

INTRODUCTION

The U.S.-China relationship is complex and of such scale that it will have an increasing impact on our economic, national security, strategic, and political interests in the Asian region and around the globe in the coming years. The pace at which the change is occurring and the rapid growth of China's influence are challenging many U.S. interests and demand greater attention from policymakers. This Report, building on the Commission's work since its inception in 2001, highlights a number of salient characteristics of this rapidly evolving relationship.

The Report responds to our nine-point mandate from Congress and overall charge to review the national security consequences of our nation's economic relationship with China. It is the result of 14 extensive hearings in Washington, D.C. and around the country that included more than 150 witnesses, intelligence briefings, and the independent work of a skilled professional staff and outside researchers.

The Commission concludes that over the past year, on balance, the trends in the U.S.-China relationship have negative implications for our long-term national economic and security interests.

America's approach to China needs a coherent strategic framework based on an understanding of the challenges and the opportunities for cooperation in the U.S.-China relationship. It must also be grounded in a clear-eyed understanding of how the Chinese political and military leadership leads the country, how decisions are made, and how the country's economy works. Far too often, policymakers expect reflections of their own set of values and decision-making approaches when projecting how China will act under different conditions and scenarios. China is an authoritarian regime and has a non-market, command economy still controlled by the Communist Party. The central goal of its leadership is maintaining its own power, at any cost.

While some encouraging changes are occurring in China, the basic differences between our countries must be neither forgotten nor underestimated. China has different interests, goals, and values underlying its decisions, and these differences present enormous challenges to U.S. interests around the globe. The Chinese government uses the system in ways that produce advantages for it and all too often fails to honor its commitments when they are inconvenient for China.

The current U.S.-China relationship is in its relatively early stages. Every effort must be made to influence and mold it with the goal of reaching cooperative approaches to resolve problems and allow us to pursue common interests. The accelerating pace of change and China's dramatic rise on the world stage require that bold initiatives be developed to engage China positively in many

areas where common interests exist or can be developed. The Commission's Report offers several new initiatives in the economic and security fields to help advance this effort.

In areas where China poses challenges to the United States, the United States must be prepared to meet them with a variety of tools and approaches. But, due to the accelerating pace of change and the enormity of many of these challenges, the United States must be prepared to respond more aggressively to China's behavior and actions when they run counter to our interests. There is no one approach to responding to these problems; a range of actions must be taken. The United States has enormous leverage to achieve its results, and it must assert its own interests.

U.S. national and economic security interests are inextricably intertwined. The Commission's greatest concern is that the United States has not developed a fundamental assessment of how American national interests are affected by our relationship with China. A detailed architecture that advances all areas of cooperation with China while reducing negative impacts on American economic and security interests still does not exist. In the absence of a coherent articulation of U.S. policy toward China by the Administration, Congress is filling the vacuum. It is taking the formulation of elements of such a policy into its own hands, for example, by acting on the proposed CNOOC-Unocal deal, China's subsidies of its industries, and continued Chinese manipulation of its currency.

China's leadership has a coordinated national strategy for dealing with the United States. It knows what it wants to obtain from the United States—most significantly, a market for its exports, investment, technology, and management skill—and it tailors its economic and diplomatic policies to achieve these goals. China is willing to achieve its goals through means that threaten many U.S. interests: it continues to proliferate components for weapons of mass destruction and ballistic missiles to countries of concern. It refuses to support many U.S. initiatives in the United Nations and other international bodies and is seeking to reduce U.S. presence and influence in the Asian region. In short, China is focused on the most effective ways to develop its comprehensive national power and further promote its position in the world.

Unfortunately, the United States has no coordinated, national strategy for dealing with China. We need one that specifies and prioritizes what we want to accomplish, what outcomes are and are not acceptable, and how to reach those goals.

There can be no higher value than the protection and enhancement of U.S. security interests. U.S. security policy toward China must strive to deter any impulse to aggression or adventurism. As documented in this Report, China is engaged in a major military modernization program, the motives of which are opaque and unexplained. It is building a modern navy and air force along with precision-strike weapons, deploying hundreds of missiles aimed at Taiwan, upgrading its nuclear-armed ICBM force, and beginning to operate in a power projection mode. It has markedly expanded its information warfare operations to a level that is clearly designed to disrupt American systems.

One of the few successes has been the engagement of the Chinese to make progress on the issue of North Korea's nuclear weapons

programs. The success of establishing at least the beginning of a Korean denuclearization settlement through an agreement on principles is a result in part of a new Chinese diplomacy—an indication that U.S.-Chinese joint action has the potential to deliver important results to achieve the vital goal of nonproliferation. Implementation of this set of principles, which are designed to denuclearize the Korean peninsula, would enhance our security and political interests and advance the goal of worldwide nuclear nonproliferation. Implementation should be a top priority of the President and the Congress in the immediate future; this is an opportunity that should not be missed.

