

**HEARING ON WHAT KEEPS XI UP AT NIGHT:
BEIJING'S INTERNAL AND EXTERNAL CHALLENGES**

HEARING
BEFORE THE
U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

**ONE HUNDRED SIXTEENTH CONGRESS
FIRST SESSION**

THURSDAY, FEBRUARY 7, 2019

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COMMISSION

WASHINGTON: 2019

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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The Commission was created on October 30, 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Public Law No. 106-398, 114 STAT. 1654A-334 (2000) (codified at 22 U.S.C. § 7002 (2001), as amended by the Treasury and General Government Appropriations Act for 2002 § 645 (regarding employment status of staff) & § 648 (regarding changing annual report due date from March to June), Public Law No. 107-67, 115 STAT. 514 (Nov. 12, 2001); as amended by Division P of the “Consolidated Appropriations Resolution, 2003,” Pub L. No. 108-7 (Feb. 20, 2003) (regarding Commission name change, terms of Commissioners, and responsibilities of the Commission); as amended by Public Law No. 109-108 (H.R. 2862) (Nov. 22, 2005) (regarding responsibilities of Commission and applicability of FACA); as amended by Division J of the “Consolidated Appropriations Act, 2008,” Public Law Nol. 110-161 (December 26, 2007) (regarding responsibilities of the Commission, and changing the Annual Report due date from June to December); as amended by the Carl Levin and Howard P. “Buck” McKeon National Defense Authorization Act for Fiscal Year 2015, P.L. 113-291 (December 19, 2014) (regarding responsibilities of the Commission).

The Commission’s full charter is available at www.uscc.gov.

March 12, 2019

The Honorable Chuck Grassley
President Pro Tempore of the Senate, Washington, DC 20510
The Honorable Nancy Pelosi
Speaker of the House of Representatives, Washington, DC 20515

Dear Senator Grassley and Speaker Pelosi:

We are writing to notify you of the Commission's February 7, 2019 public hearing on "What Keeps Xi Up at Night: Beijing's Internal and External Challenges." The Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Pub. L. No. 106-398 (as amended by the Carl Levin and Howard P. "Buck" McKeon National Defense Authorization Act for Fiscal Year 2015 § 1259b, Pub. L. No. 113-291) provides the basis for this hearing.

At the hearing, the Commissioners received testimony from the following witnesses: Jude Blanchette, Senior Advisor and China Practice Lead, Crumpton Group; Timothy Heath, Senior International Defense Researcher, RAND Corporation; Andrew Wedeman, Professor, Department of Political Science, Georgia State University; Michael Hirson, Practice Head, China and Northeast Asia, Eurasia Group; Nicholas Borst, Vice President and Director of China Research, Seafarer Capital; Greg Levesque, Managing Director, Pointe Bello; Lieutenant Colonel Dennis Blasko, U.S. Army (Ret.), Independent Analyst; Rush Doshi, Brookings-Yale Postdoctoral Fellow; and Lindsey Ford, Director of Political-Security Affairs, Asia Society Policy Institute. This hearing examined the internal and external challenges the Chinese Communist Party (CCP) faces in its attempts to consolidate power at home and increase its influence abroad. The first panel explored the implications of President Xi and the CCP's tightening control over economic and security policy making. The second panel examined China's domestic challenges, considering China's economic weakness and financial sector risks, the risks and benefits of China's state-led economic policies, and the country's reliance on a number of key foreign technologies. The third panel assessed China's external challenges, focusing on the People's Liberation Army's shortcomings and the limits of Chinese soft, sharp, and hard power.

The full transcript of the hearing, prepared statements, and supporting documents are posted to the Commission's website, www.uscc.gov. Members and the staff of the Commission are available to provide more detailed briefings. We hope these materials will be helpful to the Congress as it continues its assessment of U.S.-China relations and their impact on U.S. security.

The Commission will examine in greater depth these issues and the others in our statutory mandate this year. Our 2019 Annual Report will be submitted to Congress in November 2019. Should you have any questions, please do not hesitate to have your staff contact one of us or our Congressional Liaison, Leslie Tisdale Reagan, at 202-624-1496 or lreagan@uscc.gov.

Sincerely yours,


Carolyn Bartholomew
Chairman


Robin Cleveland
Vice Chairman

cc: Members of Congress and Congressional Staff

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**WHAT KEEPS XI UP AT NIGHT:
BEIJING'S INTERNAL AND EXTERNAL CHALLENGES**

THURSDAY, FEBRUARY 7, 2019

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, DC

The Commission met in Room 106 of Dirksen Senate Office Building, Washington, DC at 9:30 a.m., Senator James M. Talent and Senator Carte P Goodwin (Hearing Co-Chairs) presiding.

OPENING STATEMENT OF CHAIRMAN CAROLYN BARTHOLOMEW

SENATOR GOODWIN: Good morning. Before we get started this morning, I'm going to turn the festivities over to our Chairman for a brief statement.

CHAIRMAN BARTHOLOMEW: Yes. Welcome everybody. It's the first hearing of our 2019 reporting cycle.

So, we appreciate everybody. We appreciate the time of the witnesses and we appreciate all of the people who are here in the audience.

But I wanted to make a point; we have three Commissioners who have joined us who have not yet participated in hearings: Admiral McDevitt was appointed last year, but came in after the hearing cycle had finished; Commissioner Lee has joined us; and Commissioner Lewis has joined us. So, I wanted to just introduce everybody and welcome them.

Commissioner Kamphausen, you're relatively new, but you were here for a hearing cycle. So, anyway, welcome aboard to everybody. We look forward to working with all of you.

And I'll turn it over to Carte.

OPENING STATEMENT OF SENATOR CARTE P. GOODWIN HEARING CO-CHAIR

SENATOR GOODWIN: Great. Thank you Carolyn. And again, welcome to all, to the first hearing of the U.S.-China Economic and Security Review Commission's 2019 Annual Report cycle.

Today our hearing will focus on China's internal and external challenges. And their effects on China's ability to sustain economic growth, project power, and spread its influence around the globe.

This year marks the 40th anniversary of the establishment of diplomatic relations with China. Currently however, the relationship is strained by strategic competition and trade tensions as China seeks to reshape the international order in ways that are often at odds with the U.S.' interests.

While it's important to acknowledge the Chinese Communist Party's effectiveness in controlling social, economic, and political activity, it's also important to identify and understand the implications of the regime's vulnerabilities.

In our first panel this morning, we will examine challenges that the Chinese Communist Party faces from within.

In our Annual Report to Congress last year, the Commission highlighted the trend of the Party's growing control over government, business, and society, as well as President Xi's continued consolidation of power, which has sparked concern from certain corners in among Chinese elites that the country's backsliding from its stated reform and opening agenda.

This trend also extends to the military and domestic security forces, where Xi has consolidated his political control and oversight by appointing loyalists to key leadership positions.

However, this increased control and emphasis on political reliability could ultimately undermine China's efforts to build a world class military if officers are promoted on the basis of politics rather than professionalism.

According to the Party, endemic corruption is the greatest internal challenge to its legitimacy. Xi's anticorruption campaign began six years ago but it remains unclear whether the campaign is motivated and focused on strengthening his political power, or truly cleaning out the Party, and whether the campaign has had any real effect on reducing corruption in China.

These are all issues that deserve closer scrutiny. Scrutiny that we will hope to provide today.

Many analysts believe that Xi's consolidation of power has created a dangerous echo chamber for decision making, which could complicate U.S.-China relations during times of heightened tensions or crisis.

They also bear directly on U.S. economic interests. American businesses are threatened under economic and judicial systems that put the Chinese Communist Party first.

To our witnesses, I again want to extend my appreciation for taking time to be here today to shed light on these very important topics. I look forward to hearing from each of you.

We all look forward to hearing from each of you. I'd also like to thank the Senate Foreign Relations Committee and Senate Rules Committee for making this room available for our hearing today.

I'll now turn the floor over to my colleague and hearing Co-Chair, Senator Jim Talent.

**PREPARED STATEMENT OF SENATOR CARTE P. GOODWIN
HEARING CO-CHAIR**

Good morning, and welcome to the first hearing of the U.S.-China Economic and Security Review Commission's 2019 Annual Report cycle. Thank you all for joining us today. Today, our hearing will examine China's internal and external challenges and their effects on China's ability to sustain economic growth, project power, and spread its influence around the globe.

This year marks the 40th anniversary of the establishment of U.S.-China diplomatic relations. Currently, however, the relationship is strained by strategic competition and trade tensions as China seeks to reshape the international order in ways that are often at odds with U.S. interests. While it is important to acknowledge the Chinese Communist Party's effectiveness in expanding control of social, political, and economic activity, it is also important to identify and understand the implications of the regime's vulnerabilities.

In the first panel of our hearing, we will examine challenges the CCP faces from within. In the Commission's annual report to Congress last year, we highlighted the trend of the Party's growing control over government, business, and society, as well as President Xi's continued consolidation of power, which has sparked concern from some Chinese elites that the country is backsliding from its stated reform and opening agenda.

This trend extends to the military and domestic security forces, where President Xi has consolidated his political control and oversight by appointing his loyalists to key leadership positions. However, this increased control and emphasis on political reliability could ultimately undermine China's efforts to build a "world class" military if officers are promoted on the basis of politics instead of professionalism.

According to the Party, endemic corruption is the greatest internal challenge to its legitimacy. President Xi's anticorruption campaign began six years ago, but it remains unclear whether the campaign is focused on strengthening his political power or cleaning up the Party, and whether the campaign has had any real effects on reducing corruption.

These are all issues that deserve closer scrutiny. Some analysts believe President Xi's consolidation of power has created a dangerous echo chamber for decision making, which could complicate U.S.-China relations during times of heightened tensions or crisis. They also directly bear on U.S. economic interests—American businesses are threatened under economic and judicial systems that put the Party first.

To our witnesses, thank you for being here to shed light on these very important topics. I look forward to hearing from each of you. I would also like to thank the Senate Foreign Relations Committee and the Senate Rules Committee for securing this room for our use today. I will now turn the floor over to my colleague and co-chair for this hearing, Senator Talent.

OPENING STATEMENT OF SENATOR JAMES M. TALENT HEARING CO-CHAIR

SENATOR TALENT: Thank you Senator Goodwin. And good morning. I also want to welcome everyone and thank the witnesses for the time and effort they put into their really excellent testimonies.

The Commission chooses its hearing subjects carefully. And we've chosen this subject because it's a timely and important one.

China has experienced enormous economic growth over the last two decades and has, during the same period, engaged in a substantial military buildup.

It has used its growing strength to advance its ambitions in the region and increasingly around the globe. And has had considerable success in doing so.

But it's important to maintain perspective and consider China's vulnerabilities as well as its strengths. And that's the purpose of this hearing.

Now the first panel will discuss the internal political challenges facing the leadership of the Chinese Communist Party. In addition to those challenges, Beijing also confronts significant economic and external concerns from slowing drivers of growth to global pushback against its assertive behavior that could undermine its internal stability.

In the second panel of today's hearing, we'll examine the weaknesses in China's economy and finances, the risks and benefits of its form of state capitalism, and its reliance on key foreign technologies.

Chinese policy makers credit their state led economic model for the country's rapid growth. But the contradictions in their approach are increasingly apparent. For example, Beijing recognizes the financial risks associated with the country's high debt levels but continues to lean on stimulus in the face of economic headwinds.

Similarly, Beijing's preferential treatment of state-owned enterprises, continues to introduce imbalances and inefficiencies into its economy.

Finally, the third panel will examine China's external challenges. In the military domain, President Xi has directed the PLA to overcome its so-called peace disease and the enduring shortfalls in its ability to fight and win a modern war.

This view of the operational effectiveness of the PLA may influence the calculus of the regime as it considers the use of armed force to advance Beijing's interests.

Beijing's heavy-handed application of power and influence abroad has also prompted pushback from countries both in Asia and around the globe.

Japan has increased its defense spending and procurement. The United States, Japan, Australia, and India have revitalized the Quadrilateral Security Dialogue.

And a growing number of countries have banned, or are considering banning, the use of technology from Huawei and other Chinese firms in their critical infrastructure networks.

These developments suggest China's assertive economic and military activities may be causing exactly what Beijing fears, the purposeful cooperation of other countries in meeting and countering China's illicit trade tactics, aggressive foreign policy, and other violations of international norms.

By understanding the challenges Beijing faces, the United States may be able to position itself to better shape the nature and direction of the emerging competition with that country.

Before we begin, I would like to remind you all that the testimonies and transcript from today's hearing will be posted on our website, which is www.uscc.gov.

Also, please mark your calendars for the Commission's upcoming hearing on Risks, Rewards, and Results: U.S. Companies in China and Chinese Companies in the United States. And that hearing will take place on February 28.

Thank you.

PREPARED STATEMENT OF SENATOR JAMES M. TALENT HEARING CO-CHAIR

Thank you, Senator Goodwin, and good morning, everyone. I want to thank our witnesses for the time and effort they have put into their excellent testimonies.

The Commission chooses its hearing subjects carefully, and we have chosen this subject because it is timely and important. China has experienced enormous economic growth over the last two decades and has during the same period engaged in a substantial and effective military buildup. It has used its growing strength to advance its ambitions in the region and, increasingly, around the globe and has had considerable success in doing so. But it's important to maintain perspective and consider China's vulnerabilities as well as its strengths, and that is the purpose of this hearing.

The first panel discussed the internal political challenges facing the leadership of the Chinese Communist Party. In addition to those, Beijing also confronts significant economic and external challenges—from slowing drivers of growth to global pushback against its assertive behavior—that could undermine its internal stability, national security, and international influence.

In the second panel of today's hearing, we will examine the weaknesses in China's economy and finances, the risks and benefits of its form of state capitalism, and its reliance on key foreign technologies.

Chinese policymakers credit their state-led economic model for the country's rapid growth, but the contradictions in their approach are increasingly apparent as China's economic challenges mount. For example, Beijing recognizes the financial risks associated with the country's high debt levels but continues to lean on stimulus in the face of economic headwinds. Similarly, Beijing's preferential treatment of state-owned enterprises continues to introduce imbalances and inefficiencies into its economy. Additionally, while the Chinese government has poured vast amounts of resources towards encouraging domestic innovation, China remains deeply dependent on foreign technology and vulnerable to supply chain disruption.

Finally, the third panel examines China's external challenges. In the military domain, President Xi has directed the People's Liberation Army to overcome its so-called "peace disease" and the enduring shortfalls in its ability to fight and win a modern war. This view of the operational effectiveness of the PLA may influence the calculus of the regime as it considers the use of the military to advance Beijing's interests.

Beijing's heavy-handed application of power and influence abroad has also prompted pushback from countries both in Asia and around the globe. Notably, Japan has increased its defense spending and procurement to counter China's growing military capabilities; the United States, Japan, Australia, and India have revitalized the Quadrilateral Security Dialogue; and a growing number of countries around the world have banned or are considering banning the use of technology from Huawei and other Chinese firms in their critical infrastructure networks. These developments suggest China's assertive economic and military activities may be causing exactly what Beijing fears: the purposeful cooperation of other countries in meeting and countering China's illicit trade tactics, aggressive foreign policy, and other violations of international norms.

PANEL I INTRODUCTION BY SENATOR CARTE P. GOODWIN

SENATOR GOODWIN: Thank you Senator Talent. I should also state that our hearing today is being live streamed also on the Commission's website.

I'll kick off our first panel by introducing the three experts, beginning with Jude Blanchette, Senior Advisor and China Practice Lead at the Crumpton Group.

Mr. Blanchette also is an adjunct fellow with the Center for a New American Security's Asia-Pacific Security Program. He's the author of a forthcoming book, *China's New Red Guards*, which will be published this summer.

Mr. Blanchette will provide testimony on the implications of centralization and Party-ification on decision making in the Chinese Government, as well as the elite opposition to some of President Xi's policies.

Next, we're happy to welcome back Timothy Heath, Senior International Defense Researcher at the RAND Corporation. Prior to joining RAND, Mr. Heath served as a Senior Analyst for Pacific Command's China Strategic Focus Group.

Mr. Heath will address Party-ification's implications for China's military and domestic security forces.

Finally, we're happy to welcome Dr. Andrew Wedeman, a Professor of Political Science at Georgia State University, where his research focuses on China's political economy and corruption.

Prior to his tenure at Georgia State, he spent 18 years teaching at the University of Nebraska-Lincoln, where he served as the Director of the Asia Studies Program and Director of the International Studies Program. Professor Wedeman will discuss the effect of China's ongoing anticorruption campaign.

I'd like to remind the witnesses to keep your remarks as close as you can to seven minutes, so that we can have a robust question and answer session.

Mr. Blanchette, we'll begin with you.

OPENING STATEMENT OF JUDE BLANCHETTE, SENIOR ADVISOR AND CHINA PRACTICE LEAD, CRUMPTON GROUP

MR. BLANCHETTE: Well, thank you very much. Let me thank the Commission for the invitation to speak on this important topic.

Whenever I hear someone explain me as an expert on the Party, I look over my shoulder, just given how much we don't know about the Party, or at least I don't know.

So, I look to the other two panelists to help fill in some of the massive gaps that we have in our understanding of the Party.

Given the intensifying frictions between Washington and Beijing across a range of really important issues, trade, investment, and obviously military competition, I think it's more important than ever that we have an open and robust discussion on China's political trajectory. And that discussion, of course, is intimately tied up with the current structure of China's political system.

For too long, we in the West, and certainly in the United States, have made assumptions about where we thought China was going. And I think those assumptions might have been tempered a bit if we had been more squarely focused at looking on what's happened in China's actual existing political system.

So again, I'd like to thank you for providing the platform for this good discussion today. Given the time restrictions, I'm just going to make a few short points here before we open up to Q&A.

And the first is that China's political system, despite outward appearances of relative stability, has undergone a real sweeping transformation since the accession to power of Xi Jinping in late 2012.

The most salient feature of this transformation is the significant expansion in the formal administrative powers and reach of the Communist Party of China into nearly all spheres of Chinese society.

To give a very truncated list of some of these real changes, we've seen a marked expansion of Party organizations, or what folks here in D.C. like to call Party cells, into state-owned enterprises and private companies.

According to data from the Party Organization Department, the percentage of private companies in Party -- or excuse me, of Party organizations in private companies, expanded from 58 percent in 2013 up to 73 percent in 2017.

We've seen the deliberate sidelining of the State Council, i.e., the government, in policy making through the increased use of leading small groups. As well as the Party's Central Commission for Discipline Inspection, which is an internal watchdog for political discipline and corruption, which has seen a real increased use as an implementer of policy as much as a guard dog.

The State Premier, which is since the 1980s played a significant role in managing economic policy, has under Xi Jinping been moved to the sidelines to the point of near irrelevance with Xi Jinping himself playing an outsized role in formulating and guiding policy.

I think all of this reached its crescendo in March of last year at the National People's Congress meeting, where Beijing announced a program for the deepening reform of Party and governing organs.

This restructuring plan called for moving vast swaths of administrative power away from the State Council, and into the hands of the Party. Thus making the de facto end run around the

government a de jure reality.

In creating new leading small groups and commissions at the Party center, any of these chaired by Xi Jinping himself, this now enables the Party to involve itself more deeply in the everyday operations of the state. Unless we had any confusion about what the function of this restructuring was, current Vice Premier Liu He, a key Xi Jinping economic advisor, explained in an article in the People's Daily, strengthening the Party's overall leadership is the core issue of the restructuring plan.

So why do they do this? The rationale for this aggressive expansion of the CCP is the leadership's fear of losing control over China's vast bureaucratic system, its rapidly evolving economy, and an increasingly complex external environment.

Now effective control over the empire has long been a concern for China's rulers. This is not a new problem. But in the years proceeding Xi Jinping's rise to power, the Communist Party leadership felt an acute sense of crisis. One stemming from a lack of ideological, political, and organizational cohesion within the Party.

Thus, Xi Jinping came to power with a sizable mandate to make deep structural changes. Although I think, it's safe to assume that no one at the time really understood just how significant these changes were going to be.

So what does this matter? And this is where when we talk about this issue of internal risks in China, I want to focus for a minute on China's ability to govern itself. Its governance capacity so to speak.

Since 2012, I think we can't avoid the stark reality that Xi Jinping has moved the country rapidly in the direction of one man governance, with Xi occupying a position of unrivaled dominance over policy making and implementation. Things like the Belt and Road Initiative, supply-side structural reforms, the Xiong'an New Area, are examples of just how personalized policy has become now that these are all closely identified with Xi Jinping himself.

And while many observers have held out the hope that Xi Jinping would emerge as a sort of Frederick the Great enlightened despot, Chinese history and the historical record itself indicates that this is very unlikely.

So, I'd also like to add to it that it's my judgment, and here I think Andy and I will disagree, but it's my judgment that Xi Jinping intends to remain in power for life. And so the longer he remains in office, the more that the structure of Chinese governance will adapt itself to Xi Jinping himself, thus leaving the country in a worse position after he eventually leaves office.

And so now with Xi Jinping demanding more loyalty and discipline from Party cadres up and down the hierarchical ladder, we are nonetheless seeing a significant manifestation of governance issues within China. And you don't have to take my word for it, if you listen to the Party itself, it's quite clear in enunciating exactly the problems it sees from loyalty on behalf of cadres.

A 2017 study by the National Development and Reform Commission entitled, the Phenomenon of Reform Obstruction in China, listed a significant number of tactics that cadres are using to avoid compliance to top-down mandates, including complying in public, but opposing in private, a wait-and-see approach that they call glancing left and right, and one of the more famous ones called, the top has its own policies, the bottom has its own countermeasures.

So of course, these are not new problems, but they've exacerbated greatly under Xi Jinping. And this matters because China is entering now a period of significant political risk internally, but externally as well.

I saw last week in the Wall Street Journal, Zhang Yiming, who's the founder of the Chinese IT company, ByteDance, said in a letter to employees, "In 2019 the external environment is going to be even more difficult, complicated, and filled with turmoil, and the challenge we face is great."

So as my final statement I would say, at a time when the country is facing these challenges, including decreasing U.S.-China relations, tensions on the Korean Peninsula, significant economic headwinds, it's more important than ever that the political system responds effectively.

But since Xi Jinping has come to power and the Party has taken over more control, I fear that the system is less resolute and adaptable to these challenges. Thank you.

**PREPARED STATEMENT OF JUDE BLANCHETTE, SENIOR ADVISOR AND CHINA
PRACTICE LEAD, CRUMPTON GROUP**

**Testimony prepared for U.S.-China Economic and Security Review Commission
Hearing on “What Keeps Xi Up at Night: Beijing’s Internal and External Challenges”**

Jude Blanchette

Senior Advisor and China Practice Lead, Crumpton Group
Adjunct Fellow, Asia-Pacific Security Program, Center for a New American Security

February 7, 2019

Introduction

China’s political system is currently undergoing a dramatic structural transformation, the most pronounced element of which is the Communist Party of China’s (CCP) expansive new reach into nearly all domains of Chinese society. As CCP leader Xi Jinping declared at the 19th Party Congress in 2017, “Party, government, military, civilian and academic; east, west, south, north, center, the Party leads everything.”¹

For most of the post-Mao era, the organization and functions of the CCP remained largely a side-concern for the foreign business community and policymakers, or the focus of a few specialized academics and political-military analysts. Indeed, there was a credible case to be made that until quite recently, the CCP was still evolving to accommodate China’s increasingly market-led and globalized economy. Capitalism, not communism, seemed to be its *modus operandi*.²

Since Xi Jinping’s ascension to power at the 18th Party Congress in 2012, however, this trajectory has clearly evolved, and if we want to understand the future of the People’s Republic of China, it’s imperative that we understand how the CCP operates, how it’s mobilized and communicates, and perhaps most importantly, what its objectives are.

In my testimony today, I will explore several key challenges confronting China’s political system in the wake of these developments. In particular, I’d like to highlight the following points:

- The CCP has directly subsumed a number of key governing and administrative functions previously the domain of the State Council (i.e. “the government”). This began with the slow, yet deliberate, marginalization of the State Council beginning in 2013, but reached its near-term crescendo on March 21, 2018, when the CCP Central Committee released its “Program for the Deepening Reform of Party and Government Organs.”³ The massive restructuring represents the most significant overhaul of China’s political system since

¹ 习近平在中国共产党第十九次全国代表大会上的报告, cpc.people.com.cn/n1/2017/1028/c64094-29613660-5.html

² Elisabeth Rosenthal, “China’s Communists Try to Decide What They Stand For,” *The New York Times*, May 1, 2002

³ 中共中央印发《深化党和国家机构改革方案》 www.gov.cn/zhengce/2018-03/21/content_5276191.htm#1

1982, formally transferring vast amounts of administrative responsibilities from the government to the Party apparatus.

- This increase in the CCP's formal administrative authority at the expense of the State Council was accompanied by the acute erosion of institutional norms that gave China's political system stability and a degree of predictability (with some notable exceptions). Most noteworthy is CCP General Secretary Xi Jinping's systematic dismantling of the "collective leadership" system erected, albeit imperfectly, by Deng Xiaoping in the 1980s and 1990s to prevent the return of a strongman leader like Mao Zedong.
- Xi Jinping intends to remain in power for life, as is normal for authoritarian systems with weak or non-existent rules governing leadership succession. Yet the longer he remains in office, the more the institutions and machinery of governance will adjust to his leadership style and his personality, thus threatening the durability of the CCP's governing capacity.
- Xi's centralization of power and the reassertion of Party authority has led to an increase of elite dissent, yet the likelihood of organized opposition to Xi, even within the upper echelons of the Party, faces significant "collective action" barriers, and is therefore unlikely to coalesce. Thus, we should not mistake an uptick in "grumbling" for actual resistance.
- By virtue of its history, culture, ideology, and organizational structure, the CCP makes decisions behind closed doors and prioritizes political and security concerns above all other considerations. As a result, if China continues on its current trajectory, the Party's direct role in policy formulation and implementation will make China's governance more opaque, volatile, and error-prone.
- Despite an outward appearance of stability, China's political system is becoming increasingly rigid, restrictive, and thus brittle. At a time when the country faces myriad new and complex challenges – a slowing economy, a looming demographic crisis, a significant deterioration in U.S.-China relations, tensions on the Korean Peninsula, to name just a few – Xi's transformation of the political system has left the country potentially unable to deal with these future dilemmas.⁴

1.

