamabad's offer of the use of Pakistan as the site of a 'trade corridor', 'energy corridor' and a 'transport hub' in the region, Beijing showed 'marginal interest in the idea' (Fazal-ur-Rahman 2007: 54). When Islamabad called for bids for the contract to operate the Gwadar port, China's state owned companies showed little interest and did not submit any bid. The running of the port was granted to a Singaporean company for 40 years. China's

lukewarm response to the TEC was believed to be mainly due to its concern over upsetting the US when it was widely speculated that Gwadar would become a Chinese naval base and any move from China might potentially touch the nerve of the US. In addition, Pakistan's re-engagement with the US in the post-9/11 also made China to be cautious about its investment in Pakistan (Fazal-ur-Rahman 2007).

However, from 2012/2013 onwards, China has become more proactive and announced the CPEC project a month before Xi Jinping outlined a proposal of OBOR in Kazakhstan in September 2013.<sup>5</sup> In addition, when the lease of the Gwadar port to the Singaporean company was terminated by a Pakistani court in 2013, China showed its interest in the port and a Chinese state-owned firm, China Overseas Ports Holding Company, was given the right to operate it without going through any open bidding process.<sup>6</sup> Informants in Islamabad believed that China's shifting attitude towards CPEC was primarily triggered by Obama's rebalancing policy and the growing India's assertiveness in the region.<sup>7</sup> One of the major infrastructure projects of CPEC is to build an 887-km-long highway, N35, to connect the port of Gwadar in southwestern Pakistan with Kashgar in Xinjiang, China. Gwadar, a gateway to oil exporting Gulf countries, is only 120 Km away from the Iranian border. This port not only contains geostrategic importance but also helps to shorten the crude oil shipping time to China from the Middle East by as much as 85% (Chan and Lee 2017: 24).

Inside China, to counter US strategic rebalance to the Asia-Pacific, which was widely understood and perceived by China as a policy to contain the rise of China, Chinese International Relations experts have advised the Chinese government new policy ideas. In October 2012, Wang Jisi of Peking University's School of International Studies proposed a 'Marching West (西進)' strategy to counteract both US 'pivot to Asia' policy and a 'New Silk Road' initiative unveiled by Hillary Clinton in November 2011.<sup>8</sup> Wang explained the logic behind this Westward policy by pointing out that compared with the countries in Southeast Asia, all the countries west to China, with the exception of India, do not have any conflict with China. China is in a well-placed position to

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<sup>5</sup> Interviews in Islamabad, May 2017.

<sup>6</sup> Interviews in Islamabad, May 2017.

<sup>7</sup> Interviews in Islamabad, May 2017.

<sup>8</sup> For a study of the 'New Silk Road', see Kucera 2011.

collaborate with them in geo-economics and geopolitics. In addition, as many powers, such as the US, Russia, India and Japan, have gradually shifted their economic and security foci to the Central and Eurasian region, China should not limit itself to an East Asian state only. Rather, China should cooperate with the countries in its west to generate a strategically friendly environment, which will also be conducive to managing the tripartite threats of terrorism, (religious) extremism and separatism (viz. the ‘three evil forces’) to the north-western region of Xinjiang (Wang 2012).

Xue Li of the Chinese Academy of Social Sciences also contends that the primary strategic objective of OBOR is to resolve the negative effects US ‘pivot to Asia’ policy might bring to China (2015: 69). Some also argue that in facing the US encirclement in the Indo-Asia-Pacific region, OBOR also acts as an ‘enforceable policy’ to promote economic and security cooperation in Eurasian region (Li and Cai 2015). Zheng Anguang (2015) of Nanjing University holds that China’s strategies in Central Asia should shift from being reactive to proactive and that the OBOR initiative should be seen as Beijing’s diplomatic strategy to build a new regional order. Under this new geostrategic framework, the AIIB and the Silk Road Fund were set up to strengthen the infrastructure facility in the region that is desperately needed.

