INTRODUCTION

In 2008, China marked the 30-year anniversary of the economic and social reforms that Communist Party leader Deng Xiaoping introduced to a country crippled by the Cultural Revolution and other excesses of the era of Mao Zedong. While the party would maintain its absolute control over all other aspects and institutions of the country, the economy was encouraged to evolve in ways antithetical to the founders of the People's Republic. Instead of confining the economy in a Maoist communal structure, Deng sought a new, more urban architecture, sometimes referred to as "capitalism with Chinese characteristics" or "market socialism."

Neither term is adequate to describe China today. China's economic system is changing so rapidly that it not only is confounding classification but also is producing a wake big enough to rock other institutions, including the Communist Party itself. Yet western expectations that China's path of economic liberalization also will lead it eventually to free market capitalism and even to democracy have been dashed. As this Report describes, China has taken a very different path. And China's lengthy economic growth spurt has been employed more as a justification of continued Communist Party rule than as a stepping stone to political reform.

Notable in 2008 was China's successful staging of the Summer Olympics, a goal that Beijing had set for itself to prove the government's competence and to place China among the ranks of the developed nations that have enjoyed a near monopoly in hosting the games. But while China's athletes did manage to win more gold medals than any other country, the government's organization of the Olympics also called the world's attention to the difficulty China is having in dealing with the environmental consequences of its rapid economic growth as well as Beijing's relentless intolerance of free speech, free thought, and a free press.

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 sixth major Report to Congress. To complete its work, the Commission held eight hearings in Washington, DC, and one field hearing in New Orleans, Louisiana. Commissioners attended classified briefings with seven major intelligence agencies over three days and are preparing a classified report on their findings. Commissioners visited the Chinese cities of Beijing, Taiyuan, and Hong Kong as well as Seoul, Korea; Tokyo, Japan; and Taipei, Taiwan. The Commission also contracted for independent research on topics the Commissioners view as important to U.S. policy toward China.

China's double-digit economic growth continued throughout 2008, adding to a trend over a 30-year period in which China's economy has expanded by an annual average of nearly 10 percent, a pace that now is slowing as a result of the global economic downturn.

During the year, China continued to shoulder more international responsibilities. China's involvement in the Six-Party Talks assisted the negotiations to dismantle North Korea's nuclear weapons production capacity. China also has increased its cooperation with efforts to halt the spread of nuclear weapons. China peaceably settled border disputes with India and Russia. China also took a more active role within the World Trade Organization (WTO), although its actions helped derail the negotiations in the Doha Round. Rather than risk international opprobrium for conducting a repeat of last year's antisatellite missile attack, which littered space with dangerous debris, China emphasized peaceful efforts by successfully conducting its first space walk in September from a three-man orbiting capsule.

On the other hand, China's involvement in the international efforts to persuade Iran to give up on its nuclear power program so far have amounted to little more than blocking tough sanctions in the United Nations (UN) Security Council. Also in the realm of foreign policy, Chinese scholars have been arguing that its sovereignty above its territory extends into outer space.

Even though it is primarily focused on civilian uses, China's space program also is providing the People's Liberation Army with the capability of tracking and targeting U.S. military forces in the western Pacific. Even more worrisome are China's rapidly advancing cyberspace capabilities. The U.S. military is highly dependent on communications and computer networks, both of which are jeopardized by China's demonstrated ability to penetrate U.S. government computer networks. Many of the recent intrusions into U.S. computer networks, including unclassified but critical U.S. military systems, have been traced back to computer servers in China.

The Chinese leadership in 2008 approved a new rudimentary labor law. Although it lacks important workers' rights provisions, such as the right to strike or to join any but a single Communist Party-controlled union, the law does provide for guarantees that workers will be paid by employers and receive some compensation if they are laid off. The leadership also approved significant new antitrust and patent law changes modeled, in part, after internationally accepted standards. While the implementation of the laws will bear watching to ensure that they are applied equally to domestic and foreign companies, the regulatory changes have a positive potential. Similarly, Beijing has shown a growing recognition that it must mitigate the harm to the environment produced by its dependence on coal-fired power plants; its fuel subsidies, which encourage consumption over conservation; and its tolerance at a local level for factories that foul the air and water.