Since the founding of the People's Republic in 1949, the CCP has ruled the country unchallenged. While there have never been any doubts about the Party's ultimate authority, important changes to China's political system have undergirded the "reform and opening" period that began in late 1970s. These reforms were necessary to accommodate an expanding market economy and to address the weaknesses in the Party's organizational structure. Under Deng Xiaoping's leadership, the State Council was granted increased authority and autonomy in economic and social policymaking, younger and more specialized bureaucrats ("technocrats")

⁴ See Katie Stallard-Blanchette and Jude Blanchette, "Old CCP tactics present new dangers to China's development," *East Asia Forum*, October 20, 2018. www.eastasiaforum.org/2018/10/20/old-ccp-tactics-present-new-dangers-to-chinas-development/

were recruited into the system, and the Party's role gradually transitioned to that of advisor and supervisor rather than day-to-day manager. Deng's vision for the Party was that of corporate board chairman, with the government acting as the "C-suite."

More clearly defining the differing roles of Party and government, Deng argued, would actually improve the CCP's political effectiveness. As he stated in 1980, "it is time for us to distinguish between the responsibilities of the Party and those of the government and to stop substituting the former for the latter."⁵ Demarcating a division of labor, Deng added, "will help strengthen and improve the unified leadership of the Central Committee, facilitate the establishment of an effective work system at the various levels of government from top to bottom, and promote a better exercise of government functions and powers," Deng said. Then-Premier Zhao Ziyang put the matter more succinctly in 1987, "[Leaders] cannot truly play a leading role if they are entangled in trivia all day long."⁶

The issue of "separating Party and government" reached its high-water mark at the 13th Party Congress in 1987, when the central leadership affirmed that, "the separation of Party and government is the top priority of the political reform." The Tiananmen Square protests in 1989 and the collapse of the Soviet Union two years later quashed further public discussion of the topic, but the basic idea that the State Council should govern and the CCP should lead remained intact.

2.

The CCP's response to the Tiananmen Square protests and the disintegration of global communism emerged in a more complete form in early 1992 with Deng Xiaoping's celebrated "Southern Tour," which combined aggressive economic reforms with a renewed emphasis on political stability.⁷ Deng's view on the connection between economic modernization and political control was captured in his 1989 speech, in which he put it bluntly, "China cannot allow people to demonstrate whenever they please, because if there were a demonstration 365 days a year, nothing could be accomplished, and no foreign investment would come into the country."⁸

While this economic development paradigm did indeed succeed in delivering high growth rates, it also created serious side-effects, including rampant income inequality, environmental degradation, and high levels of official corruption. As a result, in the period leading up to Xi's elevation to power at the 18th Party Congress in 2012, the Party elite grew increasingly

⁵ Deng Xiaoping, "On the Reform of the System of Party and State Leadership," *Collected Works*, Vol. 2

⁶ Quoted in Susan Shirk, *The Political Logic of Economic Reform in China*, University of California Press, 1993. Pg. 64

⁷ Zhao Suisheng, "Deng Xiaoping's Southern Tour: Elite Politics in Post-Tiananmen China," *Asian Survey*, Vol. 33, No. 8 (Aug., 1993)

⁸ Deng Xiaoping, "China Will Tolerate No Disturbances," *Selected Works*, Vol. 3

concerned over the mounting “contradictions,” shaking their confidence in the system and leading to a belief that the current path was unsustainable for the CCP *as an organization*.

These problems included:

1. *Deteriorating ideological coherence and popular appeal*

- The dominant ideology of revolutionary socialism, and the legitimacy of Party control grew less appealing as China opened to the outside world and competing “isms” vied for the attention of the Chinese people and Party members.

2. *Organizational atrophy*

- As China moved away from its planned economy and the *danwei* system, the CCP relinquished control over the movement of Party members, many of whom broke off contact with the Party structure entirely as they entered private business (下海) or otherwise ignored organizational dictates.

3. *Rampant corruption*

- The lack of checks on Party power, combined with burgeoning rent-seeking opportunities in an increasingly capitalist economy, were a breeding ground for graft and official malfeasance. Current Vice President Wang Qishan warned that corruption, if left unchecked, could “weaken the party's ability to govern and shake the party's basis for governing.”⁹

4. *Flagging internal discipline*

- Internal surveys confirmed that Party members increasingly viewed the CCP as a career-enhancing credential rather than a serious political endeavor. A 2010 survey of CCP members found that younger members “are much more likely to report self-interest (such as helping their careers, advancing politically, and raising social status) as a motive [for joining the Party] and much less likely to report political and ideological motives (such as serving the people, working for communism, and faith in the CCP) than the older cohorts.”¹⁰

5. *The breakdown of elite-level cohesion*

- Rhetoric of “collective leadership” notwithstanding, the Party was replete with competing factions and differing centers of authority. From the “Oil Gang” of Zhou Yongkang to the Communist Youth League, the authority of the General Secretary had to vie with alternative, often antagonistic, patronage networks of Party elite. The events surrounding Bo Xilai’s rise and subsequent purge

⁹ Ben Blanchard, “China graft-buster says must learn from ancients to tackle corruption,” *Reuters*, October 22, 2015

¹⁰ Bruce Dickson, “Who Wants to Be a Communist? Career Incentives and Mobilized Loyalty in China,” *The China Quarterly*, 217, March, 2014, pp. 42 – 68

represented one of the most significant political schisms in the post-Mao period, likely serving as a powerful impetus to forcefully tackle intra-Party discord.

6. *Policy paralysis*

- Despite the outside perception of the Party-state as having a powerful command over its constituent units, the CCP's leadership has always struggled to enforce compliance with policy dictates at the local level. This problem is not unique to China: As Stalin said in 1935 speech to graduates from the Red Army Academies, "cadres decide everything."¹¹ But in the wake of Deng Xiaoping's early reform push, as Beijing relinquished control in order to provide local-level flexibility, it split into "30 dukedoms, with some 2,000 rival principalities," in the words of current Politburo Standing Committee member Wang Huning.¹² By the time Hu Jintao stepped down from power in 2012, the preceding ten years came to be known as the "lost decade," owing to the Center's failure to drive much needed economic reforms.

As a result of these accumulating risks to the organizational integrity and political stability of the CCP, there was widespread consensus by China analysts that Xi entered office with a strong mandate by Party elite to address the above-mentioned structural, organizational, and ideological issues.¹³

2.

Since Jiang Zemin's appointment in 1989, incoming General Secretaries have faced the unenviable position of being handed the reigns to a political system largely shaped by, and responsive to, the outgoing leader(s). Unlike the United States, where a newly-*elected* President is able to immediately remake the top levels of the government bureaucracy by appointing her own personnel, a newly-*selected* General Secretary must confront a Politburo and its Standing Committee comprised of individuals with a complex mix of patronage relationships with current and former officials. Thus, the first five-year term as CCP leader is typically spent consolidating power in order to appoint his own clients at the beginning of his second term.

But Xi, undoubtedly recognizing the power of the mandate afforded by the sense of crisis pervading the Party, launched a multi-front campaign to rectify the Party membership, attack official corruption, revive the Communist Party's ideological foundation, and elevate the power and prestige of the position of General Secretary.¹⁴ This allowed him to consolidate power with greater speed and focus than previous leaders. By virtue of the wide-spread and highly

¹¹ <http://soviethistory.msu.edu/1936-2/year-of-the-stakhanovite/year-of-the-stakhanovite-texts/cadres-decide-everything/>

¹² Quoted in Barry Sautman, "Sirens of the Strongman: Neo-Authoritarianism in Recent Chinese Political Theory," *The China Quarterly*, No. 129 (Mar., 1992)

¹³ Alice Miller, "What Would Deng Do?" *China Leadership Monitor*, No. 52

¹⁴ "The Resistible Rise of Xi Jinping," <https://foreignpolicy.com/2017/10/19/the-resistible-rise-of-xi-jinping/>

discretionary corruption probe, which purged officials in the military, state, and Party bureaucracy, Xi was able to appoint loyal officials to the newly-vacant posts. He launched numerous ideological and mobilization campaigns, backed by the credible authority of the Central Commission for Discipline Inspection under Wang Qishan, which could discipline non-compliant cadres for lapses in political discipline.¹⁵ Using his control of the media and propaganda organs, Xi oversaw (or tolerated) the creation of a modern-day “cult of personality,”

In addition to his own political authority, Xi also clearly believed that the CCP had receded too far into the shadows, and in its absence, powerful bureaucratic interests had carved-out uncooperative and uncommunicative fiefdoms. Effective policy to deal with China’s pressing issues wasn’t getting made, and worse, government and Party leaders were gorging on rent-seeking opportunities their administrative portfolios provided. Not only was this eroding the CCP’s ability to lead, it was also placing China at a disadvantage as it navigated a rapidly evolving international environment.

An important step in this governance rectification would be to claw back authority from the State Council. China’s current Vice President Wang Qishan addressed the issue of the Party’s “absolute leadership” in a lengthy *People’s Daily* article in late 2017, writing, “For some time now, some have remained silent or been ambiguous about the issue and practiced the separation of Party and government without any precondition, which has resulted in a weakened leadership by the Party.”¹⁶ Xi, Wang argued, has “clarified this blurry understanding, regained the lost battlefield, straightened out the crooked road, established the authority of the Party, and fundamentally changed the situation of a weakened Party’s leadership.”¹⁷

4.

Two momentous changes occurred at the annual meeting of the National People’s Congress (NPC) in March 2018: a constitutional amendment was passed abolishing term limits for the office of the presidency, laying bare Xi Jinping’s intention to rule for life, and a sweeping political restructuring plan was unveiled that granted new and far-reaching powers to the CCP.

The amendment on the presidential term limit opened a path for Xi to retain all three important political titles in China: General Secretary of the CCP, Chairman of the Central Military Commission, and President of the PRC. The lack of credible political opposition means that a decision to retire will be almost solely at Xi’s discretion (like it was for Mao Zedong), and even

¹⁵ Zhao Suisheng, “The Ideological Campaign in Xi’s China: Rebuilding Regime Legitimacy,” *Asian Survey*, Vol. 56 No. 6, November/December 2016

¹⁶ Charlotte Gao, “Is China Bidding Farewell to Separation of Party and Government?” *The Diplomat*, November 8, 2017

¹⁷ 王岐山“开启新时代，踏上新征程,” www.xinhuanet.com/politics/2017-11/07/c_1121915946.htm

if he formally retires from his leadership posts, he will undoubtedly remain in control of the Party and the People's Liberation Army (PLA) from behind the scenes (like Deng Xiaoping did).

Political leaders often fail to appreciate when they should retire, which is why constitutional democracies often (but not always) enforce term limits for their highest offices or allow regular popular elections to remove political leaders. As one member of the UK Parliament said after Margaret Thatcher's resignation, "The trouble with great leaders is that they don't know when to go."¹⁸ The longer Xi remains in office, the more the political system conforms to his individual personality, whims, and network of clients, and thus the more "essential" he becomes to the political system. Institutions governing China will atrophy as they grow increasingly dependent on the discretion of the top leader. Xi might also cling to power because he assesses that he or his family face the "Putin Problem," wherein the leader cannot retire out of concern for their safety once a new leader is installed and organs of the military and security services begin to shift loyalties.

Several weeks after the announcement of the plan to abolish term limits was an equally momentous comprehensive plan to "modernize, optimize, and synergize the Party and state agency functions." It called for the dissolution of three ministerial-level government entities, the reorganization of another 20, and the creation of three entirely new ministries. Such "streamlinings" have been regular occurrence: in 1998, then-Premier Zhu Rongji slashed the number of ministerial level organizations from 50 to 29. In 2003, China was hit with the surprise SARS epidemic just as Premier Wen Jiabao's restructuring plan was beginning to gain momentum, leading to a significant delay in Beijing's disaster response as bureaucratic confusion reigned.

What makes the March 2018 restructuring different—and far more significant—is the upward transfer of administrative power away from the State Council and to the CCP.

The elements of this transfer of power include:

- Upgrading prominent CCP "leading small groups" on economic and financial policy, cybersecurity, and foreign affairs into "commissions," giving them (and CCP General Secretary Xi Jinping) vast new bureaucratic powers. As commissions, and with Xi as their head, they will be the real drivers of policy moving forward.
- Civil servants, regardless of Party membership status, are now be overseen by the Party's personnel department.

¹⁸ Fredrik Bynander and Paul Hart, "When Power Changes Hands: The Political Psychology of Leadership Succession in Democracies," *Political Psychology*, Vol. 27, No. 5 (Oct., 2006)

- The State Administration of Press, Publication, Radio, Film, and Television was disbanded, and China's news and media are now overseen directly by the Party's Propaganda Department.
- The National Academy of Governance, the elite training academy for government officials, has been folded into the Central Party School.
- State organs responsible for religious affairs now report directly to the CCP United Front Work Department, which has recently gained notoriety in foreign press for its overseas influence operations.
- The State Computer Network and Information Security Management Center, which administers the country's "Great Firewall," now reports to the CCP Central Commission on Internet Security rather than its old boss, the State Council Ministry of Industry and Information Technology.
- A newly-created National Supervisory Commission, led by Xi ally and former Party graft buster Yang Xiaodu, gives the CCP power over all public officials. The Commission ranks above the government judicial authorities, and is a bureaucratic equal to the State Council, yet it answers only to the CCP Central Committee.

The details of this restructuring make clear that, despite the official emphasis on "rationalizing" Beijing's ability to govern China, the ultimate objective is to centralize political and governing power in the hands of the CCP. This was reinforced in a series of articles appearing in the *People's Daily* just after the plan was announced, including one by now-Vice Premier Liu He, Xi's key economic advisor, who said of the restructuring, "Strengthening the Party's overall leadership is the core issue."¹⁹

Moreover, the plan further entrenched Xi at the center of China's political system. As Li Zhangze stated in a lengthy piece for the Party's key theoretical journal, *Qiushi*, "to strengthen the Party's leadership [via the restructuring plan], the first priority is to adhere to the centralized and unified leadership of the Party Central Committee with Comrade Xi Jinping as the core."²⁰ Indeed, this same piece reports that Xi personally initiated and oversaw the planning and drafting of the entire restructuring plan.

5.

¹⁹ Engen Tham, "China leader's top economic adviser says profound party, government reforms needed," *Reuters*, March 12, 2018

²⁰ 李章泽, "加强党对深化党和国家机构改革的领导," www.qstheory.cn/dukan/qs/2018-05/15/c_1122827748.htm

Xi's actions are not without domestic opposition. Indeed, beginning in the summer of 2018, we've seen a significant increase in open discontent over China's current political environment and trajectory. While Xi's bold actions to clear a path to lifetime rule were arguably the most significant catalyst for public grumbling, criticisms of Xi's administration were wide-ranging, leading to rumors that Xi's political position was under threat.

Such criticism included:

- A July 2018 essay by the noted scholar Xu Zhangrun entitled “Immanent Fears, Immediate Hopes,” was a forceful attack on Xi's style of governance, including his cult of personality and the move towards one-man rule. “Yet again people throughout China — including the entire bureaucratic class — are feeling a sense of uncertainty, a mounting anxiety in relation both to the direction the country is taking as well as in regard to their personal security. These anxieties have generated something of a nationwide panic,” Zhang wrote.²¹
- In the lead up to the annual secretive leadership conclave at the seaside resort of Beidaihe, rumors emerged that Xi's wings might be clipped by retired Party elders, some rumors going so far as to claim that Xi would be removed from office, owing to the over-reach of his power consolidation and the deterioration of U.S.-China relations.²²
- Yao Yang, dean of the National School of Development at Peking University, warned in a September 2018 speech, “in the past few years, policy makers have treated macro policies as tools of structural reform, but this has led to no real progress in structural reforms, and to even greater volatility in the market, which has created the greatest harm to the crucially important private industries.”²³
- In October 2018, Peking University economist Zhang Weiying decried the country's pronounced shift towards more statist-driven economic policy. “If we single-mindedly emphasize the uniqueness of the China model, internally we will strengthen SOEs, enlarge the authority of the government, and rely on industrial policies, which will lead to a retrogression of reform and a total waste of the great strides in reform. The economy will lapse into a quagmire.”²⁴
- Also in October, Deng Xiaoping's son, Deng Pufang, delivered a speech in which he urged Beijing, “We must seek truth from fact, keep a sober mind and know our own place.” The remarks were seen as a subtle, yet direct, comment on Xi's aggressive push to expand China's global reach.²⁵

²¹ See a translation by Geremie R. Barne at <http://chinaheritage.net/journal/imminent-fears-immediate-hopes-a-beijing-jeremiad/>

²² Deng Yuwen, “A Time for Reflection,” *South China Morning Post*, July 25, 2018

²³ 姚洋：民企的危急时刻与改革的方向, www.nsd.pku.edu.cn/teachers/professorNews/2018/0921/35830.html

²⁴ 张维迎：理解世界与中国经济, zmt.sina.cn/cflb/article/20181024/03d0d2951d051000.html

²⁵ Jun Mai, “Deng's Son Call to ‘Know Our Place’”, *South China Morning Post*, October 30, 2018

While this level of discontent is certainly unprecedented in the Xi era, it's important to remember that public dissent is not the same thing as active opposition. Media discussions of domestic "push-back" typically ignore a crucial – indeed *the* crucial – question: What mechanisms could be used to defang or dethrone Xi? Not only is organizing a coalition to oppose Xi highly risky, given his strong linkages to the security services and military, but his brazen move to abolish term limits indicates he feels he does not face any significant – or effective – opposition.

A much more plausible outcome for the rise in public criticism of Xi is that censorship will ramp up significantly, and Xi will further his efforts to maintain close ties to the military, arguably the most important institution for ensuring a grip on power.

6.

With decision-making now being handled directly within the Party structure rather than being simply guided by it, we should expect more surprises and volatility, for several reasons:

- The CCP is a secretive and opaque organization. It is not prone to holding press conferences or to explaining its reasoning. In the same way outside observers had no prior warning about the March 2018 political restructuring, so too we expect future surprises as the CCP navigates a turbulent and uncertain domestic and global environment.
- More Party control over policy administration means more ideological policy. We have already seen this development with CCP's Cyberspace Administration of China, which formulates internet-related issues and policies based on a deeply ideological worldview centered around national security threats. Further deterioration of US-China relations is likely to increase the ideological lens of the Party leadership and will almost certainly color the way Beijing views the intentions of foreign governments and companies.
- When we talk about more Party control, we are really talking about more control by its "core," Xi himself. We cannot avoid the stark reality that since 2012, China has moved rapidly in the direction of one-man governance, with Xi occupying a position of unrivaled dominance over policymaking and implementation. While many observers hold out hope that he emerges as an enlightened despot in the mold of Frederick the Great, the historical record, and China's own recent experience, suggest this is unlikely.

A Recommendation for U.S. Policymakers:

As the United States looks to cooperate and compete with a rising China, it will be imperative that we have an accurate and realistic assessment of the CCP's intentions. The fact that the CCP is secretive and opaque does not mean it is an impenetrable, unknowable black box. With the

right cultural and linguistic skills, there is much to be learned about the Party and its strategic objectives. *But this cannot occur without a robust cadre of American analysts with superior Chinese language skills.* Ironically, however, given to the paucity of resources dedicated to the teaching of Mandarin Chinese here in the U.S., we've largely outsourced responsibility for language education to Beijing through its global network of Confucius Institutes.

The U.S. Government should make it a strategic priority to fund programs that build Chinese language capacity and do so at all levels: K-12, university, post-graduate, and professional. Without a deep talent pool of China-fluent professionals, American government, businesses, and civil society will continue to operate at a disadvantage compared to their Chinese peers.

OPENING STATEMENT OF TIMOTHY HEATH, SENIOR INTERNATIONAL DEFENSE RESEARCHER, RAND CORPORATION

SENATOR GOODWIN: Thank you. Mr. Heath.

MR. HEATH: Good morning Ms. Carolyn Bartholomew, Vice Chair Robin Cleveland, members of the Commission and staff. Thank you for granting me the privilege of speaking with you today.

In my opening remarks, I will discuss the impact of the consolidation of political power under Chinese President Xi Jinping on the country's security forces.

I intend to make three points. The first point I will make is that China's tightening of control over the security forces is motivated primarily by a desire to control some of the domestic political risks that my colleague, Mr. Blanchette, raised.

Second, the net effect of the centralization of CCP power is likely to be a reduction in the risk of overt domestic political conflict, as well as a more effective Chinese military.

Thirdly, in terms of the implications for the United States, the centralization of power potentially introduces new risks to U.S. forces operating near China. I will explain these points. And afterwards I will provide a few recommendations.

The first point concerns the motivation of Chinese leaders in directing a centralization of Party control over all security forces. Chinese authorities, as Mr. Blanchette has pointed out, have enacted a striking array of political, administrative, and organizational measures to centralize power, some of which I also review in my testimony.

In my view, Beijing's main motivation stems from concern about the domestic political risks related to Beijing's pursuit of economic and governance structural adjustments.

Given the political sensitivities involved, and the fact that many powerful leaders in China are sure to oppose changes that will eliminate their privileges and threaten their livelihoods, Xi Jinping and his colleagues will likely strengthen control over the security forces to reduce the risk of overt domestic political conflict.

As noted in my testimony, developments related to Politburo aspirant and then Chongqing boss, Bo Xilai, in 2012 provided an example of how powerful politicians could be tempted to co-opt and deploy armed forces to further their personal political ambitions.

Moreover, China's leadership intends to transform the western regions of Xinjiang and Tibet and the destruction caused by rapid development has exacerbated long-standing frustration and resentment among ethnic minorities in those regions. And China's leadership has vastly increased its state security forces to suppress and control those regions accordingly.

In addition to these domestic concerns, the extensive measures taken by Xi Jinping and the CCP leadership also reflected a recognition that out of control corruption was also undermining the PLA's readiness and ability to fight and win in a contingency.

My second point concerns the consequences of the CCP's consolidation of power over the security forces. In my assessment, this consolidation has succeeded in reducing the risk of overt domestic political conflict.

It has also reduced the risk of insubordination or overt opposition on the part of the military or parts of the paramilitary PAP, that's People's Armed Police, or other security forces.

Regarding the military, Xi Jinping's skillful combination of coercion, incentives, and reorganization, administrative and other measures, has allowed him to consolidate control and reduce opposition within the ranks. This has not only resulted in a more reliable security apparatus, it has also facilitated needed organizational and other reforms designed to improve the

professionalism and competence of the military and other security forces.

In terms of domestic security, the militarization of the PAP and expansion of a hugely repressive state apparatus has fueled resentment, anger, and violence in western provinces, and worsened human rights abuses. But, it has also facilitated Beijing's efforts to continue to develop those areas.

The third point I would like to make concerns the implications of these measures for U.S. forces operating near China. Beijing's centralization of command and control and tightening of civilian oversight, in some ways reduces risks. In particular, these measures reduce a likelihood that a local commander could act on his own authority to provoke an incident with U.S. forces in a manner somewhat similar to what happened in 2001 with the EP-3 airplane collision. On the positive side, the result could be an overall reduction in provocative and risky behavior by individual ship captains, pilots, and units near U.S. forces.

However, the same changes increase the risk that any provocative behavior that does occur, could be undertaken at the direction of authorities in Beijing. The risk could be growing that any apparent incident or accident may have been a planned provocation for brinkmanship purposes. If so, the escalation risk could be changing in a more dangerous way and this needs to be better understood.

This leads me to my recommendations. First, U.S. defense planners should account for the changing political dynamics when contemplating possible crisis situations involving the PLA.

Given the rising stakes, more thought needs to be put into planning for potential brinkmanship-style crisis situations involving Chinese forces, where a few rungs on the escalation ladder may have already been anticipated by the Chinese.

Planners should also consider scenarios in which risky actions are deliberately planned to score political points or otherwise favorably change the status quo. U.S. military officials should also consider robust -- or strengthening a robust hotline, channels of communication, and other crisis management mechanisms to facilitate de-escalation in the event of such an incident.

Second, U.S. officials should monitor China's law enforcement presence in western regions such as Tibet and Xinjiang for evidence of more abuses by PAP troops. Militarizing the PAP raises the likelihood that local commanders will view law enforcement in military, as opposed to legal terms.

What remains of due process and legal rights for Chinese citizens could deteriorate further at the hands of the PAP occupation. U.S. officials should consider publicizing evidence of such abuses to pressure the Chinese government into respecting human rights.

Third, U.S. officials should monitor efforts by Chinese police officials to train and build partnerships in other countries. Given the increasing overlap between political and criminal jurisdiction of a police force featuring strong CCP control, Chinese officials could be passing on practices and technologies that support political repression rather than promote sound law enforcement practices.

U.S. officials may want to consider publicizing evidence that Chinese officials are advancing repression under the guise of law enforcement and/or engagements with other countries.

Thank you again for inviting me to this distinguished panel. And I look forward to your questions.

**PREPARED STATEMENT TIMOTHY HEATH, SENIOR INTERNATIONAL
DEFENSE RESEARCHER, RAND CORPORATION**

The Consolidation of Political Power in China Under Xi Jinping

Implications for the PLA and Domestic Security Forces

Timothy R. Heath

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The Consolidation of Political Power in China Under Xi Jinping: Implications for the PLA and Domestic Security Forces

Testimony of Timothy R. Heath¹
The RAND Corporation²

Before the U.S.-China Economic and Security Review Commission

February 7, 2019

This testimony examines how the concentration of political power in China under President Xi Jinping affects its military and domestic security forces. For context, I will briefly review the broader background trends against which Chinese leaders, headed by Xi, have consolidated political power. I will then explore how these trends have affected China's People's Liberation Army (PLA) and the implications for the country's domestic security forces, most notably the People's Armed Police (PAP), the Ministry of Public Security (MPS), and the Ministry of State Security (MSS).

The current centralizing trends might aggravate tensions within China's armed forces and worsen bureaucratic deadlock. However, I assess that these measures also have increased central government control of the security apparatus, removed many opponents of Xi's authority in the security forces, and facilitated military modernization efforts. The centralization of authority in the security forces does carry some important considerations for U.S. defense planners and officials, some of which I will review in my recommendations.

Broad Developments Under Xi

Under Xi, who serves concurrently as the Chinese Communist Party (CCP) General Secretary and the chair of the Central Military Commission (CMC), China has experienced a striking consolidation of power. This consolidation involves three important trends.

First, central authorities have accrued political power at the expense of bureaucratic ministries and local and provincial governments. An ambitious intergovernmental fiscal reform

¹ The opinions and conclusions expressed in this testimony are the author's alone and should not be interpreted as representing those of the RAND Corporation or any of the sponsors of its research.