### ***Economic Soft-balancing: A Eurasian trading bloc***

As Pape (2005: 37) has argued, a major element of soft-balancing is to enhance the relative economic power of the weaker power through the creation of a regional trading bloc that would promote intra-regional trade and economic growth for the members only. For China, the first step towards establishing a regional trading bloc in Eurasia is to break out of the ‘dollar trap’ (Prasad 2014). While China’s foreign exchange reserves have been growing (until very recently) as a result of its export-led economic growth, the bulk of them are used to buy American dollar-denominated assets, especially US Treasury bonds. The huge purchase of US Treasury bonds helps Washington to finance its budget deficits and public debts, enabling the Federal Reserve to keep the American interest rate low. The global financial crisis of 2007-2008 incurred substantial loss of Chinese investment in US dollar assets, especially in both Fannie Mae and Freddie

Mac.<sup>9</sup> There have been concerns inside the country about the adverse impacts of this ‘dollar trap’ policy, pointing out the low return and the risk of the financial investment, and the concomitant need to press down inflationary pressure inside China. A policy measure to reduce accumulation of foreign exchange reserves as well as exposure to US dollar assets is to internationalize the Chinese currency by encouraging the use and circulation of the *renminbi* outside China. The AIIB is such an institution that helps re-direct China’s foreign exchange reserves away from US assets into investment in infrastructure in neighboring countries. It is even envisaged that eventually it would offer loans in the *renminbi* rather than in US dollars and part of the loans would be used to purchase China’s equipment and labour services (Mallaby and Wethington 2012; Ren 2016; Yu 2011; Zhang 2015; Zhou 2015).

As a concomitant of internationalization of the *renminbi*, the AIIB and OBOR lay emphasis on ‘connectivity’ with Eurasian states, which has the potential to create a ‘regional trading bloc’ that would exclude the US. If someday the AIIB issues loans in the *renminbi*, it will likely reduce demand for US dollars as the world’s reserve currency and accordingly undermine American economic hegemony (Pape 2005: 42). In comparison between the TPP and OBOR, Chinese scholars tend to believe that while the TPP is a rules-based economic cooperation mechanism, OBOR is a development-oriented initiative and a type of public goods that China provides to the region and beyond (Li 2016). Xia Xianliang of the Chinese Academy of Social Sciences in Beijing even bluntly states that to counter the US Asia-Pacific rebalancing strategy, the OBOR initiative will help expand China’s economic and trade cooperation between Europe, Asia and Africa. This will change the world economic and financial order and the investment pattern, and eventually put China back to the world economic centre that China has lost since 19<sup>th</sup> century, during the Qing dynasty (Xia 2015).

In short, the AIIB is founded to serve a grand strategy of China’s regional order-building. It is one of the institutional means to lend financial support for the OBOR initiative and to counter US ‘hegemonic intrusion’ in the Asia-Pacific as well as

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<sup>9</sup> The Chinese State Administration of Foreign Exchange (SAFE) in February 2011 refuted a local media report that the country suffered a financial loss of up to \$450 billion in the investment in Fannie Mae and Freddie Mac, even though it was widely speculated in society that there was a substantial loss in the investment in US dollar assets during the global financial crisis of 2007-2008 (*Shanghai Daily* 2011; *Wall Street Journal* 2011).

dominance over international finance. China does have the incentive to balance softly against a unipolar world that constrains it from becoming a great power. By looking at the membership of the AIIB, China has already allured US close allies into its fold. Among the Group of 7 (G7), only Japan and the US have not yet applied for the membership of the AIIB. The remaining question is how effective China's soft-balancing strategy is. One criteria is whether the soft-balancing measures 'can delay, complicate, or increase the costs of using [the] extraordinary power' of the hegemon (Pape 2005: 17)

### **How Effective Is China's Soft-Balancing?**

The Chinese scholar Lou Wei (2016) argues that the emergence of a dichotomy between 'an economic dependence on China and a security reliance on the United States' has created political space for China to counter the US 'pivot to Asia' policy. To what extent is China able to utilize the business opportunities created by both the AIIB and OBOR to undermine American rebalance strategy? This section will use Australia and South Korea, two of US major allies in the Asia-Pacific, as case studies to assess the effectiveness of China's soft balancing.

