

INTRODUCTION

As it prepares to host the 2008 Summer Olympic Games, China is presenting to the world the image of a confident and benevolent world power. But that image stands in contrast to a number of actions by and policies of China's authoritarian government. As a result, Beijing presents enormous challenges for U.S. policymakers who hope to see China move along a path of reform.

Today a prospering China welcomes another year of double-digit growth in its economy and a soaring stock market, and it recognizes that its free market reforms are the engine of its success. However, it is becoming apparent that China's leadership, both in the central government and at the local level, is nervous about the pace and extent of further market-based reforms. In addition, China's leadership continues to avoid political reform by suppressing political dissent and blocking efforts of most groups in the society other than the Communist Party—for example, workers trying to organize and citizens attempting to practice their religion freely.

The Commission has been given the responsibility by Congress to advise it on economic and security policy toward China. Our findings are contained in this, the Commission's fifth major Report to Congress. Contributing to this effort, the Commission held six hearings in Washington DC, and one in Chapel Hill, North Carolina. Commissioners attended three classified intelligence briefings in Washington, DC, and a full day of classified briefings on China's scientific, technological, and military capabilities at Wright-Patterson Air Force Base, Ohio, and are preparing a classified report on those subjects. Commissioners also visited the cities of Beijing, Dalian, and Shenyang in mainland China, as well as Hong Kong; Taipei and Kaohsiung, Taiwan; and New Delhi, India. The Commission contracted for independent research pertaining to topics the Commissioners view as important to consideration of key issues in U.S. policy toward China.

The Commission's conclusions as presented in this Report are a mixture of good news and bad. China has taken a constructive role in reaching agreement among six nations to dismantle North Korea's nuclear weapons production capacity. China has agreed to send a combat engineering battalion to Sudan to help with the U.N.'s peacekeeping and reconstruction activities there, and is showing signs of interest in strengthening its export control system to limit proliferation. China's economic policies have helped lift 200 million of its people out of poverty, and its leaders also have begun to acknowledge the widespread environmental degradation of China's air and water.

Among the problem areas identified by the Commission in 2007 are China's continuing harassment of journalists, bloggers, Internet users, whistleblowers, environmentalists, human rights advocates, and citizens who attempt to disseminate non-official versions of

events within China. The costs of such restrictions have become all the more obvious through many recent reports in the Western press about long-standing safety and health concerns of international as well as Chinese consumers who have been exposed to adulterated and dangerous toothpaste, baby formula, and cough syrup. Allowing the Chinese news media to fully report on such domestic scandals earlier might have led to more effective solutions to the problem within China, and controls on exporting tainted products out of China.

Some of the Commission's research during the year involved issues addressed in previous Commission reports, including a number of World Trade Organization compliance problems. China still is not enforcing its own laws against intellectual property theft. As in the past, the problem revolves around China's lax enforcement and its preference for civil fines rather than criminal prosecutions for large transgressions. China also has done little to address repeated complaints from the United States and the European Union about its extensive subsidies to manufacturers. Those subsidies include discounts on loans and land, electricity, water, waste treatment, and roads. In some cases, China provides lax environmental and labor law enforcement for favored industries. Tax holidays and rebates on exports also are available for favored industries. China maintains limited market access for American entertainment software, principally movies. Each one of these issues is the subject of a WTO complaint against China by the United States.

The Commission is disappointed that Beijing's efforts to move in the direction of a market economy appear to be slackening. In particular, the government's decision to retain state ownership or control of a large block of the economy is disappointing. In accord with its 11th Five-Year Plan, China has designated a dozen industries, including telecommunications, civil aviation, and information technology, as "heavyweight" or "pillar" industries over which it intends for government to retain control. In addition, 155 of China's largest corporations remain state-owned, including nearly all the nation's largest banks. Much of the economy remains under the Chinese government's strict control. Beijing's provision of subsidies to its pillar industries may damage competitors in other countries—including the United States where companies do not receive such subsidies.

Other Chinese economic policies, especially China's pursuit of energy assets to fuel its economic growth, raise particular challenges. Rather than rely on international oil markets to supply its energy needs as most nations do, China shows a growing reliance on owning oil at the wellhead that easily could cause significant market disruptions if prices continue to stay high and supplies remain tight. In addition, this policy has led China to develop close relationships with countries such as Iran, Sudan, and Burma, and this has made it more difficult for China to cooperate in multilateral efforts to address the human rights issues and other important challenges that these countries pose.

Congress needs to consider the growing unease in Asia about China's militarization and its strategic intentions in the Western Pacific/East Asia region. The Commission examined China's growing military power in classified briefings, in hearings, and during

its trips to Asia. The Commission concluded that China is developing its military in ways that enhance its capacity to confront the United States. For example, China has developed the capability to wage cyber warfare and to destroy surveillance satellites overhead as part of its tactical, asymmetrical warfare arsenal. With its highly developed reliance on systems of command, control, communications, computers, intelligence, surveillance, and reconnaissance (C4ISR), the American military is significantly exposed to such attacks. China also could target America's critical infrastructure in a confrontation. In the realm of traditional warfare, China is acquiring the ability to overwhelm the defenses of, and successfully attack, U.S. carrier battle groups.

Creating further uncertainty about China's military and foreign policy intentions is its reluctance to release more details about its military spending. Without such information, Americans are left with little choice but to draw adverse inferences about China's intentions from its focus on cyber warfare and anti-satellite weapons, its construction of two ballistic missile submarines, and its purchase from Ukraine of a former Soviet aircraft carrier. New generations of fighter aircraft, spacecraft, submarines, missiles, and other sophisticated weapons are coming off China's production lines, but China has been reluctant to discuss how its military spending fits into its overall foreign policy goals.

Similarly troubling are the conclusions the Commission reached concerning China's growing reliance on industrial espionage. China continues to supplement its acquisition of new technologies from commercial transfers and direct production partnerships with a large-scale industrial espionage campaign.

China's growing trade surplus with the United States also is worrisome. In the first eight months of 2007, China's trade surplus in goods rose to \$163.8 billion, up 14 percent from the same period a year earlier. China's trade surpluses already have helped create the world's largest single pool of foreign currency. United States policymakers are concerned about the China Investment Corporation recently created by the central government. The CIC will manage a portion of China's \$1.43 trillion in foreign currency reserves, which thus far have been invested mostly in dollar-denominated bonds. But the record size of China's foreign funds holdings and the fund's rapid growth are raising concerns about the direction of future investments and the impact they could have on the U.S. economy.

China's unwillingness to accelerate the pace of its currency appreciation—or at least to allow the international currency markets to have more influence over the value of the renminbi—remains a major disappointment. Since China announced in July 2005 that it would allow the renminbi to fluctuate within a narrow trading band against a basket of currencies, the renminbi has appreciated less than 10 percent against the dollar. Meanwhile, China's global trade surplus is growing at an ever-faster rate.

The Commission believes that none of these problems is insurmountable and that both governments must work diligently to build the trust and understanding essential to agreements to which the parties will adhere.

While the relationship between China and the United States is not the world's closest, there is little disagreement it is one of the most important. The future for both nations—and, indeed, for the planet—significantly depends on the direction in which this relationship is taken by the two countries.