² The RAND Corporation is a research organization that develops solutions to public policy challenges to help make communities throughout the world safer and more secure, healthier and more prosperous. RAND is nonprofit, nonpartisan, and committed to the public interest.

program will increase the role of the central government.³ Similarly, an array of supragovernment small groups, such as the National Security Commission and the Leading Small Group for Comprehensive Deepening of Reform, have been established to guide the work of ministries.⁴

Second, the CCP has dramatically expanded its powers, generally at the expense of the government and other organizations. A major reform plan announced in March 2018 transferred responsibilities from various government ministries to party organizations. As one example, management of all films, media, and publications has been transferred from a government office to the CCP's Propaganda Ministry.⁵ Earlier this year, China also established a new antigraft agency, the National Supervisory Commission, which replaced the State Council's Ministry of Supervision and merged with the party's Central Commission for Discipline Inspection (CCDI). This move aims to strengthen the party's anticorruption effort in nonparty sectors.⁶ The CCP has also stepped up its efforts to penetrate private-sector businesses as well as foreign firms operating in China.⁷

Third, the central leadership has undertaken measures to bolster Xi's personal authority. Xi has taken the helm of the most important small leading groups and commissions.⁸ In March 2018, the National People's Congress, China's national legislature, voted nearly unanimously to amend the constitution to remove presidential term limits.⁹ Official propaganda has relentlessly promoted Xi in a manner that many have compared to a "cult of personality."¹⁰ In addition, Xi's antigraft campaign has allowed him to crush potential rivals.¹¹

Official documents state that these centralizing actions aim to address two key issues: a slowing economy and the rising expectations of an increasingly educated, prosperous people. In 2017, the 19th Party Congress, a gathering of the CCP's highest-level body held every five years, declared the country's most essential challenge to be the contradiction "between unbalanced and inadequate development and the people's ever-growing needs for a better life." To ensure its long-term political survival, the CCP must both overhaul the country's mode of economic

³ Philippe Wingender, "Intergovernmental Fiscal Reform in China," IMF Working Paper, WP/18/88, April 2018.

⁴ Cary Huang, "How Leading Small Groups Help Xi Jinping and Other Party Leaders Exert Power," *South China Morning Post*, January 20, 2014.

⁵ Chris Buckley, "China Gives Communist Party More Control Over Policy and Media," *New York Times*, March 21, 2018.

⁶ Jamie P. Horsley, "What's So Controversial About China's New Anti-Corruption Body?" *The Diplomat*, May 31, 2018.

⁷ Simon Denyer, "Command and Control: China's Communist Party Extends Reach Into Foreign Companies," *Washington Post*, January 28, 2018.

⁸ Javier C. Hernández, "China's 'Chairman of Everything': Behind Xi Jinping's Many Titles," *New York Times*, October 25, 2017.

⁹ Chris Buckley and Steven Lee Myers, "China's Legislature Blesses Xi's Indefinite Rule. It Was 2,958 to 2," *New York Times*, March 11, 2018.

¹⁰ Philip Wen and Christian Shepherd, "China Cranks Propaganda, Xi Jinping's Cult of Personality into Overdrive Ahead of Party Congress," *Business Insider*, October 12, 2017.

¹¹ "China's Anti-Corruption Campaign Expands with New Agency," BBC, March 20, 2018.

growth and deliver a higher standard of living to the people.¹² However, realizing these goals requires the party to dismantle obsolete industries, governance structures, and patronage networks that oppose change.¹³ The “fragmented” nature of China’s authoritarian rule might have facilitated rapid growth in previous decades, but Chinese leaders increasingly view it as an impediment to systemic reform.¹⁴ Xi and his allies, frustrated by the glacial pace of change under Hu Jintao, accordingly embraced a highly centralized, top-down approach to systemic reform that they called “top down design.”¹⁵

The centralization of Xi’s political power may therefore be understood as part of the CCP’s strategy to minimize open conflict while realizing structural changes and overcoming resistance by vested interests. Beijing’s resolve to power through such an inherently contentious process underscores its resolve to realize the country’s revitalization as a great power. The inherent risks attendant to this process underscore the growing importance of the nation’s security forces to contemporary Chinese politics.

The party’s centralization of political power in pursuit of its reform agenda has elevated the importance of security forces in domestic politics in a manner not seen since perhaps the 1989 Tiananmen Square massacre. China’s armed forces have always provided the mailed fist underpinning CCP rule, but for most of the 1990s and 2000s, rapid economic growth and general consensus among political elites enabled security forces to easily manage incidents of mass unrest. In a period of growing plenty, Beijing focused on furthering the country’s impressive economic expansion and allowed corruption to fester in the armed forces—as it did in much of Chinese officialdom.

However, slower growth and rising personal economic expectations have created a more rancorous political situation. Central authorities can no longer afford to tolerate the malfeasance and pervasive corruption that squanders economic growth and infuriates the public. Powerful elites who benefited from past policies have resisted changes that might threaten their status and privileges. Symptomatic of the troubled state of affairs are the numerous media reports of unverified rumors of coup plots against Xi—something virtually unheard of in either Jiang Zemin or Hu’s eras.¹⁶ Firm control of the nation’s armed forces is critical if leaders are to deter powerful central or local officials from coopting troops to defy Beijing. Loyal and competent troops are also essential to control western provinces in support of the country’s economic development plans. Externally, China’s growing tensions with some Asian neighbors and with the United States have increased the need for military readiness and competence. Central leaders

¹² Alice Lyman Miller, “Only Socialism Can Save China; Only Xi Jinping Can Save Socialism,” *China Leadership Monitor*, No. 56, May 17, 2018.

¹³ “China 2030: Building a Modern, Harmonious, and Creative Society,” *World Bank*, February 27, 2012.

¹⁴ Zhenjie Yang, “Fragmented Authoritarianism—The Facilitator Behind the Chinese Reform Miracle: A Case Study in Central China,” *China Journal of Social Work*, Vol. 6, No. 1, 2013, pp. 4–13.

¹⁵ Barry Naughton, “Leadership Transition and the ‘Top Level Design’ of Economic Reform,” *China Leadership Monitor*, No. 37, April 30, 2012.

¹⁶ “Chinese President Xi Jinping ‘Foiled Coup Plot’ to Seize Control of Communist Party,” *Radio Free Asia*, October 20, 2017.

led by Xi thus face powerful incentives to ensure both the absolute loyalty of the country's military and internal security forces against potential enemies, both foreign and domestic.

Consolidation of CCP Power in the Military

As the party's armed wing, the PLA remains the ultimate backstop of party authority. Multiple levels of commissars, party committees, and inspection cadres penetrate all levels of the military, providing an interlocking, reinforcing system that infuses party authority throughout the PLA. Most military officers are party members, and units at the company level and above have political officers responsible for ensuring that party orders are carried out. Party committees oversee decisionmaking in military units, and party inspection cadres monitor the behavior of personnel.¹⁷

Key Civil-Military Developments Drive Centralization of CCP Power

Yet despite these organizational designs, Chinese leaders appear never to take the military's loyalty for granted. In the years prior to Xi's ascent, some reason for concern could be seen in reports that elements of the PLA resisted the authority of top leaders. Reports from the Hu and Jiang eras described a bloated military riddled with corruption and ill-prepared to carry out its responsibilities. A brief review of key civil-military developments provides critical context for the party's approach to the PLA under Xi.

PLA autonomy. Alarming evidence of the military's resistance to civilian oversight could be seen in the disturbing incident of senior general Gu Junshan's arrest in 2012. Hu reportedly ordered an inquiry into corruption charges against Gu, but CMC officials failed to discharge their duties. Hu had to direct the CCDI to carry out the inquiry, a move that underscored the unreliability of the PLA's own disciplinary units.¹⁸

Potential involvement in elite politics. The possibility of powerful political leaders conspiring with PLA units raised itself in the Politburo aspirant Bo Xilai's shocking downfall in 2012. News reports have suggested elements of the 14th Group Army had supported Bo's bid for power.¹⁹

Corruption. Corruption in the PLA festered throughout both Jiang and Hu's tenure, especially among individuals involved with the lucrative logistics and personnel sectors. In 2006, reports emerged that former PLA Navy Deputy Commander Vice-Admiral Wang Shouye siphoned off 160 million yuan when he was a General Logistics Department deputy director.²⁰

¹⁷ Defense Intelligence Agency, *China Military Power: Modernizing a Force to Fight and Win*, DIA-02-1706-085, January 2019, p. 16. As of January 25, 2019: http://www.dia.mil/Portals/27/Documents/News/Military%20Power%20Publications/China_Military_Power_FINAL_5MB_20190103.pdf

¹⁸ John Garnaut, "Rotting from Within," *Foreign Policy*, April 16, 2012.

¹⁹ Jeremy Page and Lingling Wei, "Bo's Ties to Army Alarmed Beijing," *Wall Street Journal*, May 17, 2012.

²⁰ Jonathan Watts, "Mistress Turns in Corrupt Chinese Vice Admiral," *The Guardian*, June 15, 2006.

The large-scale arrests and the subsequent downfall of two CMC vice chairmen, Guo Boxiong and Xu Caihou, under Xi hinted at the extent of the corruption problem.²¹

Outdated organization. In addition to corruption problems, Jiang and Hu presided over a PLA that continued to prioritize ground forces, despite the adoption of a doctrine that called for the military to fight as an integrated, joint force in 2004. Moreover, the PLA's entire command and control system reflected an obsolete, Soviet-based construct poorly suited to the needs of a modern combat force.²²

In short, the PLA's organizational, political, and disciplinary problems posed a formidable obstacle to Xi's pursuit of the military's readiness, loyalty, and political reliability. Xi assumed command of a military that carried an elevated risk of military insubordination and potential operational failure at a time when the central leadership's need for an utterly reliable backstop was reaching new heights.

Measures to Strengthen Military Loyalty, Discipline, and Professionalism

China's central leaders, led by Xi, have enacted a series of measures to strengthen the military's loyalty, discipline, and professionalism. These include organizational reforms, administrative measures, a widespread purge of the military carried out under the name of anticorruption, strengthened regulatory regimes, and appeals to the PLA's corporate interest.

Organizational reforms. Organizational changes strengthened central oversight of the military while bolstering discipline and promoting military competence. For example, the separation of the PLA's operational command and administrative functions in 2015 could improve efficiency *and* reduce the risks of delegating too much power to key commanders.²³ Similarly, the creation of the National Security Commission in 2013 centralized decisionmaking regarding military affairs, improving prospects for coordination and reinforcing the military's subordination to central authorities. The 2014 combination of maritime law enforcement agencies into the State Oceanic Administration and the Chinese Coast Guard again both streamlined command and control and increased political oversight.²⁴

Other measures strengthened party authority within the military and improved discipline but might have less direct impact on military professionalism. In November 2015, authorities announced the creation of a new PLA Politics and Law Commission to monitor compliance with antigraft provisions and other rules, mirroring a similar party organization that oversees legal and judicial issues in the state bureaucracy.²⁵

²¹ "Chinese General Guo Boxiong Sentenced to Life for Corruption," BBC, July 25, 2016.

²² Michael S. Chase, Jeffrey Engstrom, Tai Ming Cheung, Kristin A. Gunness, Scott Warren Harold, Susan Puska, and Samuel K. Berkowitz, *China's Incomplete Military Transformation: Assessing the Weaknesses of the People's Liberation Army*, Santa Monica, Calif.: RAND Corporation, RR-893-USCC, 2015.

²³ Joel Wuthnow and Phillip C. Saunders, "Chinese Military Reforms in the Age of Xi Jinping: Drivers, Challenges, and Implications," *China Strategic Perspectives*, Institute for National Strategic Studies, No. 10, March 2017.

²⁴ Liu Zhen, "China's Military Police Given Control of Coast Guard as Beijing Boosts Maritime Security," *South China Morning Post*, March 21, 2018.

²⁵ Office of the Secretary of Defense, "Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2016," Washington, D.C., April 2016.

Regulatory mechanisms. Under Xi, the PLA also has introduced an array of regulatory measures and rules. Some, reflecting broader party efforts, target corruption and aim to instill discipline. Other regulations support professionalization by outlining requirements for training and preparations as a joint military.²⁶

Propaganda. PLA media has promoted the message of the military's absolute loyalty to the party, a theme amplified by Xi's 2014 conference on the topic.²⁷ While commentators have speculated on the reason for the relentless emphasis on the PLA's loyalty to the party, it is worth noting that this theme has been exceedingly common over the past decades.²⁸ Under Xi, the theme of PLA loyalty to the party complements the other organizational, administrative, and other measures designed to reinforce discipline and control corruption. The message of military subordination to party authority is also not necessarily incompatible with the military's development as a professional, competent force. Because the CCP has defined its mission in terms of the defense of the nation's interests, fulfillment of that mission is best served by a professional, competent military.

Anticorruption. Xi initiated an extensive anticorruption purge that netted many senior officials, including the two former CMC vice chairs. In 2017, authorities carried out unprecedented anticorruption probes against two sitting CMC members, Joint Staff Department chief Fang Fenghui and Political Work Department director Zhang Yang.²⁹ The anticorruption campaign has also provided a useful pretext for Xi to remove political adversaries and eliminate potential opposition among senior leaders.³⁰

Incentives to support Xi's authority. Xi has not only enacted punitive measures to impose discipline, he has also offered incentives. Professional-minded officers and troops likely favor anticorruption efforts and systemic reforms to improve PLA lethality and readiness. Xi has reviewed several key military parades and exercises, and he has assiduously courted the military with onsite visits and promotions of loyal officers.³¹ In addition, Xi's adoption of hardline policies on sovereignty disputes, such as the enactment of the Air Defense Identification Zone in the East China Sea and the vigorous defense of the military's buildup in the South China Sea, elevates the status of the military as the protector of the nation's interests.³²

Another incentive may be withholding investigations into some senior military officers, as corruption is likely so pervasive that most senior officers actually could be targeted. Some observers have noted how graft probes have largely avoided targeting military-region grade

²⁶ "Revised Rules Set for Evolving PLA," *China Daily*, April 16, 2018.

²⁷ "Party Commands Gun Must Be Upheld," *China Military Online*, November 3, 2014.

²⁸ James Mulvenon, "They Protest Too Much (or Too Little) Methinks: Soldier Protests, Party Control of the Army, and the 'National Army' Debate," *China Leadership Monitor*, No. 15, August 2005.

²⁹ Office of the Secretary of Defense, "Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2018," Washington, D.C., May 2018.

³⁰ Charles Clover, "Xi Takes Aim at Military in Anti-Graft Drive," *Financial Times*, February 11, 2018.

³¹ Charlotte Gao, "China's Military Parade Reaffirms Communist Party's Absolute Control Over Army," *The Diplomat*, August 1, 2017.

³² "China Says U.S. Should Respect China's Air Defense Zone," Reuters, March 23, 2017.

officers, suggesting Xi may have calibrated a degree of restraint to avoid a backlash from commanders in charge of operational units and to minimize damage to morale.³³

Assessing Xi's Measures

Given the serious problems plaguing the PLA under Hu and Jiang, the measures taken by Xi will likely improve the military's political reliability, discipline, and professional competence. Although the anticorruption campaign threatens some senior military officers, Xi's assiduous cultivation of the interests of the military and security forces and various organizational, administrative, political, and other measures have significantly reduced the possibility that disaffected military personnel could conspire against the central government. However, the tension between the pursuit of political loyalty and military readiness persists, and the dangers should not be dismissed. Too much loyalty building through extensive indoctrination and intimidation could result in a military that prioritizes compliance and sloganeering over professional competence. In contrast, too much focus on improving military readiness and professionalism through purging all leaders tainted by corruption risks damaging morale and potentially inciting rebellion among those targeted.

Domestic Security Forces: The PAP

The PLA provides a critical backstop to the party's rule, but the domestic security forces play a more-critical role in managing day-to-day opposition to CCP authority among elites and the general public. The PAP is a paramilitary component of China's armed forces; its primary mission is internal security. Although the PAP has specialized units for a variety of functions, such as border security and firefighting, most units address internal security. PAP units are organized into contingents for each province, autonomous region, and centrally administered city. There are also a small number of mobile divisions available to deploy anywhere in the country to respond to crises.³⁴

As with the PLA, news reports from the Hu era illuminated disturbing PAP practices that likely inspired central leaders to tighten control. In particular, reports that local officials coopted PAP troops to carry out a variety of extralegal tasks raised the possibility that disaffected local leaders could direct local PAP units to resist central authority. For example, media in the mid-2000s mentioned incidents in which local officials sent PAP troops to carry out tax collection and debt recovery and to seize land. Corrupt officials also deployed local PAP troops to break up protests against misrule.³⁵ Perhaps the most striking example of local officials deploying PAP troops for purposes of political violence occurred in 2012, when then-Chongqing Party chief Bo

³³ James Char, "Reclaiming the Party's Control of the Gun: Bringing Civilian Authority Back in China's Civil-Military Relations," *Journal of Strategic Studies*, Vol. 39, No. 5, pp. 608–636.

³⁴ Office of the Secretary of Defense, 2018, p. 48.

³⁵ John Lee, "PAP: The Rise of the Party's Army," *China Brief*, Vol. 8, No. 13, June 19, 2008.

Xilai sent PAP troops to capture his ex-police chief, Wang Lijun, who had fled to the U.S. Consulate General in Chengdu.³⁶

To curb such abuses, central leaders strengthened central control of the PAP with a series of organizational and administrative measures. The PAP underwent a leadership reshuffle in 2014 that saw its commander and political commissar replaced with PLA officers loyal to Xi.³⁷ In 2017, authorities announced that the PAP would be commanded by the CMC, removing the State Council from the chain of command and removing the PAP from the direct control of provincial authorities.³⁸ Moreover, the reforms removed all troops not involved in domestic security duties from the PAP. Following the reform, the PAP has become a force exclusively focused on domestic security that operates under the command of the CMC. Other types of PAP troops, such as firefighting and border defense, have been transferred to other central ministries.³⁹

Authorities also revised PAP funding to strengthen central control. Mirroring the organizational and administrative changes, the central government began to almost exclusively fund the PAP, thereby removing local and provincial funding streams.⁴⁰

Stronger central control of the PAP removes these troops from possible misuse by local power holders, deters potential challengers to Beijing's authority, and enables the central government to deploy the forces to carry out its own strategic plans, such as consolidation of political control over the western provinces. However, the militarization of the PAP raises the prospect that domestic security concerns will be considered in military terms, further weakening what little remains of the rights of Chinese citizens, especially in the ethnic-minority dominated provinces featuring a heavy PAP presence.

The MPS and MSS

Chinese leaders rely on the MPS and the MSS as the primary forces for ensuring public order and controlling threats in the country. The MPS is responsible for domestic law enforcement, as well as overall maintenance of "social order," riot control, and antiterror duties. Unlike the PAP or PLA, however, the MPS provides oversight of local police forces, most of which are controlled and funded by local and provincial officials. Locally hired Chinese police forces are generally regarded as poorly paid, poorly trained, and corrupt.⁴¹

The MSS is the country's main civilian intelligence and counterintelligence agency. Its missions include protecting China's national security, securing political and social stability,

³⁶ Viola Zhou, "Why China's Armed Police Will Now Only Take Orders from Xi and His Generals," *South China Morning Post*, December 28, 2017.

³⁷ Kristen Huang, "China Brings People's Armed Police Under Control of Top Military Chiefs," *South China Morning Post*, December 27, 2017.

³⁸ Ben Blanchard, "China to Bring Paramilitary Police Force Under Military's Wing," Reuters, December 27, 2017.

³⁹ Zi Yang, "The Militarization of China's People's Armed Police," *Asia Times*, March 25, 2018.

⁴⁰ Adrian Zenz, "China's Domestic Security Spending: An Analysis of Available Data," *China Brief*, Vol. 18, No. 4, March 12, 2018.

⁴¹ "A Policeman's Lot in a Police State: Not Happy," *The Economist*, October 31, 2016.

conducting counterintelligence, and implementing the State Security Law and related laws.⁴² The 31 provincial and municipal departments of the MSS are responsible for carrying out surveillance and domestic intelligence work. Some of the departments also carry out foreign intelligence work.⁴³

As with the PLA and PAP, the MPS has experienced issues of corruption and misuse of forces in the Hu and Jiang eras. At the national level, the arrest of Central Political and Legal Affairs Commission Chair Zhou Yongkang in 2012 revealed the presence of extensive corruption and factional scheming in the security apparatus. Zhou's downfall permitted Xi to consolidate control over the internal security apparatus, ensuring no other rival could deploy these forces against Xi.

Xi has accordingly directed efforts to strengthen central control over the MPS and MSS. Following the downfall of Zhou, for example, authorities downgraded the position in status. In 2018, Xi attended a conference of security officials, during which he passed on directives aimed at strengthening the loyalty of all personnel in the security agencies to the CCP.⁴⁴

In addition to disciplinary measures to ensure the subordination and loyalty of security forces, authorities have also increased their budgets. Spending on domestic security increased significantly under Xi, building on trends stemming from Hu's tenure. In 2010, China's national domestic security spending exceeded its spending on external defense for the first time.⁴⁵ According to some estimates, on a purchasing power parity basis, China's domestic security spending in 2017 was equivalent to about \$349 billion, more than double the United States' estimated \$165 billion.⁴⁶

Besides major increases in spending, security officials have adopted advanced technologies for surveillance and security purposes, such as facial recognition and "social credit" rating schemes through information technologies.⁴⁷

In sum, the MSS and MPS have seen an increase in budgets and capacity. Xi has also secured control of their national-level leadership. The increasing expansion of law enforcement capabilities and international outreach raises the risk that Chinese security forces will extend their hunt for political opposition abroad.⁴⁸ Already, requests by Chinese police officials to

⁴² Office of the Secretary of Defense, 2016, p. 71.

⁴³ Peter Mattis, "Everything We Know About China's Secretive State Security Bureau," *War on the Rocks*, July 9, 2017.

⁴⁴ Charlotte Gao, "Xi Stresses the Party's Absolute Leadership Over Political and Legal Work," *The Diplomat*, January 23, 2018.

⁴⁵ Chris Buckley, "China Internal Security Spending Jumps Past Army Budget," Reuters, March 4, 2011.

⁴⁶ Zenz, 2018.

⁴⁷ Josh Chin, "China Spends More on Domestic Security as Xi's Powers Grow," *Wall Street Journal*, March 6, 2018.

⁴⁸ Chris Buckley, "China's Antigraft Enforcers Take on a New Role: Policing Loyalty," *New York Times*, October 22, 2016.

establish extradition agreements has raised concern that the MSS and MPS may serve as vehicles for capturing political dissidents.⁴⁹

Conclusions

Under Xi, the CCP has stepped up central control of the country's armed forces as a critical component of a contentious economic and governance reform program. Compared to the situation under Hu and Jiang, the array of administrative, organizational, budgetary, and political measures have likely resulted in stronger central control and oversight of the military and internal security forces.

Beijing likely faces a low risk of open defiance of Xi's authority by disaffected elements in the military or cooptation of armed units by recalcitrant local elites. Despite the fact that senior PLA generals have been targeted and the autonomy of the PLA threatened to a far higher extent than in the past, the party has reduced the risks through a relentless anticorruption drive and intrusive organizational and administrative reforms led by Xi. Moreover, Xi's cultivation of the PLA's interests—through directing an overdue reorganization, promoting allies, and elevating the PLA's status through hardline policies—provides an incentive for the many professional-minded military personnel to comply with strengthened CCP authority.

The consolidation of political power has helped improve discipline and may finally curb rampant corruption, especially in the PLA. Better discipline, less corruption, and stronger CCP authority is not necessarily incompatible with a more professional, competent PLA. Nor is the onset of badly needed structural reforms inimical to the party's pursuit of a more-loyal, obedient force. On the contrary, Xi's role in initiating both military reorganization and the array of measures to bolster party authority and strengthen discipline underscores the interdependent nature of these efforts. The most probable outcome is a concomitant improvement in the loyalty, discipline, and competence of the military.

However, the concentration of political power over the military and domestic security forces carries some perils for Beijing. Although Xi has succeeded to date in calibrating coercion against corrupt senior leaders and personnel, the pervasiveness of the problem means the risk of desperate individuals driven to desperate measures cannot be discounted. Chinese leaders will need to continue balancing antigraft campaigning and rooting out opposition to reform with restraint to avoid driving threatened leaders into open defiance.

The concentration of power also carries a risk of decisionmaking bottlenecks. Elevating too many decisions to elite supraministerial small leading groups raises the risks that important decisions will be delayed or grow unpredictable. The lack of institutionalization of authority between new and old command structures also causes friction and could cause problems with coordination, deconfliction, and decisionmaking in a crisis. For example, some commentators

⁴⁹ Massoud Hayoun, "Is China Using Interpol to Try to Bring Back Political Dissidents from the U.S.?" *Pacific Standard Magazine*, September 27, 2017.

have attributed the apparent lack of activity in the National Security Commission to opposition by leaders in traditional ministries.⁵⁰

Finally, the blurring of political with military and legal concerns carries implications for countries who engage or find themselves in confrontations with Chinese forces. Officials will need to attend to the political dimensions of cooperation with Chinese police and other security forces. The merging of political and military concerns also could create uncertainty and unpredictability regarding Beijing's intentions and degree of involvement in potential international confrontations involving PLA forces. Central leadership's persistent efforts to better guide the activities of military and paramilitary forces in contentious situations elevates the likelihood that those forces undertake risky or provocative behavior under Beijing's direction. This raises unsettling and unpredictable possibilities for escalation in any crisis situation involving Chinese armed forces. For example, there is a higher likelihood under the current centralized command system that any provocative action, such as an attempted ramming by a Chinese Coast Guard ship of a U.S. maritime surveillance ship in the South China Sea, could be directed by Beijing.

Xi's centralization of political authority in the security forces carries some important considerations for U.S. policymakers. First, U.S. defense planners should account for the changing political dynamics when contemplating possible crisis situations involving the PLA. In some ways, stronger central oversight reduces risks that local commanders could be acting on their own. However, the same dynamic also raises the danger that provocative military actions may have the Chinese leadership's backing, introducing unpredictable escalation possibilities. Given the rising stakes, U.S. military officials should ensure robust "hotline" channels of communication for use in a crisis.

Second, U.S. officials should monitor China's law enforcement presence in western regions, such as Tibet and Xinjiang, for evidence of more abuses by PAP troops. Militarizing the PAP raises the possibility that local commanders will view law enforcement in military, as opposed to legal, terms. What remains of due process and the legal rights of Chinese citizens could deteriorate further at the hands of PAP occupation. U.S. officials should promote the publication of evidence of such abuses to pressure China into respecting human rights.