#### ***Australia***

Well before the establishment of the AIIB, Canberra had showed its interest in participating in the institution. Joe Hockey, then-Treasurer, admitted that the membership would create opportunities for Australian companies to sell more commodities to Asian consumers (Coorey 2016). Tony Abbott, the then Prime Minister, also agreed to attend the launching ceremony where he would have signed a Memorandum of Understanding (MOU) in Beijing in October 2014. However, just days before the ceremony, Abbott announced his absence from it. It was speculated that this was mainly due to the pressure from the US. John Kerry, the then US Secretary of State, piled mounting pressure on Australia to stay out of the AIIB during his meeting with Abbott in Jakarta following the inauguration of Indonesian President Joko Widodo in October 2014 (Reuters 2014). After Britain declared its support for the new bank in March 2015, however, Australia swiftly followed suit and became a founding member of it. Three months later, Canberra was 'awarded' a free trade agreement with Beijing. However, unlike France, Germany and the UK, Australia is not given any key managing role in the bank, even though it is the sixth largest

shareholder and a regional member of the AIIB. The five Vice Presidents of the Bank go to citizens of France, Germany, India, Indonesia, and the UK (AIIB 2016). It is widely speculated that Canberra missed the opportunity of a vice-presidency because it delayed in joining due to political pressure from the US and Japan (Coorey 2016).

What tangible benefits would Australia likely gain with an AIIB membership? With Asia making up 60% of global infrastructure spending in the next decade, Australian mining, construction and service industries will potentially benefit from being a member of this infrastructure bank. It is argued that the AIIB will suit Australian needs better than the existing institutions dominated by Americans and Europeans (McHugh 2016; Daily Reckoning 2015). China is the biggest market for Australian exports. More than 30% of its US\$243-billion exports in 2014 went to China (OEC website). One of the potential beneficiaries is the coal mining industry, with Australia accounting for around one-third of all coal trade in the world. The major markets of its coal exports are China, Japan, Korea and other countries in Asia.

Currently the AIIB is going through its final round of public consultations on its future energy strategy, which will serve as a guide for the Bank's future engagement with, and investments in, the energy sector. After the final round of consultation, the strategy will be presented to the Bank's board of directors for final decision in June 2017 (Murray 2017). According to the AIIB's first draft guidelines on the Bank's energy strategy, published in October 2016, in order to achieve the demand for energy growth in the region while at the same time transitioning to a lower carbon future, the Asian region will need investment of \$8,740 billion on infrastructure improvement between 2016 and 2025 (AIIB 2016). Jin Lique of the AIIB has promised that the Bank would be a 'green bank' with an emphasis on renewable power, such as hydropower. The guidelines mentioned above also indicate that 'fossil fuel production, transport and consumption have severe negative impacts' on densely populated cities in Asia. While the paper did not completely reject the use of coal and oil, in line with the World Bank and the ADB coal financing policy,<sup>10</sup> the AIIB states that 'coal- and oil-fired power plants would *exceptionally* be considered if cleaner technologies are not available for

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<sup>10</sup> The World Bank announced in 2013 that it would stop financing coal plants except in rare cases, where no feasible alternatives are available. Similarly, the ADB only supports coal projects that use high-efficiency and low emissions technologies. See Murray (2017a).



