

INTRODUCTION

In 2010, the Government of the People's Republic of China appeared to be returning to a previous era, abandoning a path that once seemed intended to lead China to a more open economy, a better relationship with its neighbors, and a cautious but positive leadership role in world affairs. Following the 2007–2009 global financial crisis, while much of the world continued to struggle, China's economy quickly returned to its previous trajectory of double-digit growth fueled by an export-led strategy. With this strategy, China's leadership seemed determined to capitalize on its advantages, even at the expense of its neighbors and major trading partners. Furthermore, over the past year, China has increased its assertiveness when interacting with its neighbors, especially in regard to its maritime territorial disputes in the East and South China Seas. Finally, China continues to develop its military capabilities, some of which appear directly targeted at the U.S. military.

To China's leaders, the global economic crisis justified stronger government controls over the economy, slowing privatization and supporting the creation of state-owned and state-controlled "national champions." This is particularly evident in the emerging alternative energy sectors. China has provided its solar and wind industries with government subsidies while erecting protectionist trade barriers to keep out American and European suppliers. Of greater concern are restrictions China recently announced on the export of rare earth minerals. These restrictions will likely impact U.S. and European manufacturers of advanced electronics, powerful batteries used for low-emission cars, and precision-guided weapons. Beijing's move is certain to put foreign competitors in advanced technology products at a disadvantage, requiring them to either produce in China or pay more for a dwindling global supply of the scarce electronics components.

Rather than opening government procurement contracts to imported goods, as Chinese officials said they would "as soon as possible" when China joined the World Trade Organization (WTO) in 2001, China in 2010 prepared to implement a policy favoring "indigenous innovation" over imported goods. This exclusionary policy would continue to give Chinese manufacturers a preference in government contracting unless foreign companies were willing to register and disclose sensitive technological information. This requirement has alarmed U.S. manufacturers, who view China's intellectual property controls as weak. Meanwhile, China continues to exclude the state-owned commercial sector from coverage by the World Trade Organization's Government Procurement Agreement, which it has thus far not signed.

Since China joined the WTO, the United States has experienced massive annual trade deficits with China that cumulatively amount to \$1.76 trillion. China has adopted policies to encourage

foreign companies to transfer production, technology, and research and development to China in return for access to its market. Many have done so. The resultant unbalanced nature of the trade and economic relationship between the United States and China has helped give China the financial resources and new technological capabilities that have enabled it to strengthen and grow its economic, military, and political power.

A key example of this trend is China's aviation manufacturing industry. China is developing two types of commercial aircraft intended to compete with foreign aviation manufacturers. Although these projects could benefit the U.S. aviation manufacturing industry by increasing aviation-related exports to China in the near term, over time policies implemented by Beijing could undermine U.S. competitiveness. In return for current market access, foreign aviation manufacturers are providing China with technology offsets, important to its domestic industry's growth. The government is also providing Chinese state-owned aviation manufacturing firms with financial support, and ensuring dedicated markets by creating state-owned airline companies that are required to purchase only domestically produced aircraft. Moreover, Beijing is exploiting advances derived from cooperation between Chinese and foreign aviation manufacturing firms to promote the development of China's military aviation sector.

An additional economic issue of serious concern is China's management of its currency. In July 2008 in response to the global financial crisis, China halted the appreciation of its currency, the renminbi (RMB). Under considerable pressure from its trading partners, on June 19, 2010, China announced that the RMB would be allowed to fluctuate on intraday trades. But the supposed reform failed to meet global expectations. China still dictates the value of the RMB relative to the dollar on each trading day, and, according to the International Monetary Fund, the RMB remains "substantially undervalued." As of October 13, the RMB had only appreciated by 2.3 percent, far below the estimated undervaluation of 20 to 40 percent. The International Monetary Fund and the Group of Twenty nations (G-20) members have attempted to persuade China to allow its currency to reflect a market price but elicited only refusals from China's top leaders. Chinese Premier Wen Jiabao turned aside appeals, warning in October that "if the [RMB] is not stable, it will bring disaster to China and the world." In addition, there is little evidence that consumption is constituting a greater share of the Chinese economy.