Third, U.S. officials should monitor efforts by Chinese police officials to train and build partnerships in other countries. Given the overlap of political and criminal concerns of a police force featuring strong CCP control, Chinese officials could be passing on practices and technologies that support political repression rather than promote sound law enforcement practices. U.S. officials should consider sanctioning Chinese officials who advance repression under the guise of law enforcement in their engagements with other countries.

⁵⁰ Jean-Pierre Cabestan, "China's Institutional Changes in the Foreign and Security Policy Realm Under Xi Jinping: Power Concentration vs. Fragmentation Without Institutionalization," *East Asia*, Vol. 34, No. 2, June 2017, pp. 113–131.

OPENING STATEMENT OF ANDREW WEDEMAN, PROFESSOR, DEPARTMENT OF POLITICAL SCIENCE, GEORGIA STATE UNIVERSITY

SENATOR GOODWIN: Thank you. Dr. Wedeman?

DR. WEDEMAN: I want to thank the Senators and the Chairman and the Vice Chairman and the Commissioners for asking me up here to discuss the anticorruption campaign.

As Senator Goodwin said in his opening remarks, the anticorruption campaign is one of the central features of Xi Jinping's period in office. It began in 2012.

It grew out of what I think of as three major cases, one involving the Minister of Railways, the other involving a senior member of the People's Liberation Army. And the third of course, Bo Xilai, a member of the Politburo and Party Secretary of Chongqing.

What I think these three cases did in combination was, reveal the depth of corruption not within the main part of the Party state apparatus, but at the top ranks. They had several scandals in the past.

These were generally isolated. I think the three of these cases suggested to Xi Jinping and others that the Party in effect was rotten, not only in the rank and file, but in the top as well.

If you look at the trends in the anticorruption campaign, the numbers are staggering. 2.3 million Party members have undergone investigation as of the end of 2018.

By my guess, 300,000 have been indicted on criminal charges. And somewhere around 250,000 convicted. Those are based on the best numbers I had at the time of this writing.

If you actually look at the trends, which are displayed in Figure 1 in the written testimony, what you will see is the number of Party investigations in more the -- increased fourfold from about 144,000 in the years before the campaign, to what the Party said was 638,000 in 2018.

By contrast, the number of criminal indictments looks to have risen much less. In fact, it peaked in 2015 and is now back down to its 2012/2011 levels.

So you get this major divergence between what the Party is doing and what the judiciary is doing. What explains that difference?

In part, they're going after fairly mundane offenses, low-level gift taking and so forth. It's hard actually to explain that gap, because the Discipline Inspection Commission is not very forthcoming.

If we move over to the criminal side, which you will see displayed in Figure 2 of the written testimony, the impact of the campaign becomes a little clearer. The reason the overall number of criminal indictments didn't go up all that much is, the campaign is really focused on high-level corruption.

And if you look at the number of people serving in leadership posts at the provincial and ministerial level, it shot up from five to 41. Similar increases at the next two ranks.

So Xi Jinping, really the campaign, there's a big publicity or PR angle to it. Which involves a lot of publication of the data on the cases.

But then also, he's really come down very hard on what the Chinese press call the tigers. These are people serving at the vice ministerial rank and above. Not only in the government, but the Party. And also, there's a counterpart in the military as well.

The trend in this is displayed in Figure 3 of the written testimony. To date, as of last week, 184 civilian tigers had been indicted, convicted, or were under investigation.

The number's a little spongy. The definition of who's a Tiger is a matter of art rather than science.

Also, 78 military officers holding ranks at or above the rank of major general. We don't know as much about them. The Chinese press doesn't talk about them.

A lot of these cases are actually derived out of the Hong Kong press. They are people who may have been indicted for corruption.

They may have been forced into retirement. They may have been sent to remote posts in some place like Xinjiang or Tibet after coming under suspicion.

So the focus is on high-level corruption. Which brings us to one of the key questions of, is this nothing more than a factional purge on the part of Xi Jinping?

There's no question that the campaign is an effort to consolidate his power. Not only within the Party, but also within the country in general. Anticorruption is popular. It makes him look strong, et cetera.

In order to answer the question of whether this is a factional purge, I created a database involving all the tigers, all their alleged contacts. I generated a very nice network map, which I would have loved to have shared with you. But it's generated in a piece of software that does not believe in paper. And it can only be displayed on a great big computer screen.

What it shows is that the focus of the Tiger hunt was on two individuals. Zhou Yongkang and Ling Jihua. Zhou Yongkang had been the Secretary on the Politics of Law Committee that controls China's internal apparatus. Other series of important posts. Ling Jihua on the other hand was Hu Jintao's right-hand man.

So the question is, in going after these two, was he going after a political opposition? Neither man was in a position by the time Xi Jinping came to power to have been a viable opponent.

Zhou Yongkang was compromised by the Bo Xilai case. And by growing evidence that he was at the center of a network of corrupt officials, not at the top level. These were not political contenders. These were second raters. They were provincial governors. They were heads of ministries, et cetera.

Ling Jihua was basically a dead man walking by the time that the 18th Party Congress. Dead man walking is a bit graphic, but actually is accurate.

He was crippled when his son plowed a \$300,000 Ferrari into a bridge abutment. The man made \$22,000 dollars. The son driving a \$300,000 car. I'm not a mathematician, but it doesn't add up.

I think what Xi has done, is he's taken out a lot of people. He's opened up a lot of space. He's achieved a lot.

It is a political purge in the sense that it benefits him politically. But it is not an overt purge based on some sort of factional struggle.

Final thing I'll get too since my time is almost up, is, did the campaign make any difference? No idea.

Don't know how bad corruption was before. We don't know how bad it was afterwards. You can't measure corruption. All you can measure is actually anticorruption.

He's made a big effort. He's taken out a lot of people. He's taken down a lot of bad people. He has probably intimidated a great deal -- a great many people into keeping their heads down. But will it last?

And that's a matter of the institutional construction. They've done some with the National Supervisory Commission.

But the important thing, and I'll close with this is, a campaign is a response to past failure. It's not a solution.

You can clean out the, you know, you can clean out the dirty stable, but if you don't actually get people in to keep it constantly clean, a year, two years, three years, you're back to the same thing.

So, net effect? Remains to be seen. Thank you very much.

**PREPARED STATEMENT OF ANDREW WEDEMAN, PROFESSOR, DEPARTMENT
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February 6, 2019

**Andrew Wedeman
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**Testimony before the U.S.-China Economic and Security Review Commission
“The Threat from Within: ‘Party-ification’ and Internal Threats to CPP Rule”**

**A Crushing Tide Rolling to a Sweeping Victory?
Xi Jinping’s Battle with Corruption after Six Years of Struggle**

In late 2012, early 2013, newly selected Chinese Communist Party (CCP) General Secretary Xi Jinping ordered an intensification of the regime’s ongoing attack on corruption. Party investigators and the Procuratorate would, he declared, not only “swat at flies” (the rank and file), but would also “hunt big tigers” (senior officials), including those in the inner most circles of power. At the 19th Party Congress in October 2017 and then again at the 2nd Plenum of the 19th Central Discipline Inspection Commission (CDIC), the party’s internal watchdog, in January 2019 Xi claimed that the “crushing blows” dealt by crackdown had won a “sweeping victory” and that the party was now consolidating its success in China’s long war with corruption.¹ The victory was not, he warned at the 3rd Plenum of the 19th Central Discipline Inspection Commission fourteen months later in January 2019, complete and called for the struggle to continue with unabated vigor.²

Rhetorical claims notwithstanding, key questions remain about Xi’s protracted assault on corruption. What triggered the crackdown? Was the crackdown actually a political witch hunt disguised as an anti-corruption crackdown? What has the crackdown achieved and has it actually reduced corruption? What does the future hold and will the consolidation of the party, state, and judicial anti-corruption agencies into the new National Supervisory Commission strengthen the regimes defenses against corruption?

Origins of the Crackdown

The crackdown begun in late 2012, early 2013, is the latest “surge” in a battle against corruption the CCP has waged since its establishment in the 1920s. After seizing power in 1949, the party launched repeated mass campaigns during the 1950s in which corrupt officials, black marketers, and profiteers were dragged in front of mass meetings, denounced, beaten, and sometimes executed. In 1963, the party launched a new drive against cadres who had taken advantage of their power to corruptly protect their families and friends during the 1959-1961 famine. Three years later, the “Socialist Education Movement” morphed in the Cultural Revolution, a sweeping assault on what Chairman Mao Zedong saw as the corrupt privileges arrogated by party cadres and state

¹ Xi Jinping, “Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era,” October 18, 2017, available at http://www.chinadaily.com.cn/china/19thpcnationalcongress/2017-11/04/content_34115212.htm and “Xi calls for fundamental improvement of CPC political ecosystem,” *Xinhua*, 1/11/2018, available at http://www.xinhuanet.com/english/2018-01/11/c_136888965.htm.

² “CCDI adopts communique at plenary session,” *China Daily*, 1/13/2019, available at <http://global.chinadaily.com.cn/a/201901/13/WS5c3b1b31a3106c65c34e41c3.html>.

officials. As the chaos of the Cultural Revolution subsided, the party continued to attack corruption in the early 1970s. Despite repeated attacks, corruption remained a chronic problem, albeit a problem that in the Maoist era bribes was apt to be denominated in kilograms of pork, cartons of cigarettes, and bottles of cheap alcohol, not stacks of cash.

After the adoption of economic reforms in the 1980s and the beginning of the post-Mao economic boom, corruption also took off, with sums of money changing hands steadily expanding and mounting evidence that corruption was not a street/grassroots level problem but one that increasingly infected the middle-levels of the party state bureaucracy. Faced with rising corruption, the party responded with a series of drives against the rank-and-file “flies” in the 1980s and then a drive against corruption at the county and department levels in 1993. Over the next two decades, the party’s “war on corruption” ground on year-in and year-out. In the process, several major scandals, including the arrest of Beijing Party Secretary and Politburo member Chen Xitong in 1995 and Shanghai Party Secretary and Politburo members Chen Liangyu (no relation to Chen Xitong) in 2006, shook the party.

During 2011-2012, a series of new scandals likely revealed to the party leadership that corruption at the top was perhaps not a matter of “a few bad apples.” In March 2011, the CDIC announced that Liu Zhijun, the Minister for Railways, was under investigation. Liu was at the heart a web of corruption that had been feeding off the massive investments being made in the construction of China’s rapidly expanding high-speed rail system. Liu, according to rumors, had gotten so brazen that he claimed he was going to buy a seat on the Politburo. Later that year, General Liu Yuan, the son of Liu Shaoqi, the former Chairman of the People’s Public of China (PRC), accused Lieutenant General Gu Junshan, Deputy Director of the People’s Liberation Army’s General Logistics Department, of racking off huge sums from the sale of the use rights to military-controlled property and using part of the money to payoff senior military officers.³

More dramatically, in February 2012, Wang Lijun, the former Director of the Chongqing Public Security Bureau, fled to Chengdu, the capital of neighboring Sichuan province, to seek political asylum in the U.S. consulate. According to news reports, Wang had fled Chongqing after he had clashed Bo Xilai, the city’s party secretary. Following a falling out, Bo demoted Wang to head the city’s Environment Bureau, Wang countered by telling Bo that he had evidence that Bo’s wife Gu Kailai had murdered an English businessman named Neil Heywood after the two had a falling out over bribe money that Heywood had been helping Gu launder. Bo struck Wang who then fled the city fearing for his life. After the State Department declined his request for asylum, Wang called friends in Beijing for dispatched agents from the Ministry for State Security to guide Wang past Chongqing police who had surrounded the consulate and onto a flight to Beijing.

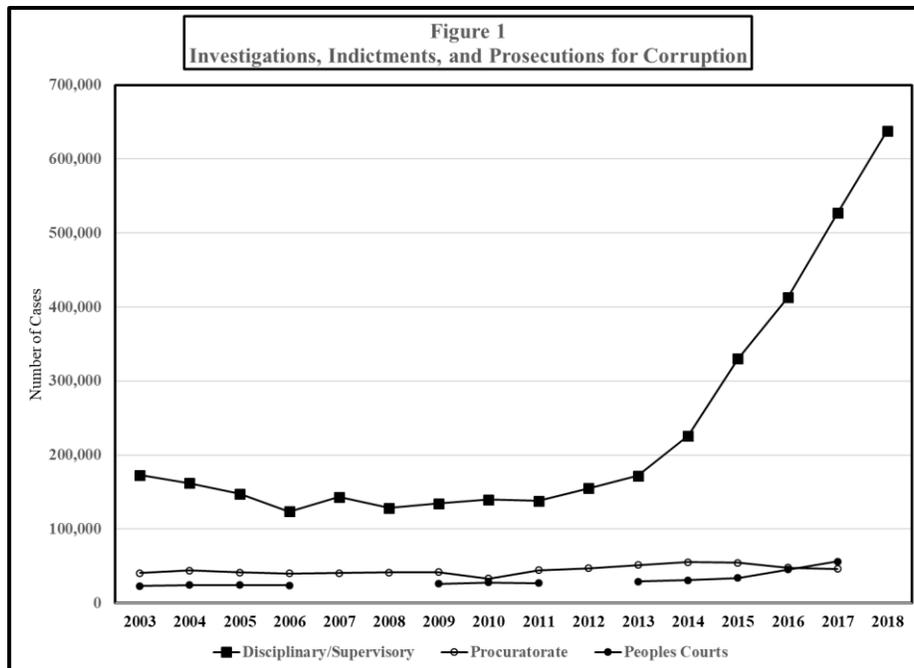
In combination, the Liu, Gu, and Bo cases likely suggested to Xi and other senior leaders that three decades battling corruption at the middle and rank and file levels had not prevented corruption from spreading upward into the core of the party-state leadership. The Bo case must have been particularly disturbing because Bo was a member of China’s red aristocracy. Bo’s father, Bo Yibo, was a first generation revolutionary and one of the eight most senior members of Deng Xiaoping’s reformist coalition. Bo himself had been a high-profile proponent of a Maoist revival that include the “singing of red songs” and a populist social welfare program aimed at China’s lower classes.

³ Liu Shaoqi died in 1969 after suffering repeated beatings by Red Guards.

It appears, therefore, that as he prepared to take over as paramount leader, Xi Jinping confronted evidence of extensive corruption at the very top of the party-state power hierarchy. Although such corruption posed an obvious threat to the party's grip on power, it also presented Xi with Janus-faced opportunity to strengthen his own grasp on the reins of power. On the one hand, a bold assault on corruption writ large gave him the chance to position himself as the new upright ruler sweeping out rotten, self-serving, money-grubbing officials who had betrayed the people. At the same time, an attack on corruption also gave Xi the chance to go after powerful officials who might have wished to hem him in and render him a weak leader, one that would be little more than the nominal first among equals within the Politburo Standing Committee. Purging – cleansing – the party as a whole, in other words, served not only the goal of attacking corruption at all levels within the party-state, it also afforded Xi an avenue to consolidate his own political interests. As such, the issue is not whether Xi's drive against corruption was a political witch hunt or an apolitical anti-corruption cleanup, because it sought to achieve multiple goals concurrently. Rather the key to understanding Xi's crackdown is how it was targeted.

The Tiger Hunt

The 1982, 1986, and 1989 crackdowns had primarily targeted the so-called flies – the rank-and-file. In 1993, the leadership shifted the focus to the middle levels of the party-state hierarchy, focusing on leading officials and cadres at the county, departmental, prefectural, and bureau levels. The crackdown launched in 2012-2013, resulted in dramatic increases in the number of investigations by conjoined party Discipline Inspection Commission and the state Ministry for Supervision, with the number of disciplinary cases investigated rising from 155,000 in 2011 and 172,000 in 2012 to 226,000 in 2014 and 330,000 in 2015. In 2017, the number of cases increased to 527,000 in 2017. In 2018, the Supervisory Commission conducted 638,000 investigations, a four-fold increase compared to 2011 (see Figure 1). The total number of criminal indictments filed by the Procuratorate increased much more modestly, rising from 44,000 in 2011 to a peak of 55,000 in 2014, a 25% increase. Thereafter, the number of individuals indicted on corruption-related charges fell, dropping down to 46,000 in 2017 (the last year for which data are available at this time), 1,000 less than in 2012. The number of corruption related cases tried by the courts, finally, more than doubled from 27,000 in 2011 to 56,000 in 2017.



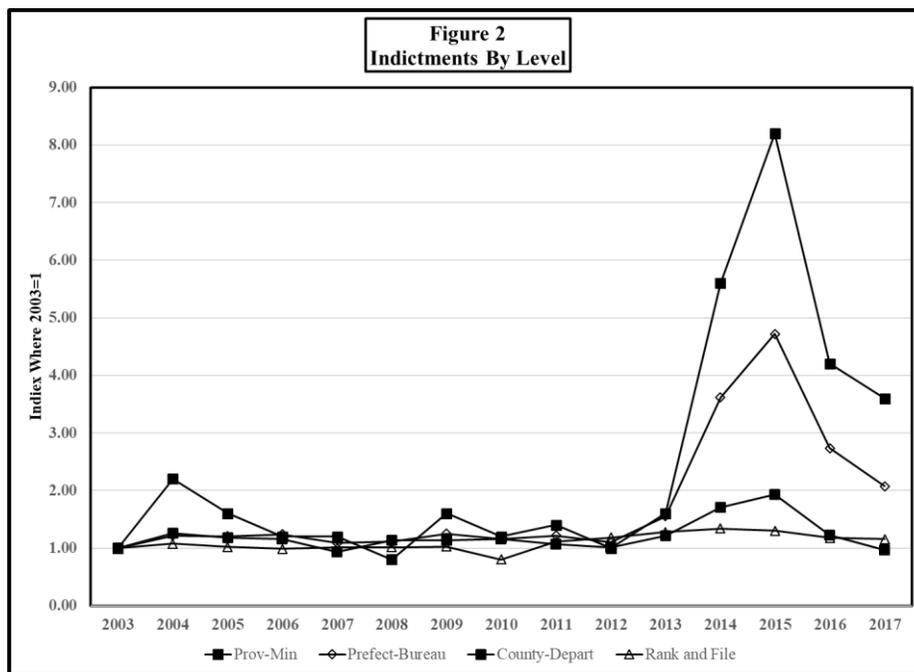
Source: Disciplinary/Supervisory: 中纪委:2013 年至 2016 年 9 月全国党政纪处分 101 万人 [Central Discipline Inspection Committee: 1.1 million party members and officials discipline between 2013 and September 2016], available at <http://politics.people.com.cn/n1/2016/10/20/c1001-28795090.html>; 中央纪委通报 2016 年 [Central Discipline Inspection Committee 2016 Report], available at http://www.ccdi.gov.cn/toutiao/201701/t20170104_125272.html; 中央纪委通报 2017 年 [Central Discipline Inspection Committee 2017 Report], available at http://www.ccdi.gov.cn/toutiao/201801/t20180110_161529.html; 中央纪委国家监委通报 2018 年 [Central Discipline Inspection Committee and National Supervisory Commission 2018 Report], available at http://www.ccdi.gov.cn/toutiao/201901/t20190108_186570.html. Procuratorate: 最高人民检察院工作报告 [Work Report of the Supreme People’s Procuratorate], various years, available at <http://www.spp.gov.cn/spp/gzxx/index.shtml>. Peoples Courts: 最高人民法院公报 [Work Report of the Supreme People’s Court], various years, available at <http://gongbao.court.gov.cn/>.

In part, the rise in the number of disciplinary investigations conducted by disciplinary-supervision agencies was a result of vigorous enforcement of newly promulgated Eight-point Regulation.⁴ According to the CDIC, the number of party members investigated for excessive banqueting, spending public money on personal travel, using official vehicles for private travel, accepting improper gifts, seeking unjustified reimbursements, and putting on extravagant weddings and funerals rose from 30,426 in 2013, the year in which the regulation was promulgated, to 70,807 in 2014. In total, between 2013 and 2018, over 223,000 party members were sanctioned for violating the regulation.

⁴ The Eight-point Regulation actually reiterated earlier prohibitions. According to the new rules, for example, official banquets were to be limited to “four dishes and a soup.” In 1989, nearly a quarter of a century before the Eight-point Regulation was enacted, the State Council had in fact mandated that official banquets be limited to “one bowl of soup and four other dishes.” Ann Scott Tyson, “Chinese Criticize Lavish Feasting,” *Christian Science Monitor*, 1/4/1990.

Disciplinary actions linked to the Eight-point Regulation, however, likely only accounted for a fifth of the increase in disciplinary investigations.⁵ Given the more modest increase in criminal indictments and trials for corruption-related offenses, an increasingly wide gap between disciplinary investigation and criminal prosecutions opened up as the crackdown proceeded. These data thus suggest that much of the fury of the supervisory agency's crackdown has been focused on non-criminal disciplinary offenses by party members and state functionaries.

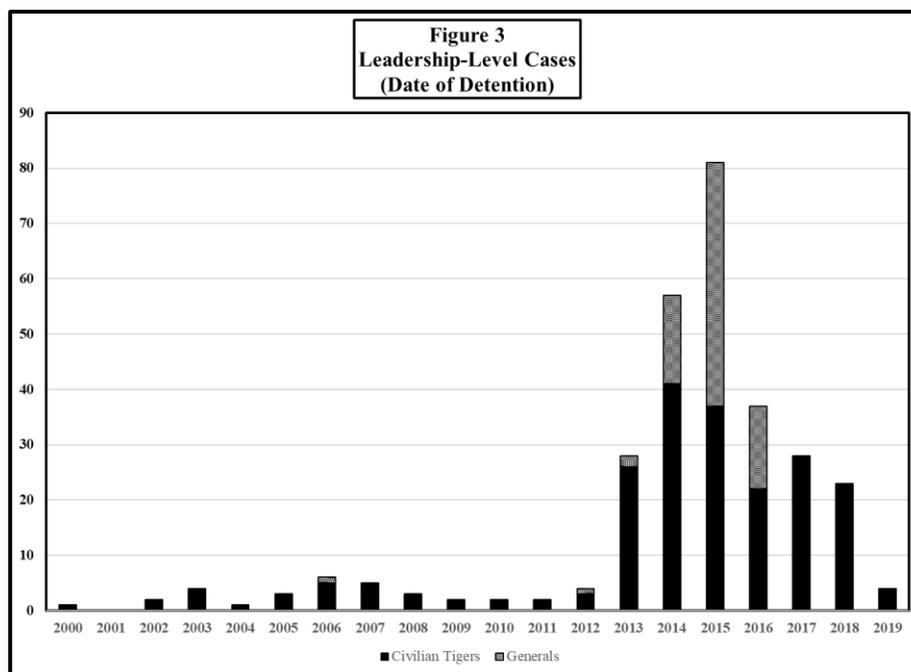
The modest overall increases in the number of criminal indictments and trials, almost all of which would result in convictions, masked dramatic increases in the attack on high-level corruption. Whereas the number of indictments for rank-and-file officials increased from 44,453 in 2012 to a peak of 50,444 in 2014, the number of indictment for senior officials at the county-department levels rose from 2,396 in 2012 to a peak of 4,568 in 2015, an 80% increase (see Figure 2). The number of senior officials at the prefectural-bureau levels increased more than four-fold from 179 in 2012 to a peak of 769 in 2015. The number of senior officials at the provincial-ministerial levels, finally, increased over eight-fold from just five in 2012 to forty-one in 2015. As a result, whereas that crackdown may have led to a surge in disciplinary investigations but not criminal indictments of ordinary officials, it resulted in a surge in criminal prosecutions of senior officials.



Source: 最高人民检察院工作报告 [Work Report of the Supreme People's Procuratorate], various years, available at <http://www.spp.gov.cn/spp/gzxx/index.shtml>.

⁵ If the number of disciplinary investigations had remained at approximately the annual average for 2007 to 2011, the crackdown would have resulted in approximately 1.5 million additional investigations between 2012 and 2018. Given that the Supervisory Commission reported investigating 270,000 violations of the Eight-point Regulations, then approximately 1.2 million, 80%, of the increase, was independent of the new restrictions on official extravagance.

The attack on high-level corruption was, in fact what sets Xi’s crackdown off from previous anti-corruption drives. Whereas press reports document a total of 30 cases involving officials at or above the vice-ministerial and vice gubernatorial levels between 2000 and 2011, between 2012 and January 2019, 184 senior officials – which the Chinese press calls “tigers” – were charged with corruption-related offenses.⁶ During those same time periods, whereas one military officer (People’s Liberation Army Navy Admiral Wang Shouye) was convicted of corruption prior to 2012, since then 78 officers holding ranks of major general and above have either been charged with corruption or were reportedly sidelined after allegation of corruption were leveled against them. Although the number of civilian tigers “bagged” peaked at 41 in 2014, thereafter the number of senior civilian officials charged with corruption has remained considerably higher than compared to the period prior to the current crackdown (see Figure 3). The announcement that four senior officials have been charged with corruption during the first month of 2019 suggests that the tiger hunt is far from over. The attack on corruption in the senior ranks of the military, by contrast, appears to have been limited to the period 2012-2015.



Source: Author’s database.

In sum, the available data suggest that the crackdown on violations of disciplinary regulations, and official extravagance begun when Xi Jinping assumed power in the fall of 2012 continues unabated as of early 2019. Criminal prosecutions of state officials and party cadres, however, peaked in 2015 and as of the end of 2017, the last year for which data on indictments by the Procuratorate and trials by the People’s Courts were available. At the time of this writing, it appeared that the overall intensity of the crackdown was beginning to wind down, with the possible exception of the

⁶ Counts of the number of tigers bagged and the number of provincial/ministerial officials indicted different because some of the tigers remain under investigation by the Supervisory Commission and have not been remanded to the Procuratorate for a criminal investigation.

attack on corruption within the most senior ranks of the party-state apparatus where investigators and prosecutors continue to “bag” new “tigers.”

A Crushing Tide?