well-founded energy security or affordability reasons’ (AIIB 2016; emphasis added). While the Bank is finalizing its energy plan, Canberra, unlike other developed countries, had lobbied hard the AIIB for including coal into its lending priorities (Smyth and Hornby 2016). The Minerals Council of Australia, the country’s biggest industry lobby group, criticizes the AIIB’s draft guidelines of ignoring clean coal technologies. The Business Council of Australia also wrote to the AIIB, claiming that Australia’s higher-quality coal could help curb carbon dioxide emissions growth in Asia. With strong interests in preserving her country’s overseas markets, Kate Williams, a Treasury spokeswoman, stated that ‘The [Australian] government wants the AIIB energy strategy to acknowledge that fossil fuels will play a significant role in energy generation in the region for decades to come’ (Smyth and Hornby 2016).<sup>11</sup>

A membership would potentially allow the Australian government to influence the Bank’s policy from within. Apart from that, other tangible benefits would come along too. For example, as mentioned, three months after Australia confirmed its participation in the AIIB, the country signed a free trade agreement with China in June 2015. In addition to the AIIB projects, the countries along OBOR would be the other major export markets for Australia. As noted above, the AIIB has engaged closely with the OBOR initiative. For example, as part of its OBOR flagship project, China signed an agreement with Pakistan to commence their \$46-billion China-Pakistan Economic Corridor (CPEC) in 2015. As part of the CPEC initiative, agreements were signed in early February 2017 between China and Pakistan in building two coal-fired power plants with total capacity of 1650 Megawatts in Hub, Balochistan and in Thar, Sindh (Murray 2017b). Australia may potentially provide material products and service for these two projects as well as other OBOR-related ones. As argued by Chan and Lee (2017), the AIIB does not exist alone. It is an, albeit not the, institutional means to carry out a larger Chinese project to transform Eurasian regional order. Both the AIIB

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<sup>11</sup> Interestingly the Australian government has actively promoted the benefit of coal power. According to the Department of Industry, Innovation and Science of Australia, if replacing the existing coal power stations with the more efficient ‘ultra-supercritical’ coal-fired power station, the country could cut its greenhouse emissions by 27%. However, the CSIRO estimates, new ultra super-critical black coal would cost A\$3,100 per kW to build and in order to achieve the reduction, it would require 20GW of new capacity, that would cost more than A\$60bn according to Dylan McConnell, a scientist at the University of Melbourne. McConnell pointed out that if renewable energy was to be used to achieve 27% reduction in emissions, it would need about 13-19GW of renewable energy, costing only A\$24-34 billion, half of the government’s new coal power plan. See Slezak 2017a, 2017b.

and OBOR are all linked together as part of China's soft-rebalancing strategy in the region.

However, Australia is on the horns of a dilemma between its relationship with China and the US. While there is little doubt that China has been the primary source of Australia's economic growth since 2008, Canberra has relied on the US as a regional security provider since the Second World War. Some argue that Canberra should 'cut the tag' with American foreign policy as it cannot risk supporting the US at the expense of its trading relationship with China (Sales and Wearing 2017). Others counter that Australia should remain the alliance with the US and that, as a liberal democracy, Australia is ideologically closer to the US than China. This was manifest in the failure of the Australian legislature to ratify the China-Australia extradition treaty in late March 2017 shortly after Chinese premier Li Keqiang's visit to Canberra. It indicated Australian long-standing concerns over China's human rights record and its state-controlled criminal justice system.<sup>12</sup> Canberra also declined to endorse Beijing's proposal to align and link Australia's \$5 billion Northern Australia Infrastructure Facility to China's New Silk Road initiative during Li Keqiang's visit (Riordan 2017). Sino-Australian relations soured after it was revealed in early June 2017 when US secretaries for defence and state were visiting Australia that China allegedly tried to meddle in Australian domestic politics by funneling political donations to Australian Liberal and Labor parties through Chinese business diaspora in the country. Australian Prime Minister Turnbull was quoted as warning the Chinese government that '[j]ust as modern China was based on an assertion of national sovereignty, so China should always respect the sovereignty of other nations, including, of course, our own' (McKenzie et al. 2017; cited in Smyth 2017b). While Australia does not want to be left out of the lucrative infrastructure investment opportunities arising from the