As a separate matter, despite periodic U.S. efforts, no institutionalized military confidence building measures (CBMs) have been put in place, which would help establish rules of the road for the operations of forces in proximity to each other, help mitigate crises or accidents when they occur, and perform other useful functions. The Commission believes it should be a high priority for the Administration to vigorously engage the Chinese in an attempt to develop such CBMs as the forces of the two powers operate more frequently in close proximity.

China continues to focus much of its strategic and diplomatic energies on Taiwan. Beijing is continuing its massive military build-up, including missile and other weapons systems directed at the island. In 2005, China passed the Anti-Secession Law, which sent a clear and direct message that it is willing to use force, if necessary, to ensure that Taiwan does not pursue independence. As well, China has continued to press other nations to isolate Taiwan in the world community. China has also strengthened economic ties with Taiwan in an effort to deepen Taiwan's reliance on China as a source of economic growth and, at least in part, increase Taiwan's dependence on its trading ties with the mainland. The Commission believes that the United States has deep and abiding strategic and political interests in Taiwan's status, including its position in the Asian region, and continues to affirm its commitments under the Taiwan Relations Act.

China is using diplomatic, military, security, economic, and political overtures in Asia to become an alternative or balancing power to U.S. preeminence in the region. The United States needs to expand its public diplomacy efforts, security assistance, trade relations, and diplomatic interactions in Asia.

Our national economic and security interests also intersect in the energy arena. This year, this issue has come to the forefront in the U.S.-China relationship as a result of efforts by CNOOC, a Chinese state-controlled company, to acquire U.S.-based Unocal, a major energy firm. China's mercantilist behavior is apparent in its worldwide quest to secure energy supplies by acquiring them at the well-head for its own use. China's practice contrasts with the practice of most other nations to buy energy supplies on the open market. As world energy demand rises, of which 40 percent is attributable to China alone, and supplies begin to peak, it is imperative that we convince China to work cooperatively to both develop alternative energy supplies and operate according to standard international practice. The alternative is heightened competition for scarce supplies with the increased danger of collisions over China's

quest for more supplies. The Commission proposes the establishment of a U.S.-China Energy Working Group at the senior government level to promote such cooperation.

Five years ago, Congress agreed to provide Permanent Normal Trade Relations (PNTR) status to China, paving the way for China to become a member of the World Trade Organization. Proponents of PNTR argued that bringing China into the international economic system and facilitating the development of a market economy would result in political reform and eventually democracy in China. Such transformations occurred across Asia in the last century, including in South Korea, Japan, and Taiwan.

China's track record to date on political reform is very disappointing. China continues to severely restrict human rights, workers' rights, and religious freedom. Freedom of speech is severely curtailed, with countless individuals having been imprisoned for criticizing the state. Official corruption is rampant. Last year, some 74,000 incidents of public unrest occurred across the country, many of which were met with deadly force. Labor unrest is on the rise, with similar responses by the government.

The economic imbalance between our two countries continued to increase over the past year. When China became a member of the World Trade Organization, our bilateral trade deficit was \$83 billion. In 2004, this deficit skyrocketed to \$162 billion and is on course to exceed \$200 billion this year—an increase of over 140 percent in only four years.

Investment flows, including high technology investment, from the United States to China continue at a high pace and are negatively affecting the American economy. Projections for market access have failed to meet expectations as China has failed to abide by its World Trade Organization accession commitments on a broad range of products and services.

We are concerned not only about the size of our bilateral deficit, but also its composition. Across the economic spectrum, China is rapidly becoming a world-class competitor. Last year, the United States had a deficit of \$36 billion in Advanced Technology Products with China, an increase of 500 percent since 2001. Software and semiconductor production and research are flowing to China. China is pursuing the development of its nanotechnology, biotechnology, and opto-electronics sectors.

As our trade balance continues to worsen and trading and sourcing patterns change, the imbalances become structural and increasingly difficult to address. Roughly 60 percent of China's exports to the United States come from foreign-invested firms and help fuel the rising trade deficit. These sourcing patterns are unlikely to change in the near future.

Our failure to correct such imbalances conveys to the Chinese that the United States is either unable or unwilling to use its economic power to encourage the proper adjustments. As the imbalances increase and the dependence on Chinese products and capital rises, the ability to act declines. China's unwillingness over the last year to make anything but cosmetic reforms to its system of manipulating its undervalued currency is an example.