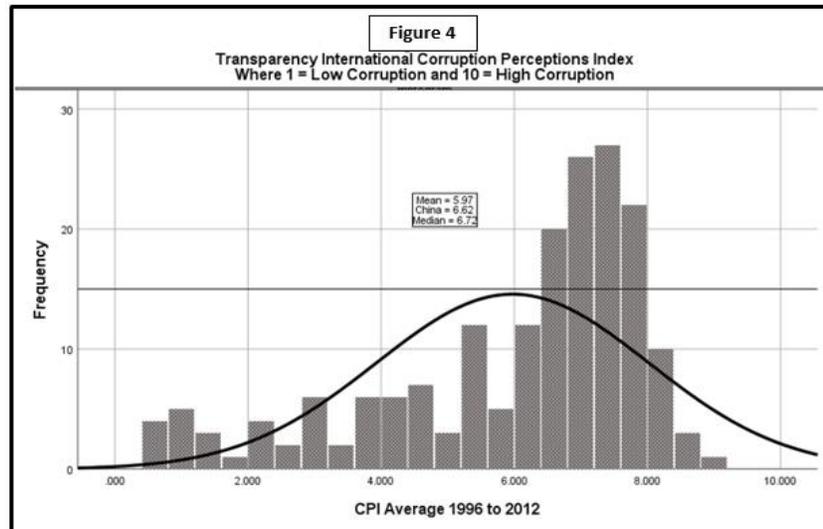
Although the data cited in the previous section may demonstrate that Xi’s call for a new crackdown on corruption did result in significantly more officials and party cadres being investigated for disciplinary violations and charged with corruption, these data per se do not demonstrate that the crackdown has significantly reduced the level of corruption in contemporary China. In abstract, of course, the “body count” data cited above imply that at a minimum the crackdown has taken out large numbers of corrupt officials and cadres. Absent data on the total number of corruption officials and cadres, however, it is impossible to tell if the crackdown has actually reduced the overall number corrupt officials or deterred others from turning corrupt and hence replacing those who have been taken down. In short, although the data show that the revealed rate of corruption (the number of officials charged with corruption) rose significantly, a rise in the reveal rate of corruption does not demonstrate that the actual rate of corruption (the total number of officials engaged in corruption) has changed.

It is important to note, however, that external assessors have not rated China as extremely corrupt. It is true, of course, that back in 1995 and 1995 China was ranked the fifth and then the sixth most corrupt county on Transparency International’s Corruption Perceptions Index (CPI). Early iterations of the CPI, however, did not include many of the countries in Sub-Saharan Africa and the former Soviet Union. As more countries were incorporated into the index, China’s ranking “improved” considerably.⁷

Moreover, rankings merely indicated where in “the line” a particular state stands. The better measure of a state’s degree of corruption relative to others is its score and its place in the distribution of scores. Analysis of the distribution of CPI scores reveals that the distribution has a negative skew, with the result that the mean (average) deviates from the median (the mid-point). China, as it turns out, was actually close to the median (see Figure 4). As a result, half of the countries listed in the CPI were more corrupt than China. In addition, China’s CPI score had decreased from 7.57 in 1995 to 6.10 in 2012, the year in which the crackdown began.⁸ Since 2012, China score rose in 2014 and 2015 but fell to 5.90 in 2017, with the result that China scored as slightly less corrupt in 2017 than it did in 2012. The 2018 CPI, however, increased China score to 6.10, moving it back to its pre-crackdown level.

⁷ In 2008, the CPI ranked China as the 102nd most corrupt county out of the 173 included in the index.

⁸ Originally, scores in the CPI range from one to 10, with 10 equating to low corruption and one to high corruption. Because I think this counterintuitive, I have reversed the scores such that 10 equates to high corruption and one to low corruption. TI later changed to a 100-point scale but retained the same order from low corruption equal to 100 to high 10.



Source: Based on data from Transparency International, “Corruption Perceptions Index,” various years, available at <https://www.transparency.org/research/cpi/overview>.

As a drive against corruption, it seems likely that Xi’s crackdown has yielded positives results. At a minimum, it has culled large numbers of corrupt officials and has likely cowed other corrupt officials, leading them to stop accepting bribes and stealing public monies, at least so long as the “heat is on” and they fear getting caught and punished. If these officials begin to sense that the crackdown has run its course and the things are “getting back to normal,” they may begin to once again discount the risk of getting caught and revert to their corrupt ways. By the same token, amidst the sound and fury of the crackdown other officials who have not resorted to corruption may be scared off and keep their hands clean. But they too could turn corrupt if they sense they can “get away” with taking bribes and stealing public monies because “everybody else is doing the same thing.” Thus, if the crackdown has in fact reduced corruption, it is hard to determine if the reduction will prove permanent or if future increases in corruption will necessitate future crackdowns.

If the focus of Xi’s crackdown was high-level corruption, was the primary purpose of the campaign actually a political purge of his rivals, as has been frequently asserted? Absent hard evidence of Xi’s intent, the only way to determine if the real goal was to curb corruption or gain political advantage would be to focus on who the crackdown targeted.

Network analysis of the tigers reveals two central figures: former Politburo Standing Committee member Zhou Yongkang and former Director of the Central Committee’s General Office Ling Jihua. Zhou had served in a variety of senior posts, including Vice Minister for Petroleum, General Manager of the China National Petroleum Corporation, Secretary of the Sichuan Provincial Party Committee, Minister for State Land and Resources, Minister for Public Security, and Secretary of the Central Committee’s Politics and Law Commission. Ling was widely considered former General Secretary Hu Jintao’s right hand man. Zhou was due to retire from his official posts at the 17th Party Congress. Ling, on the other hand, was expected to be elected to the Politburo at the congress and become Hu’s eyes and ears after Hu retired.

In theory, Zhou and Ling might have been the leaders of factions opposed to Xi Jinping. Ling had the backing, it was argued, of the powerful “Youth League” faction which had risen to prominence under Hu, who had been secretary of the league in the 1980s. Zhou was said to be a protégé of

former General Secretary Jiang Zemin. Zhou was also said to have backed Bo Xilai in his bid for a seat on the Politburo Standing Committee. The assumption that Hu and Jiang opposed Xi seems questionable, however, because Xi must have received their endorsements when he was selected to become general secretary.

If Zhou and Ling were potential rivals, by the time of the 17th Party Congress both had been weakened. The arrest of Bo robbed Zhou of his entrée into the inner circle of power. Ling, on the other hand was politically crippled when his son Ling Gu plowed a \$300,000 Ferrari into a Beijing bridge abutment during the early hours of March 8, 2012, killing himself and seriously injuring two women passengers. An attempt to cover up the accident failed and reports about the crash and Ling Gu's death spread rapidly on the internet. Ling was quietly moved aside. At the 17th Party Congress he was not elected to the Politburo and was named to Director of the Central Committee's United Front Department.

Zhou was removed from his post as Secretary of the Politics and Law Committee in May 2012 and was put under investigation in July 2013 after extensive discussions among the current leadership in consultation with former general secretaries Jiang and Hu. While Zhou remained in limbo, party investigators began rounding up his former subordinates and colleagues. Ling was put under investigation in December 2014, after his brother Ling Zhengce, a senior official, in Shanxi province, had been arrested and charged with corruption in June 2014. Zhou, his wife Jia Xiaoye, and his son Zhou Bin were convicted of accepting bribes. Zhou received a life sentence. Other members of Zhou's family, were also charged with corruption. Ling and his wife Gu Liping were convicted of accepting bribes. Ling received a 12-year prison sentence.

Whether Zhou and Ling were political threats to Xi is not clear. For the most part, Zhou's "faction" consisted of his former secretaries and subordinates. Ling, on the other hand, was charged with accepting bribes from a variety of provincial leaders in return for Ling arranging their promotions. It is thus not clear if either Zhou or Ling headed political factions or were simply tied into networks of self-serving officials bound together in pursuit of illicit plunder. Regardless of whether Zhou or Ling were true political enemies, their arrests certainly afforded Xi the opportunity to take down a wide range of central and provincial leaders and replace them with his allies and loyalists.

The attack on corruption in the military is equally ambiguous. It appears that the arrest of Lieutenant General Gu Junshan exposed evidence that General Guo Boxiong and General Xu Caihou, both of whom were Vice Chairs of the Central Military Commission, the party-cum-state body that controls China military, had been collecting large bribes from officers seeking promotions and transfers. Both retired in November 2012. Xu was terminally ill at the time of his arrest and died before his court martial. Guo was sentenced to life in prison. Although Guo had held field commands in the past, he had been a headquarters staff officer since 1999. Xu had spent most of his career in the army as a political commissar and as part of the General Political Department staff. It thus is not clear that Guo and Xu were part of an anti-Xi bloc in the army or were possibly part of a coup plot.

The fall of Politburo member and Party Secretary of Chongqing Sun Zhengcai also does not appear to have been prompted by fears that Sun had become a political threat to Xi. Sun has been described as a protégé of former Premier Wen Jiabao and had been a subordinate of former Politburo member Jia Qingling. His membership in the Politburo was not, however, necessarily evidence of that he was a "force" with the party. On the contrary, Sun likely got a seat on the Politburo because he was party secretary of Chongqing, a provincial-level city that appears to command a seat on the

Politburo because of economic importance. Some had suggested that Sun might get elected to the Politburo Standing Committee at the 19th Party Congress and that because of his age (54 in 2017) he might be a potential successor to Xi at the 20th Party Congress in 2022. But aside from his age, there seems to have been little evidence that Sun was a major political player.

Ultimately, the main purpose of Xi's crackdown seems to have been to attack serious corruption among the party, state, and military leadership. As argued earlier, by the time Xi assumed the office of general secretary, there was strong evidence of serious high-level corruption. Moreover, there was public pressure for action against corruption. Public opinion polls conducted by Pew Research between, for example, showed that whereas 78% of those surveyed said corrupt officials were a moderately big or very big problem in 2008, fully 90% of those surveyed in 2014 held those views.

Consolidating the Gains

Whatever gains the now six-year old drive against corruption may have made, in the long-term the crackdown will only be successful if the regime can prevent corruption from resurging in the future. In broad terms, crackdowns are necessary because a regime's anti-corruption agencies and regulations have failed to routinely weed out corrupt officials and deter others from turning corrupt. If a crackdown is simply a finite burst of hyper-enforcement but is not accompanied by institutional changes, it is likely to have a transitory impact on the severity of corruption.

The Chinese regime has been incrementally strengthening the regulations barring corrupt acts and improving the effectiveness of its anti-corruption agencies since the late 1970s when the first criminal statutes on corruption were promulgated and the Central Discipline Inspection Commission and the Procuratorate were rebuilt after their near total destruction during the Cultural Revolution. In 1988, the Ministry for Supervision was created and tasked with investigating malfeasance by government officials. Because many government officials are also party members, the new ministry's jurisdiction frequently overlapped with the disciplinary commission. As a result, in 1993, the two merged. Under the system in place during the 1980s and 1990s, the combined disciplinary-supervisory agencies were responsible for conducting the initial investigation of a suspect. If they found evidence of wrongdoing, they could impose a combination of party and administrative sanctions ranging from warnings to expulsion from the party and dismissal from office. If evidence of criminal offenses was found, the suspect then had to be remanded to the Procuratorate which, after a secondary investigation, could indict the suspect and refer the case to the People's Court for a trial.

In order to increase efficiency, in 2017 the regime unveiled a plan to formally merge the disciplinary-supervisory agencies with the Procuratorate's Anti-corruption Bureau. According to the plan, the new National Supervisory Commission would be more efficient because the prosecutors from the Procuratorate would be an integral part of the investigation process, which would help ensure that evidence was gathered in manner that conformed to the criminal procedure law and would be admissible in court.⁹ As such, problems resulting from slipshod work by party investigators would not need to be re-investigated and "fixed" by the Procuratorate as was reportedly

⁹ Party investigators have been accused of using various "irregular" measures such as sleep deprivation and torture to force suspects to sign confessions even though confessions extracted by party investigators are not legally admissible in court.

the case when the two agencies operated separately. New regulations that accompanied the establishment of the supervisory commission also put new limits on how long a suspect could be detain before being formally charged and the used of “extreme” measures during interrogations. Prior to the establishment of the supervisory commission, the party issued new disciplinary regulations in the fall of 2015.¹⁰

At this juncture, it is not clear if the new unified supervisory commission system is more effective than the old divided disciplinary-supervisory and procuratorial systems. The institutional merger of the systems notwithstanding, the system remain divided between an investigatory system who authority rests on a combination of party statues and state regulations and a judicial system who authority results on law and statutes. There have also been suggestions that institutional tensions and biases continue to divide the staffs of the new supervisory commission.

A second area in which the Chinese authorities have tried to strengthen the regime’s anti-corruption efforts is in recovering corrupt officials who have fled overseas in hopes of escaping prosecution. In 2014, the Chinese government launched Operation Foxhunt aimed at recovering 100 fugitives. The following year, it announced a second push to capture fugitive officials named Operation Skynet. Between June 2014 and late 2018, operations Foxhunt and Skynet have managed to recover 1,063 fugitive officials.¹¹ Efforts to have fugitives extradited from a variety of countries, including the United States, have been hampered by the lack of a treaty that would enable China to request that fugitives be detained and deported. Not wishing to harbor fugitives, counties such as the United State have sought ways in which Chinese investigators might help build cases for deporting individuals suspected of having been involved in corruption in China. In general, that entails gathering evidence that the suspect either lied on their visa applications or illegally bought monies to the United States and hence committed crimes in the United States. Absent such evidence, American authorities cannot simply accepted evidence of crimes committed in China as the basis for sending a suspect back to China.

Conclusion

As of January 2019, it is not clear that Xi’s attack on corruption has produced a “crushing tide” or a “sweeping victory.” The crackdown certainly produced a surge in the number of party members and state officials investigated by the Discipline Inspection Commission and later the Supervisory Commission. In total between 2013 and 2018, the Supervisory Commission investigated 2.3 million party members, about 3% of the total membership. Upwards of 300,000 individuals have been indicted for corruption related offenses.¹² Most of those indicted were convicted and sentenced to prison. Nearly 250 individuals holding ranks at or above the level of vice minister or military ranks of general or above had been investigated for corruption.

Despite these numbers, it is unclear if Xi’s crackdown will make a difference in the long-term. In the immediate term the crackdown has likely taken out enough corrupt officials to make a difference. It is also likely that the crackdown has scared off some and driven others to stop taking bribes. But the crackdown has also reportedly led to a degree of bureaucratic paralysis because

¹⁰ “Full text of regulation of the China party’s ‘disciplinary action,’” *Xinhua* 8/26/2018.

¹¹ “Scores of fugitives returned,” *China Daily*, 1/25/2019.

¹² Herein I am assuming that the number of indictment will be approximately the same in 2018 as they were in 2017.

officials fear being accused of corruption. The popularity of the crackdown is also difficult to gauge. In its early days, the crackdown was clearly very popular. Citizens who sought to expose official corruption using social media, however, quickly found out themselves facing restrictions and penalties. The party thus made clear that the crackdown was a party affair and the public's role would be strictly limited to that of a passive audience. Many ordinary citizens have also grown cynical about corruption. They see officialdom as inherently corrupt and believe that those who get caught and punished are merely the "unlucky" and "unloved," the poor saps who lacked the friends in high places who could have protected them.

The lack of decisive victory is perhaps not surprising. The party has been fighting corruption for decades and its war on corruption is by necessity a protracted war. Corruption, moreover, is ultimately not controlled by crackdowns and arrests. Real victory comes from changing official ethics and codes of conduct. Anti-corruption crackdowns are thus actually a response to the prior failure of a regime's anti-corruption program. Although further analysis is needed, the evidence produced by Xi's 2012-2019 anti-corruption crackdown suggests that corruption worsened significantly in the years before he was named general secretary. Xi, in other words, has been fighting against the failure of his predecessors to take effective action to control corruption.

PANEL I QUESTION AND ANSWER

SENATOR GOODWIN: Thank you. We'll open up the questions with Commissioner Cleveland.

VICE CHAIRMAN CLEVELAND: Thank you all for appearing. It was compelling and helpful testimony.

I'd like to start with a basic, in terms of the concept of reform is constantly used, that term. And I think Mr. Blanchette in a Foreign Affairs article, you talked about the country needs a leader who can ram through reforms including property tax reform, budget discipline, and then deleveraging of local SOEs. That is one definition.

But I'm wonder if each of you could define or could we come to some common understanding of what reform means?

MR. BLANCHETTE: Just insert the word change. And that's what it means. It's value-neutral in the Chinese context.

And one of the problems we've had is we usually sort of ram it into a normative understanding of it where we envision China moving in a liberalizing direction.

But if you look at the broad history of how the term reform has been used, you can have reform that liberalizes. You can have reform that centralizes.

So I just use a value-neutral term of every -- anytime you hear the Chinese leadership talking about reform, just put in the word change.

VICE CHAIRMAN CLEVELAND: That's helpful.

MR. HEATH: If I can offer a refinement of that. I agree that when the Chinese use the term reform, we should not hear that through the lens of democracy, liberalization, and those things.

But I think more specifically when the Chinese say reform, what they are talking about, are changes in the structure of the economy and the political structure designed to lead the country to a point of being a rich, powerful country under Communist Party leadership.

So, when they say reform, what they're interested in is, what are the adjustments that need to be made in order for the Communist Party to remain in power, and to lead the country to be extremely powerful and wealthy.

DR. WEDEMAN: In the context of the anticorruption effort, a reform really refers to improving institutional ability to detect, punish, deter, and to deal with corruption. They've been working on this now for over three decades.

They came into the reform period with no criminal code. They had to write a criminal code. They had to develop the institutional capacity to investigate, try, and track corruption.

It's been incremental. I think the most recent reform in the form of the formation of the National Supervisory Commission isn't really much of a change at all. It's kind of moving one piece, you know, under the umbrella of several others.

So there is an effort on the part to reform their system in the sense to improve its institutional capability.

VICE CHAIRMAN CLEVELAND: Okay. Thank you. I think Mr. Heath, you mentioned that they -- in your testimony, that Beijing faces a low risk of open defiance to Xi's authority. And Mr. Wedeman, you talked about in the context of anticorruption activities that there's been some evidence of a purge of political rivals.

I'm curious as to what your assessment is of the risk of silencing all opposition. And I can't remember, one of you may have mentioned it. But, you know, nobody's willing to stand up

and say, the emperor has no clothes.

Does the very fact that there are fewer critics, create a new or different kind of a risk for Xi?

MR. HEATH: It does. I would first off, point out that the purge of the military is not extensive and all-inclusive. It is very selective and very targeted.

There are certain echelons that Xi has been very reluctant to target. Such as the commanders of operational units. He's mostly targeted very senior generals who are in staff jobs. And those guys are easier to target and less risky.

But he has also sent a message that he has the right to -- that all the officers are under the gun. And they are all under threat of being arrested at any time.

So they get that message loud and clear. I agree with my colleague that intimidation is a great part of what Xi Jinping is doing.

He's not going to get all the corruption. But he can try to coerce, intimidate, as well as incentivize compliance while taking out some of the most egregious violators.

In terms of new dangers that this creates, certainly there is a risk that military advisors will be afraid to offend Xi Jinping by saying things he doesn't like to hear, and which -- and it gives Xi Jinping and his allies a reason to start looking into some commander.

So I think a lot of these commanders have an incentive to try and stay below the radar. To be very cautious in everything they say and advise. And be reluctant to cross the authorities for fear of their own political careers.

DR. WEDEMAN: Well, I would agree with Mr. Heath that the target -- that the military -- attack on corruption in the military has been very targeted.

What they've targeted is, the places you can really make money. Logistics and the political -- general political line. The latter, you make money by taking kickbacks. The former, you make money by basically selling commissions.

If you're selling commissions then obviously you're right. The operational officers are the customers. And they have not been gone after.

So, selective in that sense. It's hard to pin down whether there is a coherence or growing pushback against the anticorruption campaign. It would be pretty hard for someone to stand up and say well, you shouldn't attack the corrupt because -- because of what?

So I think he's managed to use that pretty effectively to establish himself as the paramount leader. Has he totally silenced all of the inner discussions? Well, we have no idea.

We don't know what goes on within the Politburo Standing Committee. We don't know if he just simply gives an agenda and says, here it is boys, you know, rubber stamp. Or do they actually have discussions.

We assume by looking at the outside of the black box that that's taking place. But we really don't, I think, at the end of the day, know what, you know, what is it.

Is he simply the first among equals? Is he double the first among equals? Just really don't know except for what we see in the kind of public arena. Thank you.

MR. BLANCHETTE: I'll just take a stab at Professor Wedeman's comment about us not knowing. Which is, of course, entirely true.

But my guess is going to be, as an organization moves to centralize power and install a leader who governs primarily based on using the tactic of fear over the sub -- the membership of that organization, it's less likely that people are speaking truth to power.

So I think to the crux of your question, I think China is moving pretty rapidly towards a garbage in, garbage out model of governance.

Wherein I think it's safe to assume given the sort of epistemic closure, which has enveloped Beijing, wherein independent media think tanks hearings such as this, which are public, where people can come and give their honest opinion about really important topics, is not occurring in Beijing.

So, to Professor Wedeman's point, we've got to take a big leap of faith and hope that within the halls of power in China that you've got some pretty robust cadres who are marching down the hall, knocking on Xi Jinping's door and saying, by the way, I think the Belt and Road Initiative is going catastrophically wrong. Let's pivot to something else.

And I'll take a stab that that's not happening. What is happening is you have a leader who is marching ahead resolutely, probably increasingly blind to the policy errors that are stacking up in Beijing right now.

SENATOR GOODWIN: Thank you. Senator Talent?

SENATOR TALENT: Thank you. This is really interesting. So, I have two questions. And I'll give them both to you. One is kind of broad based.

So, as I understand it, and the Party understands that it maintains its power through a combination of a perceived legitimacy among the public and coercion. Right, it's a balance.

And the legitimacy was based on the deal that they would deliver economic prosperity. And also in part on appeals to Chinese nationalism. You know, the recovery from the century and a half of weakness, et cetera.

So, one of the things I'm wondering, because the economy is slowing. I personally think it's slowing more than they're admitting. And they're facing a lot of challenges.

So, I'm wondering if part of this is less Xi than just they all -- the leadership understands, you have to step up the coercion because the time when they can, you know, claim legitimacy based on, you know, continued stratospheric economic growth, is disappearing.

So, I'd like your opinion on that. And then the other is, we had an interesting article in our briefing book the staff gave us, from the China Leadership Monitor by Minxin Pei, who described the episode last summer, where he said, from his view was that Xi was dealing with a real problem. That there was a lot of internal opposition. He was able at their leadership conference in the fall to suppress it.

You know, but his theory is that this is surfacing in the Chinese way. By what people are not saying, by expressions of support that they're not offering.

And I just want to know if you have a view of that? Thank you. I'll await your answers for any of you who what to address it.

MR. HEATH: I'll offer to start. And I'll certainly welcome my colleagues to weigh in.

Regarding the CCP rule, I think you put it well. There is an aspect of legitimacy through appeal to nationalism. And economic prosperity an increase in the standard of living is how I characterize it. And then there's the coercion element.

Certainly it has been the case that the Chinese have greatly increased the spending on internal security. So the coercion has definitely been going up.

They spend more on internal security than they do on the military. That's been true since 2011. And the spending continues to grow. I don't know the latest figure of how much that gap has grown, but I imagine it continues -- it's still considerable.

So there is definitely the coercion aspect. Not to mention all the technologies that the Chinese are rolling out to increase surveillance, and monitoring other people. Very repressive.

I think in terms of the urgent -- the legitimacy, the prosperity aspect, I think this underscores the urgency with which Beijing is facing this challenge of carrying out the structural

adjustments to put the economy on a sustainable footing.

And the political problem with that is too many elite, you know, Party members and patrons and their patronage networks benefit off of doing business the old way, which is continuing production of totally unnecessary industries, et cetera, et cetera, and they have an incentive to resist any changes that will remove their power and their money. So, I think their -- a large part of the core of opposition to what Xi Jinping is doing that you mentioned in your second question.

So, I don't doubt that there is intense opposition. A lot of these people are enormously wealthy and a lot of them are extremely well-connected. They have large bases of support. And they have no intention of giving that up.

Now you don't have view Xi Jinping as an altruistic man. He's a very, you know, egomaniac guy who cares about making China rich and powerful, and destroying everybody who gets in the way of his personal power and his vision.

But I think it's, in my view there is a clash between the vision that Xi Jinping has, and his allies, about how to make China rich and powerful. Which means destroying the livelihoods of a lot of elite and powerful people in China. And then a lot of elite and powerful people in China who disagree with that who think that's not the way to do things that would make China rich. And they resist that vision.

And I think that tension is probably going to remain in China, if not grow.

MR. BLANCHETTE: Just a couple of quick answers to really good questions. On the first question of regime legitimacy, I think we've tended to over emphasize the simplicity of the legitimacy story to the Chinese people.

Right, so we for most of the reform and opening period phrased it as this unspoken social compact where the Party will deliver economic growth. And the Chinese people in turn will choose to sit out politics. Which was never quite as neat as the reality turned out to be.

But I think a better way to think about it is there's a legitimacy meter. And there's a bunch of dials. And on these you have economic growth, you have nationalism, you have international prestige, you have management of U.S.-China relations, you've got the Party's historical narrative of its ability to have delivered sovereignty and independence from colonial powers. And the Party's always been adjusting these depending on the circumstances.

So, after 1989 with the Tiananmen Square massacre and the collapse of the Soviet Union, it took the nationalist dial and it turned it up a little bit. As it did the economic growth dial.

And so now we're seeing a readjustment of that. Because as you say, there's hard cold realities of economic growth coming back down from the stratosphere.

So you can't lean on that as much as you might have. And so we're seeing turning up the dial on sort of narratives of national greatness, prestige, international prestige, strong powers.

So, that's to your first question, is, I think the dials are certainly being readjusted.

SENATOR TALENT: So that might be happening whether it was Xi or somebody else.

MR. BLANCHETTE: Totally. And in fact I think the dials were adjusted after the global financial crisis in 2008.

SENATOR TALENT: Right.

MR. BLANCHETTE: The Beijing Olympics in 2008. You saw a readjustment of the dials.

Frankly, the leaks by Edward Snowden, which spooked the national security state, turned up national security as one of the dials that we can sort of stop hostile forces from infiltrating our country and mucking around in our political system.

On the second question of elite pushback, I actually think we've overestimated the extent to which Xi Jinping was in the hot seat last summer.

This is one of the things where we tend to look at visible manifestations of grumbling as some sort of, you know, target on Xi Jinping's back.

But I think to Tim's testimony here, what really matters to Xi Jinping is where are the guns and who's in control of them?

And you can have a great amount of grumbling on the streets and in public and in elite salons and in publications where people are criticizing Xi Jinping.

But if you know you've got the security services and the military on your side, you can take a lot of public flak.

And so you remember, if we go back to that summer, there was just a series of press reporting on how Xi Jinping's position was really tenuous. And he was going out to the summer conclave at Beidaihe where all the Party elite and Party elders gather every summer. And there were even rumors that they were going to -- that they were going to push him out of office.