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<sup>12</sup> The extradition treaty was concluded between China and Australia under the Howard government in 2007 but was waiting for ratification by the Australian legislature. The Australian government pulled a parliamentary vote to ratify it in late March 2017, just days after the Chinese Premier Li Keqiang's visit to Australia, where he stressed the importance of tackling cross-border crime between two countries. The failure to ratify was mainly due a cross-party concern over inadequate protections for human rights as well as the non-existence of the rule of law in China. During Li's visit, the Chinese government detained Chongyi Feng, an Australian permanent resident and a professor at the University of Technology Sydney, in southern China, preventing him from leaving China after his research in the country in March 2017 (Boreham 2017; Smyth 2017a).

AIIB/OBOR, it at the same time perceives a non-democratic China as a potential threat to its national security and political values.

Overall, China's soft-balancing strategy has scored some, albeit far from full, success, as Australia is treading a thin line between seeking closer economic ties with China and preserving strong political and military relations with the US. So far, Australia eschews to be forced to take side.

### ***South Korea***

South Korea is the fifth largest shareholder of the AIIB. Akin to Australia, not long after Seoul's commitment to being a founding member of the AIIB, it sealed a free trade agreement with China in November 2014. China is also the biggest trading partner of South Korea, accounting for 25% of the country's total exports. As a regional member and the fifth largest shareholder, Korea had its national Hong Ky-tack appointed as one of the five vice-presidents and the chief risk officer at the AIIB in February 2016. However, after Hong was allegedly involved in a corruption scandal related to his previous job at the Korean Development Bank, he applied for a six-month leave from the Bank in June 2016. While Seoul was still seeking a replacement of Hong from its own country, the AIIB swiftly appointed a French national Thierry de Longuemar, a former Vice President of the ADB, to replace Hong in September 2016 (AIIB 2017). It was widely speculated that the removal of a vice president position from South Korea was linked with Seoul's intention to deploy THAAD (Shim 2016).

For some years, South Korea has tried to balance its relations with the US and China. While Seoul has relied on the US for security protection since the Korean War, its increasing economic ties with China have put Seoul in a strategic dilemma between its relations with the US and China. Given China is the only benefactor of North Korea, President Park Geun-hye (in office, 2013-2017) hoped that the strength of Sino-ROK economic and diplomatic relations would influence Beijing's policy towards Pyongyang. Her attendance in the military parade in China's commemoration of the 70<sup>th</sup> anniversary of Japan's defeat in the Second World War in Beijing in 2015, while the leaders of many Western countries were absent from it, had clearly shown President Park's intention to strengthen relations with China (Heritage 2017: 164-165). However, North Korea's increasing militarized activities, such as ballistic missile testing in 2012-

2014 and its fourth and fifth nuclear testing in January and September 2016, in defiance of China, have amply demonstrated that Beijing has limited leverage over Kim Jong-un who has yet to have any summit meeting with Xi Jinping since his ascent to power in December 2011 (Cha 2017). Accordingly the Obama Administration wanted to upgrade its shield capabilities on South Korea from 2014 onwards. South Korea dragged its heels until late 2016 after Pyongyang launched three ballistic missiles in August 2016 (Heritage 2017: 167). Despite strong domestic and Beijing's opposition to its deployment, South Korea finally agreed to deploy the missile system in December 2016 and the deployment started in February 2017. Both Washington and Seoul claim that THAAD is a defense system and a necessary defensive response to North Korean leader Kim Jong-un's belligerent behaviour, particularly concerning the reclusive regime's frequent ballistic missiles and nuclear weapons testing since 2012.