While regressing on its economic reforms, the Chinese government has sought to tighten its control over its economy by extending laws protecting "state secrets." Under the new rules, foreign companies may be prosecuted for obtaining financial, investment, managerial, and organizational information about state-owned competitors. For example, an American geologist was sentenced in July to eight years in prison for purchasing publicly available geologic reports that Chinese authorities retroactively deemed to be state secrets. The Chinese government also introduced other state secrets legislation that ratcheted up restrictions, and imposed obligations, on Internet service providers.

Over the past year, China has also used other means to tighten controls on the use of the Internet, restricting the access of its citizens to the outside world in order to censor or influence news about such sensitive issues as Tibet and the Dalai Lama; ethnic unrest in Xinjiang Province; the Sichuan earthquake; and human rights protests within China. China's media almost entirely blocked news and thoroughly censored Internet discussions about the 2010 Nobel Peace Prize awarded to Liu Xiaobo, a prominent dissident active in promoting political reform in China.

Cyber attacks emanating from China also continued over the past year. In January, Google, Inc., reported that its servers had been breached and a large amount of proprietary information stolen in an attack that appeared to originate within China. The same operation targeted other U.S. companies in an effort to obtain intellectual property through computer intrusions. Such efforts likely operate with the tacit knowledge of the Chinese government and may even involve full government support. Other developments in 2010 suggest increased opposition to foreign technology firms. For example, Chinese authorities issued a series of new regulations designed to promote domestic information technology suppliers while undermining foreign competitors.

On the international stage, China has undermined the progress it had made over the past decade in promoting its peaceful rise with a renewed assertiveness in advancing its sovereignty claims to large areas in the East and South China Seas. China's claims are disputed by Brunei, Japan, Malaysia, the Philippines, Taiwan, and Vietnam. Early this summer, China labeled the South China Sea a "core interest," on par with its claims to Tibet and Taiwan. Following the U.S.-South Korean announcement of joint naval exercises in the Yellow Sea and the Sea of Japan, held in response to North Korea's sinking of a South Korean naval vessel, Beijing held military exercises in the Yellow and South China Seas. In September, China retaliated against the Japanese detention of a Chinese fishing boat captain by imposing an unofficial ban on rare earth metal exports to Japan.

Beijing continues to modernize its military and develop an anti-access strategy intended to deny the U.S. military the ability to operate freely in the region in the event of a crisis with China. Key components of China's military modernization efforts include the development of a modern offensive air force and the qualitative and quantitative improvement of its conventional missile forces. In further support of its anti-access strategy, China is in the final stages of developing a ballistic missile capable of targeting U.S. aircraft carriers up to 1,000 miles from China's coast. Taken together, these advances provide China with the ability to strike every U.S. base in the region.

One area where China has shown clear progress is in its relations with Taiwan. Over the past year, political, diplomatic, and economic ties between China and Taiwan continued to improve, culminating in a major cross-Strait trade liberalization agreement. These improvements have enhanced peace and stability in the region. Nevertheless, China still refuses to renounce the use of force in the event of a crisis with Taiwan, and continues to bolster its military forces opposite the island. In particular, China continues

to increase the number of short-range ballistic missiles targeting Taiwan in an attempt to deter the island from seeking de jure independence.

These and other issues are discussed in this, the Commission's eighth Report to Congress. Congress gave the Commission the responsibility to advise it on economic and security policy toward China. To complete its work in the past year, the Commission held seven hearings in Washington, DC, and one field hearing in Toledo, Ohio. In support of its research, Commissioners visited Vietnam and Taiwan and the Chinese cities of Beijing, Baoding, Tianjin, and Hong Kong. The Commission also contracted independent research on topics the Commissioners viewed as important to U.S. policy toward China, which can be found in Appendix IV. This year, Commissioners attended a series of classified briefings at the U.S. Air Force's National Air and Space Intelligence Center and will submit a separate classified Report to Congress.