What happens? He comes back in roaring in September. I mean, September 6, I think he's on the front page of the People's Daily. Forty-six times he's mentioned in it. Which is a way of saying, "Screw you. I'm back."

So, I think it's important we distinguish grumbling. Which is what we've seen a lot of as he's made a series of missteps from actual organized opposition.

And what Xi Jinping has done quite effectively is make it very hard to coalesce opposition. There's a big collective action problem right now in China, because you're very likely to be found out.

And in fact, another way we can look at Xi Jinping's first term is that he essentially coup-proofed his position. And I think the bar now for organizational opposition is just stratospherically high.

DR. WEDEMAN: I have two responses to the question. First, we look at the slowing of growth as a major negative that basically people are reading the quarterly statistics and, as they fall, they're becoming less and less enchanted with the Party. I think the problem is more the fading of the memory of the bad times.

If you look at people like people of my age, or the age of some of the others in here, they remember what the Cultural Revolution was like, they remember what the Great Leap Forward was like and they, in their minds, can do the compare and contrast between where we are today and where we were before.

And even if that growth rate begins to diminish and their income doesn't keep going up like it's been, they still look back. They're basically the Depression era in the United States where anything was better than the 1920s and '30s.

The problem is their kids and their grandkids. The kids who grew up in the '90s, the kids who grew up in the 2000s, they don't remember the bad times. The bad times are what grandpa talks about over New Year's dinner.

We see this problem also in Taiwan and in Hong Kong. Expectations are falling. It's the younger generation.

You could pump up growth to about seven or eight, nine percent and those people still might not be buying it.

So, I think there's a larger problem beyond just the slowing of the economy which we know is partly inevitable.

As to the second question, I think Xi Jinping, the leadership and the Party in general has a

much bigger problem.

When the reform process started, there were no rich people in China. Reform produced an awful lot of rich people, and what they face is how do we work out the relationship between power and money; because power and money in China are connected by blood, by marriage, by old-school ties.

Well, wealth and power in the United States and elsewhere is connected in the same ways. We know how to regulate it somewhat imperfectly, it's not as well as we probably should, but we know what the relationship should be. In China, that's not the case.

And what the Communist Party is trying -- is really, in a macro term, grappling with is how do we transition to a plutocracy; in other words, a system where the wealthy exert considerable political influence.

Obviously, Xi Jinping is attacking the robber barons, the crooks and so forth within the emerging plutocracy, but ultimately he's got to figure out a way, or his successor, to regulate that relationship because he can't survive with the rich, the rich can't survive without him, and the economy will not grow unless the two can figure out how to interact in a less overtly corrupt manner than they do at the present. Thank you.

SENATOR GOODWIN: Thank you.

Commissioner Kamphausen.

COMMISSIONER KAMPHAUSEN: Thank you all for a very stimulating panel. I have two questions.

The first is a variation of this how does the developments of central -- increasing centralization of political control and the anticorruption campaign, how do they manifest themselves in challenges for Xi?

I think you've addressed the elite level risks or challenges that he might consider. I'd invite your comment about the risks that he faces when he considers how the Chinese people think about these twin developments.

I had a fascinating discussion with a senior American political leader last fall, and I shared some of these developments about centralization and anticorruption campaign, and his immediate judgment was Xi has created -- or he has made himself the single point of failure in all matters related to Chinese domestic life.

So, I'd invite your comment about the scenarios in which that might present challenges for him apart from the elite politics level that you've already addressed.

And then, secondly, very specifically for Mr. Heath, I'm intrigued by your judgment and your conclusion that centralization -- increased centralized control of the Chinese military might introduce unpredictable escalation possibilities.

Heretofore, our concern has been, from the U.S. defense establishment, that incidents would occur that were essentially sanctioned by lower-level commanders and that the center, the top, was not witting of those developments and, thus, could distance themselves from them in the aftermath.

Your comment suggests that -- if I hear you correctly, and I invite your comment -- that the risk -- that risk is diminishing and that the new risk is that the center might direct lower-level units to actually engage in brinkmanship, and your point is that can escalate in unknown ways.

I'd like you to play that out a little bit and think about what are the second and third order effects on the part of the Chinese military high command that would precipitate a crisis believing that it could manage the aftermath in ways that didn't result in really high-level escalation.

Thank you.

MR. HEATH: Great questions, Roy, and let me take the first one briefly.

I think the opposition to Xi Jinping is mainly concentrated, in my view, among the elites who have the most to lose with what Xi is trying to achieve.

All the available data we have suggests that Xi Jinping is personally very popular among the people. I think the Communist Party, according to Gallup and Pew and Western polls, the CCP and Xi Jinping have approval ratings in the 80s or 90 percent area.

And I think -- I don't think that's just -- I don't think that's fake news, so to speak. I think there's a reason for that.

One, I think the -- he's a politically savvy operator. He's done some very effective propaganda portraying himself as a man of the people. So, there's a propaganda aspect.

The political aspect, popularity with anticorruption resonates, but also his agenda, in many ways, would open opportunities for a lot of the people in terms of making the economy more efficient and opening opportunities for workers, service workers, professionals, you know.

There is -- if he's able -- you know, the whole welfare state agenda where he's trying to expand welfare benefits, this is all part of the vision of making China's economy more balanced, less dependent on exports and more of a consumer-driven economy.

So, the consumer, which is mainly working people, would -- if these changes go through, would benefit. And so, they have incentive to support him.

In terms of the escalation risk, I agree. I think, in the past, we have mainly been concerned -- as a person who's observed the security developments in the theater, you know, the main view has been that there's a risk that local commanders could act on their own.

And one of the stabilizing features of those scenarios, however frightening they may be if some local commander, you know, whatever he does, is if Beijing doesn't support what he's doing, the escalation potential is very low because at a certain point he's going to run out of his authority and Beijing most likely will try to squash the situation or somehow get control of it.

Now, there are two or three things that made me think this risk could be evolving. First, deteriorating relations between the U.S. and China gives Beijing an incentive to start looking for other cards to play, especially as we continue to face a standoff in our trade relations and the rest of senior Chinese officials like Huawei's Meng.

So, the deterioration of U.S.-China relations provides Beijing an incentive to think about what cards they can play.

And, two, this centralization of power increasingly removes that fig leaf where the Chinese can claim, well, we have no idea of what local commanders are doing.

They are making institutional organizational changes to enable Beijing to monitor or direct or control, you know, even maritime law enforcement officials.

You have that reorganization which is facilitating centralized control. You have small groups that are looking just at maritime issues that there are -- there's the National Security Commission that, in theory, has some oversight.

So, the Chinese are removing, themselves, some of the fig leaves that allow them to pretend not to know what's going on and I think that they are having more visibility in what the commanders are doing.

Plus, the commanders are more afraid of doing highly risky behavior that antagonizes and enrages Beijing because they're already under the gun with anticorruption.

I think the odds that local commanders will act on their own to provoke something with the U.S. is much lower, partly out of this fear of Beijing and missteps, and partly because of these organizational reforms.

Now, to play that out, what would happen? Suppose Beijing decides they want to send a message to the U.S. that, you know, freedom of navigation operations are fundamentally -- need to stop near the artificial islands.

I could see Beijing directing the PLA to plan and come up with some kind of scenario where they position -- they direct the PLA to position certain forces near the artificial islands, and then they direct the Coast Guard to do something like ram, collide or otherwise harm a U.S. survey ship and cause real casualties.

And if the U.S. moves in grey hulls to try to stabilize the situation, the Chinese have already anticipated that and immediately they have grey hulls on hand as well.

And they've already prepared the messaging campaign about what they're willing to do to defend themselves and have essentially preplanned how they're going to respond when Americans show up on the scene with military hardware.

So, I think these kind of scenarios, in my view, are dangerous. We don't have evidence that, you know, Beijing is actually doing this, but I think there is a growing risk that that could be a possibility.

DR. WEDEMAN: On the side of what do the ordinary -- what does the man in the street think about Xi Jinping, I think -- I agree he's pretty popular.

He's projected an image of a kind of man of the people forcefully attacking the vested interest, the corrupt, the crooks, et cetera.

Early on, the campaign clearly was very popular. People tried to jump in. They were posting things on the internet exposing corrupt officials. Hide your watches, that was a big thing that they would post, et cetera.

That effort got slapped down very quickly and it was made clear that the people -- this is not a campaign in the Maoist sense. This is an anti-corruption crackdown. The public's role is that of an audience.

Now, the thing about -- that Xi has been very successful at, is he's hunted all of these tigers, he's taken down a former member of the Standing Committee, he's taken down five members of the Politburo, he's taken down governors, ministers, Party secretaries, et cetera.

So, on one level, you know, he's putting these pelts up on the side of Zhongnanhai and he looks pretty tough.

We're now six years in. He's still hunting tigers. They've just recently nailed the first -- the Party Secretary of Shaanxi. It looks like there are a whole bunch of tigers that were connected to him that are about to be bagged as well.

It's great to bag a lot of tigers. But after a while don't you begin to wonder, he's got 184, how many more are out there?

And then, of course, the suspicion becomes how many Xi Jinping tigers are out there that he's actually protecting?

So, there's a, you know, there's a popular element to the crackdown, there's a real danger to it that over time he -- that people become very cynical.

On the other hand, he's got to keep hunting them because what if he calls it off, says everything is fine, and then we get a new scandal a la Bo Xilai erupt.

So for the ordinary Chinese going about their regular lives, I think we in the public -- you know, we who are involved in politics in the public sphere -- vastly overestimate how much they pay attention to these things, but they do pay attention and over time he could generate a popular backlash.

What happens if the public begins to grumble? Well, if they're relying increasingly on

the course of apparatus, it means people will grumble and complain, but they won't really have anywhere to go with those grumbling and complaints, and they'll get hardened and cynical and keep on living their ordinary lives and focusing on their families and income. Thank you.

SENATOR GOODWIN: Thank you.

Admiral McDevitt.

COMMISSIONER MCDEVITT: Thank you.

First, I'd like to congratulate the panelists. I thought your written testimony was excellent and your commentary has been equally good.

I have two questions. One for Mr. Blanchette. You were unequivocal in your written testimony that Xi Jinping intends to remain in power for life.

I'd like you to, if you would, explore that a little bit for me to explain why you've come to that conclusion other than perhaps your gut just tells you that's a -- and everybody in China seems to be saying that.

And the other question I have is for Tim Heath and it relates to the question that Commissioner Kamphausen raised to you, this issue of everything is being controlled by Beijing.

The one thing -- you seem to have disenfranchised in your commentary the new theater commands that Xi Jinping broke lots of rice bowls to get established and what have you.

And you're implying, at least in the way you characterized it, that the theater commanders really don't have very much power at all and that, still, everything is going to be referred to Beijing, which would -- it strikes me as counterintuitive given all of the problems that were associated with creating that in the first place. So, if you could elaborate on that.

And, finally, just a thought on tiger hunting for Dr. Wedeman. I think from the point of view if you were thinking of this like a fighter pilot and you just want to put -- become a double ace and a triple ace and a quadruple ace and what have you, until there aren't any more tigers to hunt, I think he's going to keep hunting tigers.

MR. BLANCHETTE: Well, I guess the first reason I made that prediction is because I figured everyone would forget in five or ten years if I turned out to be wrong.

(Laughter.)

MR. BLANCHETTE: But if pushed to explain my reasoning, I think a problem we've had when we are looking at China's political system, is we've extrapolated from the wrong starting point.

And so for us we usually, in modern memory, think back to the post-Mao Era, specifically we think back to the sort of '89 and beyond era where China seemed to have come into sort of a more normal pattern of leadership succession.

The problem is that when you open up the hood and look more closely, it was far from normal.

And so, really in China's -- in the 95, 96-year history of the Communist Party of China, there's really only been one normal, clean leadership succession or handover in power, and that was from Hu Jintao to Xi Jinping.

And that was in 2012 where all three hats that the top leader wears, head of the Central Military Commission, Office of the Presidency and the General Secretaryship were all cleanly handed over.

Even in 2002 when Jiang Zemin handed over power to Hu Jintao, at the time Jiang Zemin was openly saying he wanted to stay on as head of the Central Military Commission for longer, which he did. He stayed on for an extra two years.

And he was even saying to some people before the leadership handover that he wanted to

stay on as general secretary.

Second is institutionally, there now is no institutional restraint on Xi Jinping's ability to stay in power forever.

There's nothing in the guidelines of the General Secretaryship, Central Military Commission and now, as of March of last year, on the Office of the Presidency when the only constitutional requirement of a two-term limit was removed by Xi Jinping, there's nothing keeping him from power -- staying in power forever.

So, there's nothing institutional there. It really will depend on his goodwill and what he wants to do with his time other than rule the country.

But I think more importantly if we just generalize more clearly from authoritarian systems with weak or nonexistent succession norms, it's always been the problem of command and control communist systems that the leader stays in power for too long.

This has been the problem with China where consistently, starting with Mao Zedong, if you were the number two or the guy in waiting, that was not a great position to be in because the current leader begins to mistrust the person that he has anointed.

This is called the crown prince dilemma where as soon as the crown anoints a prince to be the successor, that person now becomes a potential enemy.

So, we have a long string of individuals who throughout the Mao era and even afterwards were supposed to take over the top position who were eventually passed over or purged.

For the Soviet Union, the same problem existed. You either died in power, because you weren't going to give up the reigns, or you were purged like Khrushchev.

So, this is a more systemic problem in authoritarian political systems. And unless China has found a way to defy the laws of gravity, I think it's very unlikely that Xi Jinping will wake up one morning and decide he wants to step down.

And increasingly, and this is crucial, his -- the ability of external actors to push him from power, I think, will decrease as time goes on and his position in power solidifies.

MR. HEATH: Admiral, a very good question about theater commanders and a very good point of clarification.

I do not mean to imply that the theater commanders are powerless or irrelevant. On the contrary, I think they have been given a large array of responsibilities and are carrying out day-to-day management of a lot of these responsibilities.

It could be everything from managing day-to-day patrolling and exercises -- they have a lot of day-to-day missions that they can carry out without the need to consult Beijing.

However, I would argue that the reorganization that is underway that creates the theater commands also streamlines command and control up and down the chain between services, between all the maritime law enforcement agencies.

So, there is a tightening and a rationalizing of the command and control so that the theater commanders, I think, increasingly have visibility over what the various actors are doing in their command, which may not have been the case in the previous -- latest 2015 reorg when a lot of the maritime law enforcement actors in particular were largely operating unsynchronized, uncoordinated.

I think coordination is improving and the visibility by theater commanders is improving, and these new structures in place in Beijing allow Beijing to consult with theater commanders.

And when they pass guidance on, I need you to start thinking about coming up with some kind of, you know, plan, some kind of incident for political purposes, I think the theater commanders with these reforms underway are better positioned to calibrate what kind of, you

know, scenario Beijing wants compared to in the past when the command system was much fragmented, fractured and dispersed and it was harder for the military region commanders to coordinate with his forces.

SENATOR GOODWIN: Doctor, I'm sorry, we're getting a little tight on time and still have a handful of commissioners that want to get their questions in, so let's move on to Commissioner Wessel.

COMMISSIONER WESSEL: Thank you to our witnesses and chair, vice chair and staff for putting together a great panel.

I'm looking at this somewhat through the lens of what's on the front page or the front section of our newspapers everyday about trade conflicts, but what each of you is describing here, which are the underlying issues that go to the challenges and opportunities we and other nations face with China, are the underlying continuity here.

It seems to me that trade is, and the current U.S.-China issues, are somewhat of a distraction. They are -- President Xi is treating them as only one item or one inbox on his desk and that what each of you is talking about are going to be continuous issues that we're going to continue to face that are really going to be the challenges whether it affects the Uighurs, whether it affects military challenges in the regions -- China's geopolitical posture. So, help me.

Do you see current events having any impact on the trajectory of reform change of being more than a distraction?

Would you like to see more in terms of a broader engagement by the U.S. and others to address, if possible, any of the underlying issues that each of you has talked about?

Mr. Blanchette, do you want to start?

MR. BLANCHETTE: Will current events have an impact on -- how will current events have an impact on China's domestic and reform agenda, I think, is a question that we have been asking about China certainly for four decades, oftentimes overemphasizing the extent to which we can impact or affect what happens in China.

So, as a starting point for me, I usually assume that all politics is local and China's domestic agenda is, by and large, based on realities on the ground in China of which certainly the external environment is an important input or player.

That being said, I think this year is likely to be different. I think if you're Xi Jinping and you're looking out into 2019, it's the, quote, complicated external environment, as Xi Jinping called it in a January speech, that is likely to dominate a lot of your thinking this year.

I think given China's own domestic slowdown, which the Party has been calling the new normal for some time now, which is driven by structural changes, a productivity crisis, you're looking down the barrel of a demographic crisis, and just the normalcy of not having double-digit growth rates, begins to take on a more concerning -- becomes a more concerning threat vector when the Party increasingly understands that of the many economic levers that it can pull to affect the growth trajectory, market and investor sentiment is not one of them.

And so, we've seen repeatedly over the past couple of years as the slowdown continues, it's really when there's a ramp-up in concern by investors and businesses about investment that China really gets -- becomes quite concerned.

Everything that we've heard so far this year is that the U.S.-China frictions which are -- I think more importantly than calling them trade frictions, it's the investment restrictions that the United States is placing, and will be placing, on Chinese investments that are going to be very concerning, are likely to really dominate, I think, a lot of the discussion this year because they're seen as amplifying, intensifying the already existing slowdown, but in a way that the Party can't

quite see what the off-ramp is.

Add to this, you've got tensions on the Korean peninsula, you know. We've got the just-announced meeting at the end of February between Donald Trump and Kim Jong Un, two leaders not known for their predictability, from the Party standpoint as an ultraconservative organization in the traditional sense of the word, this makes for a very worrying year, so I suspect external events are going to have a big impact.

The question is, and this is where I'm going to punt because I have no idea, is how are reform agents within the system likely to be able to ju-jitsu these external complications in a way that bends China's reform trajectory back in a direction that we'd all like to see?

A recurrent pattern throughout the past four decades is you can use external events like China's accession into the WTO, for example, as a way to intensify the reform agenda.

You point to external things and say, we've got to change internally if we want to be able to face that external challenge.

I hope that that's the case that reform agents will be able to do it; but I think given Xi Jinping's real strong, professed belief in state capitalism, I think we're unlikely to see the reform that we want to see.

COMMISSIONER WESSEL: And, again, when you -- it was, I believe, Commissioner Cleveland's question about what does reform mean. Now, when you're using the word reform --

MR. BLANCHETTE: The good kind.

COMMISSIONER WESSEL: -- I hear improvement rather than, you know, a change to solidify and enhance the power of President Xi and the Party, which appears to be under every structure. You talked about the increase to, I think, 73 percent for Party cells, et cetera, the strengthening of state as part of the economy.

It seems, again, that we're talking more of a distraction and a speed bump than we are a significant event in terms of our bilateral relations to inject the kind of reform that we want.

Is that -- Mr. Heath, do you have a view on that?

MR. HEATH: I concur. I think that's the way to put it. I have nothing further to add.

COMMISSIONER WESSEL: Okay.

MR. HEATH: And I'm aware that we're limited in time, so I defer to my colleague if he has anything else.

DR. WEDEMAN: To the extent that corruption comes up as an issue between the U.S. and China, it's in the context that the Chinese believe that there are large numbers of Chinese officials who have fled to the U.S. and/or have hidden money in the U.S.

Our tenuous or our tense relationship with them doesn't do anything to improve that. They feel we're not being cooperative because we won't deport these people.

The people that actually work on the anti-corruption effort actually understand that well, there's no extradition treaty, there's not going to be an extradition treaty, so the way to get these people is to help the U.S. prove -- U.S. authorities prove these people lied on their visas or brought illegal money.

That means they have to be forthcoming in terms of showing us information that often they don't want to show us or not bringing a document from the Party discipline inspection commission that the Americans think has probably been beaten out of some suspect and is not going to hold up in an immigration court.

If our relationship improves with them, maybe they'll be less suspicious of us, but the barrier is basically there.

There's no mechanism for us to turn around to deport someone because they committed

crimes in China. They have to have committed a crime here. Thank you.

SENATOR GOODWIN: Thank you.

Chairman Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you. Thank you all for very interesting testimony.

Usually I try to do a question that will cross all of you and I can't say that I have one this time. But if you have anything you want to add on any of the questions for each of you, I'd appreciate it.

And Dr. Wedeman, you actually preempted me on some of the questions because I was wondering if there was any evidence that any of the anticorruption has reduced corruption in Xi Jinping's inner circle.

But I have a bigger question there which is several of you have talked about sort of the role of the richest elites as a force within China, but so many of them seem to have managed to get money out of the country, have real estate if not in the United States, in Canada or the UK or other places.

And I just wonder how much of a force are they if it's perceived or seems like some of them have a safety valve of leaving, you know, their kids are in school someplace else, some of them have dual citizenship and they have one foot out the door?

I mean, how much of an influence are they if everybody knows, well, yeah, they can get out if they need to. That's one.

Mr. Blanchette, first I want to note your acknowledgment of the Tiananmen Square massacre. Of course we've got the 30th anniversary coming up, which is just kind of astonishing.

And the Party has still not acknowledged what happened then, so sort of the, what are they so afraid of?

But I also, on a separate track, you had mentioned the increase in Party cells in companies, and I wish -- I hope you can just give us a little bit more information or go through that again.

And then, Mr. Heath, you specifically mentioned the militarization of the PAP and note the impact, of course, in Tibet and Xinjiang, but it's got impact to other places.

There's a new political and legal work directive and I think a lot of us have had any skepticism that China has an independent judiciary system, but this certainly is codifying the fact that they don't.

And I wondered if you, or anybody else, could talk a little bit about what you think the impact of that on American companies is going to be -- American companies and American citizens. All right. On that note, that's a lot.

DR. WEDEMAN: Well, the problem of having people -- of people being able to stash money abroad is fairly extensive.

How much money is flowed out, we don't know. How much of the money that flows out of China flows back in, in a process called round-tripping.

The Chinese have grown increasingly suspicious of individuals, whether they're Party members, government officials, business executives, whose children are living abroad, whose wife has gotten Canadian or Australian citizenship.

Most of them have had their passports taken away. If you've got to go on a trip, you got to go get permission. They want to know where you're going, why you're going, et cetera, you know, you have to get out of China -- you can get your money out of China, but it doesn't do you any good if you can't get out of China, but it's a big problem.

The problem with the inner circle is also there. We don't know how corrupt the inner circle is.

Early on, there was a story about Xi Jinping's sister and her husband, very wealthy individuals. He made his money in rare earths.

It's a little hard to figure out if Xi Jinping had anything to do with that or was this guy just really smart and foresaw that down the road the demand for rare earth would grow exponentially with the advent of electric cars, et cetera.

What we're told is Xi told them to sell off their assets, put the money in the bank, live off the interest.

His daughter is, you know, a minor government official. She's been told to keep out of the spotlight.

Beyond that, your guess is as good as mine, but, you know, certainly if people started fleeing in large numbers, that would be a sign that he was in real trouble.

And so, of course, as I said earlier, he's got to figure out a way to work out this relationship because he needs those people, he needs their talent and he needs to have a stable relationship between power and money, and I don't think he's -- I don't think anyone has quite figured that out in China. Thank you.

MR. HEATH: On the issue of the rich elites, I do not deny that there is capital flight going on, there are people who are afraid for their lives and leaving the country; but, in my assessment, that's a small number of people.

Whenever you see the Chinese growth rates of six percent or seven percent, you have to remember the way that they are growing at that rate is by relying on these often corrupt and rich elites to lend money at an unprofitable rate to industries that are not needed or to chair up, you know, various other economically nonviable ways of keeping people employed and keeping the pockets lined of SOEs, state-owned enterprises, and their backers in local government or in the ministries.

So, there are many powerful SOEs who are also benefitting from Xi Jinping's prioritization of SOEs in his economic strategy. They have very little incentive to make their business actually efficient and competitive. They will simply keep taking the money and operating at a loss because they know that they're not going to be accountable.

So, there are still powerful people who are profiting off of economically nonviable ways of running the economy.

Again, it underscores the urgency of the need for China, if they really want to grow on a sustainable basis, to right size their economy, wean themselves off of these SOEs and unproductive industries and make their economy more efficient.

The way you do that, you're going to have to eliminate a lot of these banks, a lot of these SOEs, put a lot of these guys out of power.

They don't want that to happen, and they have been very successful in resisting efforts by Beijing to knock a lot of these guys out. The people that have fled is, I think, a small percentage.

On your question of the militarization of the PAP politicization of the legal system, I think there is a tension in China between a recognition by Beijing that if they are going to right size this economy and make it more balanced, they need to have institutions that are more efficient at adjudicating, you know, legal disputes, for example, and contracts and less clearly slanted to all these cronies who are gaming the system for their own benefit.

And on the other hand, if they go too far towards making those institutions, they will threaten the livelihoods of these crony politicians who will resist or flee or do other things to

destabilize, that could have destabilizing effects.

So far what we've seen is the progress towards building these institutions and a more fair -- it's not going to be nonpolitical, it's going to be always a political legal system, but they could at least make it more fair.

There is some progress, but it's very incremental and there's frequently, you know, pushback and resistance by, you know, cronies who have a lot to lose if a fair system really comes into play.

MR. BLANCHETTE: Just quickly on the issue of Party organizations, which in and of itself deserves an entire hearing, it's a really fascinating subject, just quickly it's -- I think it's best to frame this as the function of Party organizations is about the Party members rather than the Party cell trying to co-opt, control, direct a company.

Any organization in China that has three or more Party members must have a formal Party cell, a baseball team, a church, an SOE, you name it.

So, this is not about targeting companies, per se, but nonetheless, over the past three years especially we've seen a market growth in the number of Party cells partly because Xi Jinping, with the help of CCDI, is now just formally demanding that people implement what's on the books.

The question moving forward with -- having dealt with this quite frequently in my day job, is we're seeing a real wide spectrum of how these Party organizations are behaving.

Some of them are sleepy little affairs where once a week, you know, the three or four Party members will sit in a boring conference room and watch a propaganda video. But on the other end of the spectrum, if you have an active Party secretary of that Party cell, we've seen these do some much more nefarious activities.

So, this is definitely something to watch more closely, crucially because the Party has no idea where this is going.

This is sort of a million experiments going on right now as the Party charts this course forward trying to keep up with and adapt to a really innovative domestic economy and global environment. The Party has never been in this situation before.