But China's dependence on the American marketplace for the sale of its products and as a source of investment and technology

is so large as to make China's economic growth to a substantial extent dependent on the American economy. This provides the United States with enormous leverage to demand that China adopt greater reforms and abandon its mercantilist practices.

Unfortunately, the United States has pursued a policy of economic engagement with China that has not yielded results, while China has actively pursued its own interests. The result is that our corporate sector is increasingly looking to China as a source of profits, either in terms of offshoring or outsourcing, and it is becoming more and more an export platform for products. The transfer of manufacturing capacity to China has been joined by the creation of numerous and substantial research and development centers and capabilities, capabilities which affect the competitiveness of the American economy. As production and R&D move to China, the resulting pressure on remaining U.S. operations and the downward pressure on U.S. wages intensify.

In the absence of well-defined and effective public policies, corporate interests have been able to set the course of our economic relationship. The cycle intensifies as investments in and trading relationships with China increase. More companies are concerned that they will face retaliation by Chinese authorities and/or their related businesses. And, as the sourcing patterns of these companies change, their vested interests in protecting their investments increase, to the detriment of the U.S. standard of living. Elected officials must reclaim control of the policy agenda.

Advancing our interests requires that the United States, in cooperation with its allies, be willing to use many policy options. The World Trade Organization could prove to be an effective venue—to address China's illegal subsidies, forced transfers of technology by companies wishing to gain access to China's economy, rampant and exceedingly destructive intellectual property violations, and currency manipulation—yet the United States and its allies have largely refused to seek redress there. Recent indications that the U.S. Trade Representative may be preparing a case against China in the intellectual property arena are an encouraging sign. The Commission believes that the successful use of the WTO dispute settlement process could be an important mechanism to address China's unfair and mercantilist trading practices.

The Committee on Foreign Investment in the United States (CFIUS), designed to reject foreign acquisitions that damage our national security interests, has been used in only limited ways by this and past administrations. As China's financial reserves rise, largely as a result of its bilateral trade surplus with the United States, Beijing will increasingly seek to recycle those dollars by acquiring U.S. assets. Clearly, the United States must remain open to foreign investment and, indeed, the size of our twin deficits—budget and trade—demands that this be the case. But we must never allow our need for capital to jeopardize our security interests and the CFIUS process needs to be reformed and strengthened to protect our interests.

While China has built up substantial reserves, its efforts to attract funds in the United States and other international capital markets are accelerating. Hong Kong is presently the preferred venue for Chinese listings, particularly on the part of China's state-

owned enterprises. This is in part a function of the new corporate governance and other disclosure requirements in U.S. markets. The Commission continues to be concerned with the security dimensions of the growing Chinese presence in the U.S. debt and equity markets, especially as Beijing seeks to list or trade its major state-owned banks in this country. Customers of these banks could well include proliferators, defense-industrial firms, arms traders, environmental despoilers, and abusers of human and workers' rights.

Addressing the problems posed by China and the impact of globalization demands that America initiate new efforts and programs to advance our own national competitiveness. The nation needs a self-renewal on the scale of the post-Sputnik era, with major new educational programs to create new generations of scientists and engineers. We can remain competitive only if we address education, health care, community, transportation, and industrial infrastructure, job training, and other issues. We must learn the importance of balancing consuming, saving, and investing. To become competitive again, America must take responsibility for its future.

The debate about trade and globalization is framed by discussions about trade theories that do not adequately account for mobile factors of production such as technology and capital. The theory is intended to apply to free markets, a condition that does not exist with China, which is by definition and in reality a non-market, command economy. China can, and does through government actions, alter the trade equation and its outcomes on a daily basis.

China has adopted a model that emphasizes strategic accumulation of productive capacity, and an important part of this strategy is export-led growth, which constitutes a modern form of mercantilism. Export-led growth is an economic strategy in which China seeks to enhance its industrial growth through a variety of policy devices that promote exports while strategically restricting imports to items needed for domestic growth and export production such as technology and raw materials. These policy devices include wage repression, industrial subsidies, government procurement policies, closed distribution systems, performance requirements on foreign investors, and an undervalued exchange rate. This challenge is not new: Japan posed a similar problem for the United States and the world trading system in the 1980s. But the nature of China's approach and the size of its economy result in even greater threats to the U.S. economy and the world trading system.

Though China's economic growth profits from a liberal and open international economic order, it is far from certain that the Chinese government either accepts the rules of this system or intends to comply fully with them.

The challenge is to bring China into the international order as a responsible actor rather than, by inaction or acquiescence, condone its behavior within an international order it manipulates for its own accumulation of economic, political, and military power. We must carefully craft and articulate a U.S.-China policy based squarely on the national and economic security interests of the United States.