However, China has been infuriated by US deployment of a missile shield in the region. It sees the system as a threat to its security and part of the 'containment' strategy set by the US. The radar and tracking components of THAAD can also be readily used as a surveillance equipment capturing the Chinese military due to the geographical closeness between two countries. Chinese scholars are also convinced that the system is all about containing China, rather than defending South Korea from its northern brethren. They believe that it is the US to pull the semi-willingly South Korea to agree to the deployment of THAAD in order to fit with the broader US security strategy to contain China (He 2016; Zhao 2016).<sup>13</sup> The day after parts of the THAAD components were delivered to Seongju, southeast of Seoul on 6 March 2017, China's Foreign Ministry strongly emphasized that 'we [the Chinese government] firmly oppose the deployment of THAAD ... and we will resolutely take necessary measures to defend our security interests' (Rauhala 2017). In suspected retaliation, Beijing employs economic statecraft to offset an imminent threat it believes coming from the US.<sup>14</sup> It imposes informal economic sanctions against South Korean firms in various sectors,

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<sup>13</sup> Experts outside China have argued that China's concerns are overstated because the US already gain access to the radar systems in Qatar, Taiwan and Japan that can be used to monitor Chinese missile tests. What China really wants is rather to close the door on the possibility of further deployment of more advanced anti-missile systems along the Chinese periphery (Buckley 2017).

<sup>14</sup> Economic statecraft can be defined as the use of economic instruments, inducements and/or sanctions, to influence the actual and potential behaviour of other international actors (Baldwin 1985: 40-42; Zhang 2014: 2).

ranging from cosmetics, supermarket chains, automobiles to tourism. South Korea's entertaining business, such as movie stars and pop singers, are also banned to perform in China. The hardest hit target is Lotte Group, a Korean conglomerate, after the company reached a land-swap deal with the South Korean government in February 2017, which allowed the THAAD system to be deployed to a golf course owned by Lotte in Seongju. The Chinese website of the conglomerate's affiliated company, Lotte Duty Free, was a target of cyberattacks. The construction of the company's multi-billion-dollar real estate project in China was also suspended right after the land-swap deal (Reuters 2017). Another affiliated company, Lotte Mart, was also caught by the THAAD dispute since the announcement of THAAD in July 2016. Accordingly, its business in China reported a loss of over US\$88 million in 2016. Three of its retail stores in Beijing also had to shut down in the same year (Duo 2017; Hernández et al. 2017).<sup>15</sup>

At the beginning of the economic boycott, South Korea did not bow to the mounting economic pressure from China. Its legislature passed in late March 2017 a bipartisan resolution, expressing 'deep concern and regret' over Chinese retaliatory measures against its companies. Its ambassador to China called on China's ministries of foreign affairs, commerce and public security to put an end to the sanctions against Lotte. Informal complaints against China were also raised at World Trade Organization (Jun 2017). However, soon after the election of Moon Jae-in of the centre-left party, Minjoo Party of Korea,<sup>16</sup> South Korea decided in June 2017 to suspend the deployment of the THAAD for a year. Moon seems to adopt a middle-of-the-road policy on the defence. The missile shield has a total of six rocket launchers. Two of them had been deployed before the presidential election and will not be withdrawn by the new government.

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<sup>15</sup> China and South Korea reached a Free Trade Agreement in November 2014 and the Agreement went into force in December 2015, not long after South Korea applied as a founding member of the AIIB. However, the decision of the deployment of THAAD in July 2016 has put the relations of these two countries on hold. Geopolitics and economics are mixing together. The suspected retaliation also involves mobilization of Chinese population to boycott Korean products. For example, all 3,400 Chinese cruise tourists, part of a reward trip organized by a Chinese company, arrived Jeju, South Korea on 11 March 2017, but refused to disembark, even though 80 tourist buses had been arranged and were waiting to take them for shopping at duty-free shops in Jeju (Linder 2017).

<sup>16</sup> Arguing that economic sanctions had failed to prevent Pyongyang from proceeding with its nuclear weapons programme, Moon calls for a less confrontational approach to dealing with the North. He and his liberal supporters are also loath to let their country be drawn into hegemonic conflicts or wars between major powers (Choe 2017).

However, the deployment of the remaining four launchers has been suspended pending an environmental impact assessment (Harris and Harding 2017). On the surface, it seems that China's soft balancing has delayed, complicated, or increased the costs of the US 'pivot to Asia' policy.