CHAIRMAN BARTHOLOMEW: Thank you.

SENATOR GOODWIN: Commissioner Lewis.

COMMISSIONER LEWIS: Thank you.

I'd like to raise the issue of public policy in China, both domestic policy and foreign policy, as it relates to corruption and as it relates to the struggles for leadership.

Are there any instances that any of you are aware of where corruption has influenced domestic public policy in China?

And are there any instances, that you're aware of, where corruption has caused the Chinese to influence public policy in other places?

And then finally, has the differences in public policy, both domestic and foreign, has it had any impact on the struggle for leadership in China?

DR. WEDEMAN: Well, corruption, by and large, is basically about gaming policy, figuring out how to profit from the loopholes and the differences, et cetera.

Almost every case is an example of someone gaming public policy, so it influences, I suppose not the actual writing of policy, but rather the way it gets implemented.

Has it influenced the leadership succession? Very hard to say. I think I give a different view about Xi Jinping for life.

My view -- well, not my view. The alternative view is under the system that evolved in

the '90s, your first term in office you auditioned potential heirs. You picked a couple, three, you put them into the Politburo Standing Committee.

In your second term, they competed against each other to figure out who would be one and two. Then, you were replaced.

My sense is that what -- or a sense would be that Xi Jinping came into power, spent five years auditioning members of what the Chinese would call the sixth generation, and he could not find anybody who was clean enough, competent enough and a good enough leader.

And so, what he's done now is he's basically gone back and said, okay, we're going to have a second round of auditions and we're going to look to the seventh generation. We're going to skip the sixth. It's too dirty.

There would be -- that would be the biggest impact I see that, in fact, it was corruption that prevented him from leaving after two terms.

I think he's playing a long game and I think he understand the way you play the long game is not to be Mao and stay in office until you're dead, it's to be Deng and to basically manipulate not only your succession, but the next one after that.

That way he would have, under the two-term scenario, gotten about 20 years of being able to control the leadership.

I think he's going to stay on for a third to groom his heir, and then I think, you know, he'll step back and then go to the process of picking his heir's heirs for his heirs. Thank you.

MR. BLANCHETTE: This is the expert, so I hesitate to say anything about corruption in his presence.

All I'll say on the question of elite leadership politics is that more often than not a corruption charge is the proximate cause for felling a leader where we know the ultimate cause is a much deeper issue about -- that oftentimes we can't understand, but it's almost always that a leader comes down for issues of corruption.

This happened with Bo Xilai, the Party Secretary of Chongqing, but obviously what little we know about the instance, it wasn't -- being corrupt was necessary, but not sufficient. There are deeper causes behind why these officials are coming down.

So, in that sense, there's an intimate linkage between leadership politics and corruption.

COMMISSIONER LEWIS: Are there any instances, that you know of, where any of the Chinese officials have been accused of changing policies because of corruption?

MR. HEATH: I think there is, at the local level, plenty of evidence where corrupt government officials simply don't implement what Beijing tells them the policy is or subverts it or otherwise disregards it.

Implementation of policy has frequently been a problem in China. It's one reason why Hu Jintao essentially failed to do similar-type reform or changes -- structural changes.

He had a similar vision of right-sizing the economy, balancing the economy and officials routinely, mainly often because of corruption and all the benefits they're accruing through the cronyistic arrangements they had, simply disregarded the directives from Beijing and refused to implement them.

A lot of that is still going on, you know. Where we're seeing the imbalances in the economy, there's plenty of evidence that officials are simply disregarding or refusing to cooperate or refusing to implement.

So I think the main way corruption affects public policy, in my view, is that it enables or incentivizes officials to subvert or disregard or otherwise undermine efforts by Beijing to, you know, fix serious economic problems.

COMMISSIONER LEWIS: Thank you.

How about in the foreign policy sphere?

MR. HEATH: Well, in the foreign policy sphere, I would say corruption is a big part of the Belt and Road Initiative.

There's plenty of, you know, circumstantial evidence, and some indirect reporting, that a lot of these infrastructure deals that are landed in, especially, parts of Africa, Southeast Asia, South Asia, are accompanied by a lot of corruption, backdoor buying of projects, buying of influence, influence peddling, things like that.

It's very much a part of the way of how the Chinese are operating, especially in regard to Belt and Road.

DR. WEDEMAN: If you want an example, there is a case right now in Shaanxi, which is out in Western China, in which a great number of luxury villas were built in a nature reserve.

Xi Jinping ordered them demolished eight times. They have still not all been demolished.

There's -- I mean, eight times the president calls you up and -- or the general secretary calls you up and says, demolish those buildings, and you don't do it. I'd say that's a pretty good example of how corruption has influenced the process.

Belt and Road, again, I mean, that -- any infrastructure project that's got a lot of money involved with it generates a lot of corruption. That's true almost nationwide.

And Belt and Road simply is a kind of huge pot, just like high-speed rail was in China and other projects as well. I mean, it's bound to generate a surge in corruption.

SENATOR GOODWIN: Gentlemen, thank you for your time. Great testimony. Very enlightening.

We will take a 10-minute break and start our second panel at quarter after. Thank you.

(Whereupon, the above-entitled matter went off the record at 11:04 a.m. and resumed at 11:17 a.m.)

PANEL II INTRODUCTION BY SENATOR JAMES M. TALENT

SENATOR TALENT: All right. Welcome to our second panel. We have a great group of experts. I'll introduce them now.

First, we'll hear from Michael Hirson, China and Northeast Asia Practice Head at the Eurasia Group.

Mr. Hirson leads the Eurasia Group's coverage of China with a focus on China's macroeconomic and financial policies, economic reforms and political developments affecting foreign firms and investors.

Previously he served at the U.S. Treasury -- or as the U.S. Treasury Department's Chief Representative in Beijing. He will discuss the risks and benefits of China's state-led economic policies.

And then we're going to hear from Nicholas Borst, Vice President and Director of China Research at Seafarer Capital Partners, an investment advisor, focused on emerging markets.

Previously, he was a senior analyst at the Federal Reserve in San Francisco covering financial and economic developments in greater China. He will discuss China's economic and financial sector vulnerabilities.

And then, finally, we'll hear from Greg Levesque, managing director at Pointe Bello, a research and strategy firm focused on global markets.

Previously, he served as the lead consultant on China at the Crumpton Group and as the business advisory services manager at the U.S.-China Business Council. He will provide testimony on China's defense industry challenges and reliance on foreign technology.

So, each of you will be addressing different subjects. But as you've just seen, if you were here for the first panel, we'll ask questions about all kinds of things and expect all of you to answer.

(Laughter.)

SENATOR TALENT: Thank you very much for your testimony. I do want to remind you to keep your remarks to seven minutes and, Mr. Hirson, we'll begin with you.

OPENING STATEMENT OF MICHAEL HIRSON, PRACTICE HEAD, CHINA AND NORTHEAST ASIA, EURASIA GROUP

MR. HIRSON: Thank you very much. It's a great honor to be here for this hearing.

The topic that I was asked to address is China's state capitalism and how it impacts the domestic challenges that are the overall topic of this panel, which is, namely, how Beijing is dealing with slowing growth and technological dependency.

Now, it's a very timely moment to be talking about state capitalism. These issues really lie at the heart of current US trade and technology disputes with China.

Internationally, we see growing blowback against aspects of China's state capitalism really in different markets, but in particular in developed countries, not just in the U.S., but also Europe.

And then, finally, within China there's an increasingly active debate about the state of the private sector, the role of industrial policies and really how all this ties into the challenges that China faces from slowing growth, high rates of leverage and economic rebalancing.

So first, let me just define what we're talking about in terms of state capitalism, and then I'll talk about some of the key issues.

China is not a state-controlled or really even a state-led economy, but state capitalism does play a critical role and it continues to evolve.

We're talking about two main aspects here; the role of state-owned enterprises, and then the role of industrial policies.

And by industrial policies, I mean the government using administrative decisions, direct and indirect subsidies and other tools to pick winners and to actively shape industry development.

So starting with SOEs, state-owned enterprises account for no more than a third of China's economy today, but they do dominate a number of key sectors, in particular those that Beijing views as providing sort of the strategic backbone of the economy and providing key inputs. So that would be energy, metals and other parts of heavy industry, infrastructure, telecoms and several others.

SOEs, very importantly, are less efficient than private firms. However, they receive a disproportionate share of credit and other resources in China's economy, and this is posing significant challenge for deleveraging and for rebalancing.

In the last several years, SOEs have seen something of a resurgence in China, and this is the result of some intentional and unintentional policies.

On the intentional side, Beijing is promoting a pattern of industry consolidation that favors the large SOEs and the strategic industries getting larger.

The unintentional policies really come from the financial derisking campaign where China has been choking off areas of shadow banking that do represent systemic financial risks. That's a positive.

The negative is that those channels have also been key sources of financing for private firms which are finding it very difficult to obtain credit.

Now in terms of top-down industrial policies, these are becoming, I would say, more ambitious under Xi Jinping, certainly.

And here, I think we can point to two key policies that have been at the heart of U.S.-China disputes. One is the Made in China 2025 program; the other is a very large fund that seeks to promote China's role in semiconductors.

These aim to make China competitive in strategically important sectors, but there is a very key imperative here of reducing China's reliance on foreign technology, in particular, the U.S.

And thus, these increasingly represent import substitution schemes from China, and that's what makes them so thorny as a trade issue.

So, let's think a bit about what impact state capitalism has on China's economy. I think the bottom line is that state capitalism is probably detracting from China's growth and rebalancing.

As I said, SOEs receive a disproportionate share of credit and other resources, but they are less efficient from private firms.

And so, this is creating persistent problems in terms of how quickly China can reduce its debt levels and it also ties up resources in lower productivity firms and sectors, which is lowering China's potential growth rate.

This is not to say that these economic challenges are necessarily going to motivate a real change in state capitalism anytime soon, in part, because the political logic for China's leaders remains quite strong.

SOEs, in particular, represent a way of maintaining control for the Party over key resources and they're also a source of stability.

China frequently relies on SOEs to stimulate the economy as it did in the aftermath of the global financial crisis, when it unleashed a massive infrastructure campaign that was funded by state-owned banks and largely executed by SOEs.

Another key issue very relevant to the topic is whether or not state capitalism actually promotes innovation in China; is it accomplishing these goals of reducing China's technological dependency.

The bottom line here, is that I think the evidence in China and cross country would suggest that industrial policies are a quite costly way, and often ineffective way, of promoting innovation.

Especially as you get closer to the frontier of technology, areas like AI and quantum computing, which China is increasingly focused on, it's less clear that the government can really pick winners in these areas.

And there is a significant amount of evidence that the way that China promotes innovation through subsidies, for example, is subject to high levels of political distortions which lowers its efficiency in promoting innovation.

So, none of this is to say that China will not become increasingly sophisticated and become a true innovation leader -- I think it's already headed that way -- but it's the result not so much of industrial policies, but more of the bottom-up innovation that's taking place in China's economy.

So, let me just speak to a few key policy implications in terms of the U.S. in particular.

I think, clearly, state capitalism creates an unlevel playing field for U.S. firms -- I give the Trump administration credit for focusing on state capitalism as the source of some of the key technology and trade disputes that we have -- but there are also some very important indirect effects.

One is the fact that state capitalism is increasingly leading to growing investment in trade barriers, not only the U.S., but Europe, and these might be quite appropriate responses, but they also create the risk of unintended consequences and barriers to free trade and investment.

State capitalism is also leading to questions about the legitimacy of the WTO in dealing

with this challenge, and I think there would be a major risk to the U.S. if we see legitimacy and effectiveness of the WTO really called into question.

In terms of policy responses on the U.S. side and thinking about state capitalism, this is a big topic, but let me just offer a few quick thoughts.

One is, I think that the U.S. needs to be spending more time working in a multilateral fashion to address state capitalism and less reliant on tariffs as one of the key policy tools here. And really, the issue here is the sustainability of policy.

I do not think that tariffs are going to be, over the long term, an effective way of compelling changes in China's economy, whereas working through the WTO, working through trade agreements, provide a much more comprehensive way of changing the playing field and leveling it in ways that advantage the U.S.

In terms of domestic policy, my concern is that as we deal with China's state capitalism, we are somewhat ironically conducting industrial policy without calling it that.

So, the decisions that we're making on tariffs, on investment restrictions, on export controls really amount to quite significant intervention in the U.S. economy.

I am not saying that those are not appropriate, but I don't know that we're really having the debate necessary to ensure that those policies are effective and, in particular, to tie those in with policies that look to promote innovation within the U.S. domestic economy.

So my fear is that we're going to take actions, including through tariffs, that could hurt U.S. economic competitiveness without the follow-through necessary to really address the fundamental challenge in the state capitalism from China.

So, let me stop there. I'm sure we'll have an active question and answer session. Thank you.

**PREPARED STATEMENT OF MICHAEL HIRSON, PRACTICE HEAD, CHINA AND
NORTHEAST ASIA, EURASIA GROUP**

State Capitalism and the Evolution of “China, Inc.”: Key Policy Issues for the United States
Testimony before the U.S.-China Economic and Security Review Commission on
“China’s Internal and External Challenges”

February 7, 2019

Michael Hirson¹

I. Introduction

This is a particularly timely moment to examine China’s state capitalism. Issues posed by this aspect of China’s economic model are at the heart of current US trade and technology disputes with China, as well as growing pushback against Chinese investment from other trading partners. Within China, there is a heated debate over the environment for domestic private firms, who continue to face systemic disadvantages competing against less efficient but politically powerful state-owned enterprises (SOEs). Such concerns are taking on a new urgency as China deals with slowing growth and the steep challenges of debt deleveraging and economic rebalancing.

This paper first outlines China’s evolving model of state capitalism, placing it in the context of China’s economic reforms and the priorities of the current leadership. A key emerging trend is that with Xi Jinping’s emphasis on strengthening Communist Party control over the corporate sector, China’s state capitalism is morphing further into a mode that can be termed “party capitalism.” The paper then discusses the role of state capitalism in China’s economic rebalancing and efforts to promote innovation. It concludes with a discussion of the implications for the United States and global trading system, and related recommendations for the United States and for Congress.

This is not a comprehensive treatment of the topic, which is enormously complex, or an academic work. The intent is to highlight the key policy issues posed by China’s unique model of state capitalism, while capturing nuances of a topic often prone to exaggerated claims (positive and negative).

II. A brief overview of state capitalism in China

What do we mean by state capitalism in China? For the purposes of this paper, it refers to the role of SOEs, as well as government policies that take an active role in shaping industries and “picking winners” among specific firms and technologies.

¹ All views expressed here are those of the author, not of his employer.

State capitalism in China is not static. Since the start of the reform period in the late 1970s, China's hybrid economic model has continually evolved, with major shifts in the role of the state. SOEs have gone from accounting for four-fifths of China's output at the start of the reform period to roughly one-fifth today. Private enterprise represents the most dynamic part of China's economy, contributing most output and employment and accounting for China's most innovative companies.

But the state still plays a pervasive role in the economy, especially the "commanding heights" of strategically important sectors. SOE's control roughly 40% of industrial assets in China. This share partly reflects the dominance of SOEs in capital-intensive industries such as oil and gas, heavy industry and telecoms, which are still largely off-limits to private and foreign firms. State-owned banks dominate the banking system, and while they are increasingly commercially minded, they represent an important lever for the state to direct capital to favored sectors or initiatives.

The role of SOEs has evolved substantially through successive waves of SOE reform. During the late 1990s, Premier Zhu Rongji oversaw a massive restructuring of the SOE sector, with many failing firms closed or merged, and the government imposing tighter financial discipline ("hard budget constraints") on surviving firms. Under Xi Jinping, Beijing is focused on further consolidating the 96 mostly industrial SOEs owned by the central government into global champions, keeping them under firm political control while taking modest steps to improve their commercial orientation. There is more flexibility towards the many thousand of SOEs owned by local governments, which are less strategic in nature; Beijing is encouraging local governments to close money-losing local SOEs (so-called "zombie companies"), which local officials protect as a source of employment and tax revenue.

Aside from state-owned enterprises, the government and Communist Party play an active role in guiding sector-based industrial policies, both at the central and local levels. Tools for such intervention include regulatory actions (e.g. approvals for investment projects), price controls, direct subsidies and indirect subsidies (e.g. discounted access to bank loans, land, and energy). The extent and effectiveness of these industrial policies vary -- many have been failures, with China's success coming despite government intervention. China's industrial policies can have an enormous impact on global markets; measures to promote industries such as steel, aluminum, and solar photovoltaics (PVs), including through subsidized credit policies, have helped China massively expand global market share, but also created overcapacity that has depressed global prices and created problems for China's economy, as well.

Such outcomes are a reminder that China's industrial policies, in planning and especially in implementation, are the product of heavy internal politicking among key stakeholders -- different central government ministries, industry associations, SOEs, private firms, and local officials. When policy moves down to the local level for implementation, local officials will try to shape it according to their own incentives, leading to effects that are often far different from the leadership's intentions. Local officials seek to advantage their local firms and demonstrate that they are carrying out the leadership's objectives, resulting in a common phenomenon of duplicative and wasteful investment in sectors that Beijing has signaled are priorities.

In its industrial policy orientation, China is partly carrying on the planning legacy of the socialist era, but much more so the course set by governments in Japan, South Korea, and Taiwan during their "catch-up" periods of rapid industrialization. A common feature of this model is the government's active role channeling resources to favored companies or sectors, effectively "picking winners" among competing firms and industries to spur rapid industrialization and create large companies capable of competing

internationally. China has a larger role for the state sector than was the case in either of its three main predecessors; on the other hand, by some measures it is today a considerably more open economy than Japan was in its high-growth phase.

A unique feature of China's state capitalism is the complicated role of the Communist Party. As a political organization with more than 80 million members, the party sits above China's government but has a reach that extends far beyond it, into private firms and other institutions in Chinese society. The party can exercise control over economic policy and influence the behavior of firms -- for example, encouraging a bank to provide financial support to a key initiative -- through political rather than formal administrative channels. The party's role in China's economy is strengthening under Xi Jinping, while that of the government is weakening, a trend that can be termed "party capitalism."

In sum, China is not a centrally planned economy or even "state-led" economy. But state capitalism remains a key feature of the economy: SOEs play a strategically important role in many sectors, and officials at various levels are often deeply involved in shaping industry development and guiding economic outcomes through direct administrative intervention, political influence and other means.

III. Recent trends in China's state capitalism

a. "The state advances, the private sector retreats"

Since 2013, and especially since 2015, SOEs have experienced a resurgence relative to the private sector, reversing the long-term trend since the start of the reform period². Growth in output and investment by SOEs has outstripped that of private firms in recent years. Bank credit has been flowing mainly to SOEs, which received 83% of new bank loans in 2016 (the private sector received just 11%), compared to a share of only 35% in 2013³. Reflecting their greater ease of access to capital, many SOEs have taken stakes in listed private firms, especially in the last year; while many of these transactions represent bailouts for ailing private firms, some Chinese commentators fear "re-nationalization." Importantly, all the above trends are taking place even though SOEs remain less efficient than private firms.

The renewed momentum of the state sector reflects a mix of intentional policies and unintended consequences, including:

- **An SOE-friendly approach to industrial consolidation.** Xi's "supply-side structural reforms," launched in late 2015, are an effort to modernize the production side of China's economy and reduce symptoms of wasted or inefficient investment: industrial overcapacity, high leverage, excess inventory (including in real estate), and pollution. In practice, Beijing prefers large, centrally owned SOEs to be responsible for securing and supplying basic commodities and strategically important inputs, including energy, metals, chemicals, grains, and shipping. Thus, Beijing has engineered a number of mega-mergers between the central SOEs in these fields. Further, as Beijing has sought to reduce excess capacity in sectors such as coal, steel and

² For the most comprehensive treatment of this issue, see Nicholas Lardy, *The State Strikes Back: The End of Economic Reform in China?* (Washington, D.C.: Peterson Institute for International Economics, 2019)

³ Nicholas Lardy, "The State Strikes Back: The End of Economic Reform in China?," accessed February 4, 2019, <https://piie.com/system/files/documents/lardy20190128ppt.pdf>

aluminum, it has encouraged the largest players (typically SOEs) to acquire smaller firms (often private). These mergers often have the aim of creating industrial giants that are even larger in scale and at least theoretically more competitive; however, further bulking up sprawling SOEs could well lower their productivity and increase their market power at the expense of the private firms that operate downstream from them.

- **China’s financial de-risking campaign**, launched in late 2016, has taken an even larger toll on private firms but with much less intention. The campaign has focused on shutting down channels of “shadow finance” in China, meaning “wealth management products” and other unregulated or opaque investment vehicles sold by banks and other financial institutions. The problem is that these same channels, while a potential source of systemic financial risk, are also a key channel of financing for private firms and especially SMEs. Banks have long preferred to lend to SOEs rather than private firms, especially in their formal loan books, since SOEs enjoy an implicit government guarantee; even if an SOE does default, the professional and political consequences for the loan officer are less serious than in the case of private firm. China’s regulators are now using political pressure and a bevy of new financial instruments to try to encourage banks to lend more to private firms, but banks are especially afraid to do so in a climate of slowing growth and trade tensions with the United States (private firms account for most of China’s exports).

The troubles faced by the private sector, especially in obtaining finance, have led to an increasingly loud chorus of alarm from entrepreneurs and economists that “the state is advancing while the private sector retreats,” a reversal of a credo from earlier in the reform period. After many months of relative inaction, China’s leadership realized in October that this state of affairs was weighing on business confidence amid a sharp slowdown in growth. Xi has recently made a number of high-profile statements in support of the private sector, and government agencies have unveiled a host of new measures and proposals to boost access to credit and lower costs (including through tax cuts). Beijing has also pledged to put private firms on a more level playing field with SOEs in areas such as regulatory treatment and legal protections. But there are no signs yet that Beijing is contemplating the legal and political reforms this would likely entail, including greater political independence for regulators and the court system.

b. Party Capitalism and the next evolution of “China, Inc.”

The most significant political development in China under Xi Jinping has been the strengthening of party control across all major institutions in China. This was the dominant theme of the 19th Party Congress in October 2017, which kicked off Xi’s second five-year term as China’s leader. Xi’s address to the Congress contained a key line that was also added to the CCP constitution: “Government, military, society and schools, north, south, east and west — the party is the leader of all.”

Party control has major implications for China’s state capitalism, and is playing out in two main ways:

First, tighter party control over the corporate sector. All SOEs have long been required to have party committees, but their role was often more about political education of party members than key

business decisions. Since a wave of party building that began in late 2015⁴, and an amendment to the CCP's constitution in November 2017, SOEs must now ensure that the party committee is consulted on major issues⁵. The party committee is not a "shadow" decision-making body, in that senior managers are already party members. Instead, the significance is to formalize the importance of the party's direction, such as adhering to rules against corruption. SOE executives face serious consequences if they fail to carry out key party objectives. Their career trajectories will suffer, since the party's organization department decides key personnel moves within SOEs. And for serious infractions they face discipline from the party's anti-corruption body.

A wave of party building is also taking place in private firms, especially in the aftermath of the 19th Party Congress, though their function is not as formalized as in SOEs, and the CCP's constitution does not specify a management or governance function⁶. Many private firms are advertising their party activities primarily to show ideological correctness. Tech companies have been particularly keen to send this message, especially as Beijing has cracked down on what it considers to be politically or morally incorrect content in video games, video streaming, and other forms of online content.

Party building is also impacting some foreign firms in China. Chinese joint venture partners (especially in the case of SOEs) are increasingly requiring amendments to corporate charters to elevate the role of the party committee in the JVs decision-making⁷.

Second, the formalized role of party decision-making bodies, rather than government ministries and the State Council (cabinet), as the primary locus of economic policymaking. While the party has typically set economic policy at the highest level, under Xi Jinping the party has come to dominate policy formulation and even implementation, at the expense of the broader government bureaucracy. A key example here is the transformation of several of the party's "central leading groups" overseeing economic policy into more formal "central commissions" in March 2018. This streamlining has allowed Xi to more effectively shape policy but comes with the downside of policies that haven't necessarily been well-vetted by the bureaucracy. Beijing has also been using the anti-corruption campaign as a tool to force officials to comply with key policy directives. This has improved enforcement, including over initiatives such as environmental protection and financial deleveraging, but has also led to "over-shooting" as officials take draconian measures for fear of punishment.

With tighter political control, some room for modest economic liberalization

By having all players in China's system hew to the CCP's line, the leadership aims to channel all resources to accomplish strategic priorities -- whether those are economic (such as controlling financial risks, reducing excess capacity, and toughening environment protections) or political/geopolitical (such as combatting corruption, ensuring ideological correctness, and promoting the Belt and Road Initiative and other efforts to expanding China's influence abroad). Indeed, China's firms and other traditionally less political players in the system (such as universities) are increasingly quickly to promote their efforts to

⁴ See "CCP central committee and State Council's Guidelines on Deepening Reforms in SOEs" (in Chinese), August 24, 2015 : http://www.xinhuanet.com/politics/2015-09/13/c_1116547305.htm

⁵ Jake Laband, "Fact Sheet: Communist Party Groups in Foreign Companies in China," *China Business Review*, May 31, 2018, <https://www.chinabusinessreview.com/fact-sheet-communist-party-groups-in-foreign-companies-in-china/>

⁶ Laband

⁷ Laband

back priority initiatives such as Belt and Road and Xi's poverty alleviation campaign and to stress their ideological correctness.

However, it would be misleading to characterize this trend as a return to central planning. From a practical perspective, Party control creates the political conditions for Beijing to -- at least in theory -- create more room for the private sector and to reduce administrative control over SOEs.

Xi Jinping's greatest aspiration for the economy, other than ensuring basic stability, is turning China into an innovation superpower. This is important to Beijing not only for purely economic reasons, but also for national security (reducing reliance on the US for critical technologies) and military competitiveness. It is not lost on Beijing that China's private firms are more critical to this task than SOEs. Private players such as Huawei, Alibaba, Baidu and Tencent -- rather than state-owned behemoths like China Telecom -- represent China's "national champions" in next generation areas such as artificial intelligence and its applications. Ensuring effective political control over private firms provides Beijing with the comfort to work in increasingly close partnership with them. Indeed, the internet giants are becoming deeply embedded in aspects of China's economic and even governance infrastructure, from the payment system to inputs into China's social credit system.