In some cases, it has been the Chinese people, rather than the government, who successfully have demanded necessary changes. But this too often occurs only after tragedy. China's citizens have been ill served by a lack of enforcement of health and safety standards at all levels of government. This regulatory failing has had international consequences, as food and medicines tainted with industrial solvents and toys contaminated with lead are among China's exports to the rest of the world. As detailed in this Report, the United States and China have agreed on some measures to monitor

the safety of China's seafood exports, but much remains to be done on a wide variety of China's food exports.

China's economic liberalization also has its limits. Beijing has chosen carefully among the menu of economic reforms to select only those that enhance its own prospects for growth. In the most egregious example, the government of China continues to control tightly the value of its currency, the RMB, at an artificially low rate by means of strict capital controls. This violates the spirit and the letter of International Monetary Fund bylaws, which require members to "avoid manipulating exchange rates . . . in order to prevent effective balance of payments adjustments or to gain unfair competitive advantage." Rather than try to hide the manipulation of the RMB, Chinese officials openly debate the value of the RMB that the central bank should establish in order to keep China's exports booming—even while claiming that China complies with international norms of monetary policy. The result of this policy is evident in the rapid accumulation of China's foreign currency reserves—at nearly $2 trillion, it is the largest such hoard in the world.

China traditionally has held its foreign currency reserves, two-thirds of which are estimated to be in dollars, in longer-term U.S. Treasury and government agency securities as well as U.S. corporate bonds. That trend is changing since China established in late 2007 its first official sovereign wealth fund, and as a result of the global financial crisis. The combination of China's massive foreign currency reserves, its establishment of sovereign wealth funds, and the potential for China's state-owned companies and investment banks to begin acquiring American companies and other assets is the subject of a section of this Report. The Commission concludes that the potential size and rapidly evolving nature of China's government-owned or -controlled investment in the United States requires that the U.S. government closely examine this development and its implications.

Some examples of China's objectionable economic actions are perennials and are described in this and past Commission Reports. The country's lax enforcement of intellectual property protections continued throughout 2008. It was the subject of a preliminary World Trade Organization ruling that China violates the WTO rules in two important aspects relating to protection of works that have been rejected by Chinese censors and auctioning of seized counterfeit goods. (By contrast, China's enforcement of its own copyright on Olympics-related sales was nearly absolute.) China continues to provide favored domestic companies and industries with additional government subsidies, including favorable tax treatment; low-interest loans and loan forgiveness; discounted land and electrical power; lax enforcement of pollution control regulations; and deliberate market-entry barriers, such as China's insistence on maintaining government control or ownership of a dozen favored industries, such as telecommunications, aviation, steel, automobiles, and shipping.

This year, the Commission looked into the disturbing issue of prison labor in China and found that the government in Beijing still is not complying with its formal bilateral agreements to refrain from exporting the products of prison labor and to allow timely

U.S. inspections of prisons to ensure that no products manufactured there are being exported. The Commission also examined China's energy and environmental policies. Other than an overdue concession by China's leadership that pollution is a serious and growing problem, the Commission found little cause for optimism. Chinese leaders are expending little effort in improving energy efficiency or in mitigating the increasing environmental damage that has resulted from strong economic growth combined with lax pollution controls. The notable exception was China's strict enforcement of pollution regulations during the Summer Olympic Games, but many of these measures were temporary. China is now widely acknowledged as the world's largest emitter of carbon dioxide gas and yet has resisted committing itself to reduce emissions in order to counter climate change.

In the coming year, the Commission intends to continue its examination of these issues as well as others designated by Congress to analyze whether U.S.-China policy is serving the interests of the American people.