### **Concluding remarks**

This paper first put forward a neorealist account, focusing on the use of soft balancing to undermine American military hegemony in the Asia-Pacific, to complement the existing economic and commercial explanations of the Chinese decision to found a multilateral development bank on its soil. Consistent with Pape's argument, China's soft balancing does not directly challenge American military preponderance but has 'a real, if indirect, effect on the military prospects' of the US (2005: 17). China has increasingly utilized its growing economic clout to achieve its foreign policy objectives. The establishment of the AIIB (and OBOR) serves as part of its soft economic balancing strategy to fend off Washington's 'containment' policy. Thus far, this soft-balancing strategy seems to have attained some of its expected results by impaling US Asian allies on the horns of a dilemma, depriving them of the chance to earn *both* economic and security gains from the US. To reap the rewards from China's rise, all the US key allies, apart from Japan, are members of the AIIB.

Following on this soft-balancing account, this paper also examined how Beijing capitalizes on its growing economic prowess to employ a Chinese regionalization strategy, aimed at creating a regional trading bloc in Eurasia, to weave a spell over American key allies in both Europe and the Asia-Pacific against US and Japanese opposition to the AIIB. Growing interest in the AIIB and OBOR may bear testimony to the relative decline of the US in economic and financial governance. This paper echoes Ikenberry's (2016) observation that a 'dual hierarchy' is emerging in East Asia in which the US can only maintain a security hierarchy while an economic hierarchy is now under China's domination. US withdrawal from the TPP in early 2017 under the Trump presidency that followed the launch of the AIIB and OBOR will only help China tighten its grip on the East Asian economic hierarchy. The RCEP can potentially serve as an alternative to the TPP. The Trump administration's decisions to slash

funding to the State Department and foreign aid programme in 2017 may inadvertently help China strengthen its role and influence in international development.<sup>17</sup>

However, there are limitations of China's soft-balancing. The US manages to maintain its security hierarchy in the region even when China can dominate the economic hierarchy. In spite of signs in the early days of the Trump presidency that US-Australia relations would become strained (Thrush and Innis 2017), the Trump administration has not been prepared to withdraw US military deployment to and commitments to Australia.<sup>18</sup> Mutual meetings between senior leaders of the two countries have continued.<sup>19</sup> In addition, whether China's lashing out with economic sanction against South Korea will eventually push Seoul to give up the deployment of THAAD and weaken the US alliance network is not abundantly clear although the deployment has been suspended for a year. As illustrated above, Australia and South Korea, both with democratic systems, do not share with a non-democratic China a belief that the US and American hegemony pose security threat to them. They still remain allied, politically and militarily, with the US and rely on Washington for being their sole security provider guarding against threats emanating from authoritarian regimes. Even with growing economic clout, China fails to undermine the Western democratic solidarity. An implication of this study for further research in International Relations is whether a non-democratic country can soft-balance against a democratic hegemon effectively. Which countries do have shared and steadfast preferences with it for checking the power of the democratic hegemon?

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<sup>17</sup> Trump administration announced in his budget blueprint in March 2017 that the State Department and USAID budget would be reduced by nearly 29%, falling from \$36.7 billion to \$25.6 billion (Morello 2017).

<sup>18</sup> Rather American military bases in Australia will become more crucial for US navy after the Trump administration ordered an aircraft carrier and other military vessels to move towards the Korean peninsula in April 2017 (Schmitt 2017). During the presidential campaign, Trump suggested that South Korea should shoulder the financial burden of deploying THAAD. However, it was the US, under Trump's administration, paid the cost of the first deployment of the missile shield in February 2017 (Harris & Harding 2017).

<sup>19</sup> Turnbull visited Washington to meet Trump in early May 2017; it was followed by the visits by US Defence Secretary Jim Mattis and Secretary for State Rex Tillerson together to Canberra in early June 2017.

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