This is not to say that private entrepreneurs are necessarily seeking out this tighter embrace, which can become suffocating, but they face a difficult balance act given the importance of keeping up strong ties with regulators and other government officials. It is also important to note that Beijing's embrace of strategically important private firms has not translated to broader efforts to level the playing field for private firms against the state sector, such as by removing the direct and indirect subsidies and political protections that SOEs enjoy.

When it comes to SOEs, Beijing is combining tighter party control over these firms with reduced administrative interference in their operations. This is an effort to improve the financial discipline and commercial orientation of SOEs while ensuring their fealty to Beijing's key priorities. Significantly, the wave of party building within SOEs began in late 2015, just as Beijing began moving ahead with modest reforms to SOEs' corporate governance. These include providing more leeway to SOEs to make personnel and compensation decisions without approval from SASAC, the state agency that supervises SOEs, as well as "mixed ownership reforms" that invite private firms to take stakes in SOEs and (at least in theory) bring greater market savvy to their decisions.

In sum, party capitalism represents something of a gamble. In theory, it allows Beijing to work in closer partnership with dynamic private firms, and improve the commercial orientation of SOEs, all while maintaining political control and ensuring that these firms support the leadership's strategic priorities.

Will it work? Much depends on whether Beijing takes a light or heavy touch to the degree of political control it imposes over firms. But there are reasons to think that even under this new approach, state capitalism will continue to suffer from some of its existing drawbacks -- namely, inefficiency and low productivity because of political distortions (see next section).

Even if current SOE reforms provide SOE executives with more professional management and greater independence, these executives know that they will be evaluated on political objectives such as support for the Belt and Road Initiative, which may trump measures based on financial performance. Moreover, unless China reduces the implicit government guarantee that SOEs enjoy, these firms will continue to

receive preferential access from China's credit system regardless of their financial performance, leading to continued misallocation of credit and capital.

The blurring of lines between state-controlled and private firms creates its own risks for the private sector. First, tighter political control over private firms could introduce *new distortions* in the behavior of these firms, much as we see with SOEs. Second, if political control is particularly aggressive, it could harm the confidence of private firms, who are already unsettled about the security of their property rights in China.

Finally, it risks exacerbating a growing trend in which private firms from China are increasingly viewed internationally as agents or potential agents of the Chinese state. This is one factor in the growing pushback against Chinese investment, particularly in Western countries. Increasingly, the perception is that the distinction between private companies and SOEs is meaningless.

Is this charge fair? In most contexts, private firms remain quite different from SOEs. They are profit-maximizing companies facing ruthless competition at home. But for cases involving national security -- such as reviewing a foreign investment in a sensitive technology -- it is hard for trading partners to completely dismiss the possibility that private firms are acting in part to accomplish China's strategic objectives. Such a judgement will often be wrong, but the bias towards suspicion is an unfortunate and inevitable byproduct of China's recent emphasis on party control over the private sector.

IV. Motivations of state capitalism: Costs and benefits for China

China practices its model of state capitalism for reasons that are a mix of political, economic, and geostrategic:

- **Rapid industrialization and modernization:** As noted above, the heavy hand of the state in China's industrial policies reflects the influence of Japan, Korea, and Taiwan during their "catch-up" periods of rapid industrialization. As with those states, China has used measures such as low-cost credit, protected markets, and a host of direct and indirect subsidies to promote favored firms and sectors. Given their close relationship to government ministries, SOEs have historically been the main recipients of these favorable policies.
- **Political and economic stability:** The state sector is a critical tool by which the CCP seeks to promote economic and political stability, the leadership's overriding concern. The most dramatic example came in the wake of the global financial crisis, when China launched its RMB 4 trillion (\$590 billion) stimulus package in November 2008. The stimulus relied on China's state control of the banking system to finance infrastructure projects, most of which were in turn undertaken by local government-owned SOEs. The spending package cushioned China's economic growth (and global demand) during the crisis as exports cratered. But its excesses also exacerbated the debt risks and problems with industrial capacity that China is now grappling with.
- **Securing vital resources and promoting China's influence abroad:** SOEs dominate strategically important sectors in China such as energy and heavy industry, where Beijing has sought to

groom national champions that have the scale and financial resources to compete internationally. SOEs, with their strong financial backing from banks and the government, are a key tool for China to acquire strategically important assets overseas, as well as to expand China's economic influence through high-profile investments in the Belt and Road Initiative.

How well has state capitalism actually worked for China? The country's economic achievements since the start of the reform period in 1979 have been remarkable, but economists debate the degree to which the various policies grouped under "state capitalism" contributed to this success. Most economists would agree that China's growth has been driven primarily by factors over which state capitalism had relatively little bearing, including: high-quality human capital (a starting point of high basic literacy, and then continued investments in education), a high savings rate (allowing China to finance long-term investments), and policies of liberalization/decentralization that have promoted entrepreneurship and gains in productivity (including mobility of labor from the countryside to urban areas). If there is one area where state intervention has played a key role in the growth model, it is in the use of state banks and state firms to finance and execute infrastructure construction. Infrastructure has generated significant benefits for China but is also a key factor behind an increasingly serious debt load.

From the standpoint of China's leaders, for whom political objectives matter as much as economic objectives, SOEs and top-down industrial policy have been a necessary part of the toolkit that China has used to secure its rapid growth without suffering from widespread economic or social instability or a diminution of the party's hold on power. The leadership views SOEs as essential arms and symbols of China's global influence, with 3 Chinese SOEs in the top five of the Fortune 500, and China as a whole -- again, mostly SOEs -- accounting for the second most firms on the list (120) behind the United States (126). While there is a significant debate in elite policy circles over the role SOEs should play in the economy, few in the leadership would suggest dramatically paring it back.

Is China's State Capitalism Sustainable?

China's economic growth suffers from major imbalances, including: high and rising levels of leverage; a continued reliance on investment as a growth driver, with consumption rising as a share of the economy but still below China's peers; and a slow transformation from a manufacturing-led economy to one driven by an efficient service sector. The state's heavy involvement in the economy is a key factor in these various imbalances:

- **High leverage and inefficient investment:** China's non-financial debt (260% of GDP) is among the highest in the world and has grown rapidly since the 2008-9 stimulus. Reducing this debt burden without a disruptive slowdown requires China to reduce the credit intensity of its growth -- that is, to require less credit to produce a unit of economic output. That, in turn, involves improving the allocation of credit and capital across the economy, of which state-owned enterprises represent perhaps the most significant challenge. SOEs are less efficient

than private firms⁸, but due to political distortions they receive an outsize share of credit from the banking system. The most serious corporate leverage problems are concentrated in SOEs⁹.

- **Over-investment and under consumption:** Money that goes to support SOEs through direct and indirect subsidies could be better channeled to uses that support greater household consumption -- in particular, a further expansion of China's still under-funded social safety net. One example of an indirect subsidy is the fact that SOEs retain a large portion of their profits rather than paying them out to their government shareholder, a dynamic that also contributes to SOEs' tendency towards over-investment. Beijing is forcing SOEs to pay out a greater share of dividends to the government budget, where they can fund much-needed social spending, but payout ratios are still below international norms.
- **Slowing productivity growth:** China's growth model, especially over the last ten years, has relied on mainly on increasing the capital stock (investment in infrastructure and manufacturing) and population growth, with a small and shrinking role for total factor productivity (TFP). Boosting the role of TFP will be vital, given that the other two main inputs to growth face serious headwinds: fixed investment is running into the constraints of high leverage, while China's working-age population has already started to decline in relative and absolute terms. Accelerating productivity gains will require channeling more resources away from SOEs to private firms, as well as breaking down the monopoly of SOEs in key sectors of the economy, especially in the highly protected services sector.

The longer China takes to resolve these imbalances, the more vulnerable it is to an external shock (such as another financial crisis) or internal shock (such as major downturn in the property market). While China's government likely has enough policy tools to avoid a hard-landing in the next several years, it is at significant risk over the medium term of entering a period of Japan-style stagnation, in which banks and corporates are encumbered by high levels of debt in the economy, and a lack of productivity gains saps potential growth.

State capitalism is likely significantly lowering China's potential growth. Nicholas Lardy estimates that "the deteriorating productivity of SOEs and the squeezing out of private investment is reducing China's growth by an estimated 1.6 to 2.0 percentage points annually."¹⁰ Similarly, the IMF estimates that China would boost its medium-term GDP growth by about 1 percentage point per year, relative to a baseline scenario, if it implements a reform agenda that features SOE reform and progress closing "zombie firms."¹¹

The political logic of state capitalism makes it unclear whether growing economic pressures would be enough to drive major reform. In the late 1990s, China pushed through a series of politically contentious reforms to SOEs that closed many of the most inefficient firms. But the leadership has also been inclined

⁸ Private firms had a return on assets that was an average of 7 points higher than SOEs in 2014-2017. See International Monetary Fund, "People's Republic of China: Staff Report for the 2018 Article IV Consultation", 50.

⁹ In 2017, industrial SOEs carried a debt-to-equity ratio of 152%, compared to 107% for industrial private firms. See IMF, 50.

¹⁰ Lardy, 17.

¹¹ IMF, 30.

to further rely on SOEs to prop up growth, as it did during the global financial crisis. The last 2-3 years of slowing growth and leverage issues have seen both dynamics at work. Beijing has become more serious about closing inefficient SOEs at the local level but has also relied more heavily on SOEs to boost growth as private sector investment has slowed.

In sum, state capitalism provides significant economic, political and geopolitical benefits to China's leadership, but is also responsible for increasingly serious imbalances in China's growth model. Without a serious growth crisis, which is difficult to predict, the balance of factors suggest that Beijing is unlikely to make wholesale changes to the state's role in the economy anytime soon.

V. What is State Capitalism's Role in Promoting Innovation?

With China's leadership intensely focused on making China an innovation superpower, the state is deploying multiple lines of effort to achieve this task. Some efforts, such as funding basic research and expanding China's cadre of highly trained scientists and engineers, are similar to those in the United States and not "state capitalist" in nature. But China frequently also employs a host of top-down industrial policies to decide which specific firms, technologies and standards should receive support, and then coordinates efforts to give these firms/technologies an advantage in the domestic or global marketplace.

The most well-known of these industrial plans is the Made in China 2025 initiative, a key focus of the US's Section 301 investigation but also of concern to a wide set of China's trading partners, particularly Germany and Japan. The initiative, officially launched in May 2015, sets out a host of policies for central and local governments to help domestic firms grab global market share in 10 key industry sectors. Another example is the China National Integrated Circuit Industry Investment Fund, set up in 2014, which aims to reduce China's dependency on foreign companies (particularly the United States) in semiconductors. But there is a long history and long list of other active policies that aim to directly promote "indigenous innovation" in various fields of technology.

How effective are such policies? This paper won't attempt a rigorous answer, but stylized facts and observations support a general supposition: industrial policies are often far less effective than advertised and can be a highly inefficient approach to promoting breakthrough innovation. Among the key arguments:

- Cross-country experience -- including from Japan and South Korea -- suggests that government bureaucrats can do a reasonable job of "picking winners" during a catch-up period, but that this becomes increasingly difficult as technologies move to the cutting edge; not only do technological issues themselves become more complex, but there is no existing market to test which firms/technologies are most competitive. With China increasingly focused on dominating frontier technologies such as quantum computing and advanced semiconductors, there is ample room for the government to place expensive bets on the wrong horse. The Made in China 2025 initiative and National IC Fund are part of a broader agenda of import substitution policies, reflecting Xi's growing concern with "self-reliance" in technology. But without the discipline of competition with foreign products, import substituting policies may be more likely to suffer from rent-seeking and capture by domestic firms.

- Several academic studies show that political distortions undermine the effectiveness of innovation subsidy programs in China. Wei, Xie and Zhang found that subsidy allocation is highly biased towards SOEs, despite private firms being more innovative¹². Another recent survey concluded that “the firms that receive innovation subsidies do not have higher productivity, more profits, or larger market shares. Overall, the results point to inefficiency of allocation of innovation subsidies and show that the subsidies encourage only incremental innovations and not radical ones¹³.”
- Finally, and most impressionistically, it is not uncommon to hear Chinese officials and economists voice skepticism about whether China’s past industrial policies have been effective in competitive sectors -- especially when compared to the bottom-up innovation from private firms.

None of this is to say that China is not becoming more innovative, only that the sources of industry-leading innovation may be more likely to arise from the broader inputs in China’s innovation ecosystem - including talented scientists and engineers, an entrepreneurial ethos and thriving venture capital scene -- than top-down industrial policies.

However, China’s innovation and industrial policies don’t need to be successful to represent a cause for concern for the United States and other trading partners. One of the key concerns of US and European industry is that China’s industrial policies, including extensive subsidies on non-market terms, lead to over-investment and excess capacity, with Chinese producers flooding global markets with exports. Solar photovoltaics (PVs) are a prime example. Extensive subsidies helped Chinese firms grab market share from US and European firms, who found it difficult to compete on pricing as the sector suffered from significant overcapacity in 2009-2013. Support from state-owned banks helped many Chinese producers stay afloat and emerge with a dominant role in the market. In 2018, China announced extensive cuts in subsidies to solar PV firms to cope with yet another bout of overcapacity.

Major trading partners fear that the Made in China 2025 and other industrial policies will create a similar dynamic in a broader array of high-tech industries, ranging from semiconductors to industrial robots. Local governments in China are using “government guidance funds” to invest in projects favored by Beijing to hit political and economic targets. For example, European think tank MERICS added up planned investments in production by local governments in the automation sector and found that the total far exceeded projections for the size of China’s market in coming years¹⁴.

¹² Shang-Jin Wei, Zhuan Xie and Xiaobo Zhang, “China’s Transition to a More Innovative Economy: Progress and Challenges,” in *China’s New Sources of Economic Growth: Vol. 2* (edited by Ligang Song, Ross Garnaut, Cai Fang, Lauren Johnston), July 2017.

¹³ Hong Cheng, Hanbing Fan, Takeo Hoshi, Dezhuang Hu, “Do Innovation Subsidies Make Chinese Firms More Innovative? Evidence from the China Employer Employee Survey,” NBER Working Paper No. 25432, January 2019.

¹⁴ Jost Wübbeke, Mirjam Meissner, Max J. Zenglein, Jaqueline Ives, and Björn Conrad, “Made in China 2025: The making of a high-tech superpower and consequences for industrial countries” (Mercator Institute for China Studies, December 2016), 25, https://www.merics.org/sites/default/files/2017-09/MPOC_No.2_MadeinChina2025.pdf

While such concerns about overcapacity are a key theme of the US Section 301 investigation, messaging by the US government could be more effective in highlighting this point -- especially in China. The author has been in numerous meetings in which Chinese officials and economists claimed that the US is overly concerned about the likelihood that the Made in China 2025 initiative succeeds, not realizing that the US and other trading partners are also concerned about expensive failures that depress global markets.

Another concern with state capitalism and innovation is that Beijing will use its influence over domestic firms, its market size and its diplomatic heft to promote global standards that benefit China -- even when these solutions are not necessarily best-in-class. The process of standard-setting in 5G has become intensely geopolitical, with Chinese firms, at Beijing's urging, playing a highly active role in ensuring that China controls key standards and is not left dependent on licensing foreign technologies, as was the case with 3G and 4G¹⁵. The political pressure on domestic firms to "back the home team" spilled out into public view in 2018, when Lenovo chairman Liu Chuanzhi issued a public statement pushing back on criticism online that Lenovo had been "unpatriotic" by allegedly not voting for a 5G standard promoted by Huawei¹⁶.

In sum, China's top-down industrial policies may not be highly effective in promoting innovation -- at least relative to the hype in China as well as overseas. However, the US and other trading partners will face risks even from unsuccessful policies, including the potential for over-capacity to depress global profits, and for Beijing to use its influence to promote standards that advantage domestic firms at the expense of open global competition.

VI. International pushback against China's State Capitalism

Pushback against "China Inc." is leading to growing trade frictions

China's state capitalism is not inherently unfair -- it is a choice of economic model that China is entitled to make. The unfairness comes from its interaction with a trading system that is designed for an economic model in which state support is less extensive and more transparent. In this environment, companies competing on commercial terms and without state support stand to face an unlevel playing field.

The conflict between these two systems was politically and economically tolerable when China was a smaller economy. But tensions are growing now with China's economic importance and the surge in China's overseas investment over the last decade. 2018 marked a tipping point in this pushback among developed countries.

In the United States, the Section 301 investigation directly targets China's industrial policies and the unique challenge posed by state capitalism. USTR's focus on forced technology transfer, for example, reflects the concern that when US companies enter joint venture agreements in China, they are negotiating as individual companies against a Chinese government that is intentionally seeking to

¹⁵ See "Eurasia Group White Paper: The Geopolitics of 5G," November 15, 2018

¹⁶ See Fan Liya, "China's Tech Luminaries Back Lenovo Amid Public Backlash," May 18, 2018

<https://www.sixthtone.com/news/1002303/chinas-tech-luminaries-back-lenovo-amid-public-backlash>

acquire valuable US intellectual property, and willing to hold back market access to compel this action. In such a circumstance, US firms will make decisions that are profit-maximizing for the firm in the short term but pose long-term damage to US economic competitiveness and even national security.

Likewise, recent US legislation to tighten CFIUS (FIRRMA) and export controls (ECRA) are motivated in part by a similar logic: China's state system is using all avenues to acquire US IP, requiring a significantly stepped up level of protection. Whether a firm is state-owned or private is increasingly meaningless to US regulators in this context, a shift triggered in part by several episodes in which China has used venture capital funds and other non-state players to attempt acquisitions in sensitive areas, even when the funding ultimately comes from the state.

In the last year, several other major trading partners have announced actions or proposals to tighten investment restrictions against China. A common theme is similar concern that China is acquiring key firms and technologies to further broader industrial policy goals. Notable developments include:

- Under a new legal framework, Germany blocked a Chinese acquisition on national security grounds for the first time, and proposed to lower the threshold for such investment reviews from 25 to 15 percent;
- The UK proposed to establish a new framework to review transactions on national security grounds, a move reportedly targeted mainly at China;
- France is also proposing to establish new hurdles to foreign investment in strategically important sectors;
- The European Parliament is considering legislation, driven by France and Germany, that would harmonize how individual EU states approach investment reviews to close loopholes between member countries.

Ripple effects - proliferating industrial policies?

These moves may well be appropriate responses to the unique challenges posed by China, but it is still important to note that there are potential risks or unintended consequences whenever such barriers are imposed. In the case of the United States, tariffs, investment restrictions, and export controls -- unless implemented carefully -- have the potential to hurt the competitiveness of some US firms, potentially undermining a longer-term objective of preserving a lead in strategically important areas of technology. New barriers erected by other countries to safeguard "strategic investments," even when initially targeted at China, could be used to block investments by the US or other trading partners.

Indeed, as countries react to the state capitalism in China, they are taking steps that look increasingly like full-scale industrial policies. The Federation of German Industries (BDI) recently released a detailed set of recommendations urging a more proactive response to countering Chinese policies, including promoting mergers to create European champions with the scale to compete against China. BDI charged that China "is establishing its own political, economic and social model," which Germany and the EU cannot ignore. EU regulators were not persuaded by this logic in the specific high-profile case of a proposed merger between Alstom and Siemens, which BDI argued was necessary to compete against Chinese SOEs in rail. However, the notion that governments must take a stronger hand in creating or strengthening national champions appears to be gaining momentum in Germany and France.

If this trend becomes pronounced, it could have significant implications for the global economy and free trade and investment. National champions will come under increasing protection from host governments, and more ambitious and interventionist industrial policies may proliferate. Such moves could exacerbate existing strains in the current multilateral trading system (discussed below).

Even the US is moving closer to practicing industrial policy as a response to China, if not in name. Policies to “decouple” from China in critical areas of technology almost by necessity end up requiring greater amounts of state intervention than the United States is used to. With new export controls, the US government is now deciding whether cutting-edge areas of innovation, such as AI, can be exported overseas. When the US government blocked the attempted acquisition of Qualcomm by Broadcom, citing national security grounds, one justification seemed to be the need to preserve Qualcomm as effectively the US “national champion” in 5G, given concerns about China’s growing dominance and the national security threat this poses.

Risks to the WTO

A common theme in the above responses is that national governments believe that China is taking advantage of the standard rules-based trading system, which was never intended for a system of state capitalism like China’s. This same concern is leading to growing doubts about whether the WTO is “fit for purpose” in dealing with China’s unique circumstances. Harvard law professor Mark Wu takes the pessimistic view that WTO members will likely not rise to the challenge of reforming the WTO in response to the dilemmas posed by “China, Inc.¹⁷”. He concludes that “the most likely outcome is one in which China’s rise will exacerbate the diminishing centrality of WTO law for global trade governance.”

Wu draws this conclusion partly due to the political difficulty of convincing China to approve reforms that it will almost certainly view as harmful to its interests. Wu also notes the danger that as other WTO members become more frustrated with China’s policies, they will simply go outside the WTO in addressing these concerns. Indeed, the Trump administration has its foot in two camps regarding China and the WTO. USTR is working with the EU and Japan to promote reforms in the WTO that would close some of the key loopholes that China falls through, such as subsidies provided by SOEs. At the same time, the Trump administration is taking unilateral trade actions -- including under Section 301 as well as Section 232 -- that reflect a dim faith in the WTO as an institution equipped to deal with China, and which threaten to hurt the WTO’s legitimacy.

VII. Conclusion and Policy Recommendations

The discussion above is meant to place China’s state capitalism in the context of China’s political system, economic model, and role in the global economy. China’s state capitalism has evolved considerably over the reform period and will continue to do so. Economic pressures on China, as well as growing international pushback against aspects of state capitalism, could both be important factors in this evolution. However, given the strong political logic for state capitalism from the standpoint of China’s

¹⁷ Mark Wu, “The ‘China, Inc.’ Challenge to Global Trade Governance,” *Harvard International Law Journal*, 57, no. 2 (Spring 2016), http://www.harvardilj.org/wp-content/uploads/HLI210_crop.pdf

leaders -- such as the use of SOEs to stabilize growth and employment and spread China's influence overseas -- one shouldn't assume that even strong pressures will lead to a wholesale shift in policy.

The discussion also pointed to some of the key challenges that China's state capitalism poses to the United States and other key trading partners, especially as China continues to rise as an economic power and innovation leader. These challenges are both direct -- in the form of policies such as forced technology transfer -- as well as indirect, such as the risk of a less effective and legitimate WTO.

The key challenges for the United States are:

- An unlevel playing field, as individual US companies compete against Chinese companies that benefit from extensive direct and indirect state support, including a protected market at home. These have longer-term consequences for US competitiveness against China and in some cases national security.
- The risk that over-investment in China because of top-down industrial policies will create over-capacity, hurting the financial viability of US companies involved in key areas of technology, such as semiconductors.
- The potential for China to use its influence over Chinese firms, and its diplomatic and economic heft, to shape global industry and technology standards in ways that benefit China at the expense of open global competition.

The key challenges for the global economy and trading system are:

- The likelihood of growing trade and investment barriers directed against China, some of which could have spillover effects that impact global growth and US growth.
- The potential for a proliferation of industrial policy and "national champion" policies in response to China's state capitalism.
- The danger that the WTO fails to address the unique challenges of China's state capitalism and declines in its effectiveness and legitimacy.

And finally, state capitalism poses risks for the sustainability of China's economy:

- The potential for continued political distortions to slow China's progress in rebalancing and deleveraging, increasing the risk of an eventual hard-landing and/or stagnation.
- The potential for political pressure to weaken the performance and confidence of private firms, as well as limit their ability to invest overseas due to perceptions that even private firms are acting as arms of the Chinese state.

Recommendations for the United States

The United States has several policy tools to address aspects of China's state capitalism -- ranging from the unilateral tariffs and investment/export restrictions that the Trump administration has imposed to a more multilateral and engagement-focused approach favored by past administrations.

Before reaching for specific policies, however, the United States should consider its longer-term strategy for dealing with China's state capitalism -- questions that the US of course cannot separate from its broader strategy towards China. What are the specific problems with state capitalism that the US is trying to solve? The US strategy towards China should have three main elements:

(1) Work with allies on a multilateral framework that closes the loopholes from state capitalism. The Trump administration deserves credit for several aspects of its trade strategy with China. It has recognized the need to take a new, more assertive approach with China on issues of long-standing concern. It has rightly focused on innovation and industrial policy as the most important issues to resolve with China. And the Trump administration has pinpointed some of the specific challenges posed by state capitalism, such as the political conditions that compel US companies to transfer valuable IP as a condition of market access in China.

However, the administration has focused too heavily on using tariffs to compel change in behavior from China, and not enough on working in concert with allies. A key drawback to tariffs as a strategy is sustainability: while tariffs might force China to make concessions in the short-term -- even this is open to question -- Beijing could well resort to past practice as soon as the pressure is off. The other shortcoming is that, as we have seen, different responses to China's state capitalism threaten to create new barriers in markets outside of the US, legitimize activist industrial policies, and undermine the confidence and effectiveness of the WTO. None of these are in US interests.

The only sustainable approach to addressing the problems with state capitalism is to work with like-minded countries to update the rules of the trading system and make it less vulnerable to an unfair advantage from state capitalism. While the administration has made some important efforts in this area, such as the trilateral working group on WTO reforms formed with Japan and EU, such efforts would be more effective if the US settled ongoing -- and far less consequential -- trade disputes with those partners, reaffirmed US commitment to the WTO as an institution that upholds market capitalism, and led robust reform of that institution to take on state capitalism and other 21st century structural challenges to global trade. In kind, the US should look to re-engage CPTPP and other multilateral trade agreements that provide platforms to address some of the most problematic Chinese trade policies; CPTPP, for example, contains groundbreaking provisions in areas related to SOEs, and is the only agreement to establish benchmark rules for the digital economy.

(2) Develop a cohesive strategy to maintain economic competitiveness against China -- and, as necessary, "decouple" in some areas. This approach to meaningfully work must tie in US domestic innovation goals and be based on both sound science and concrete economics. As noted earlier, an irony of the US policy response to China's state capitalism is that the US is now taking a more interventionist role in trade and investment policy -- deciding which US industries should be exempted from tariffs on China, and which technologies US firms should be allowed to export. Indeed, one aspect of US tariff policy is to encourage US companies to remove supply chains from China. These policies may be legitimate responses to the threat posed by state capitalism, but the US is effectively practicing

industrial policy without naming it, absent a debate or coherent strategy such a shift in policy should involve.

For example, US tariffs are hurting the international competitiveness of US firms in several sectors, including technology. Unless done carefully, this approach risks undermining one of the key objectives of this policy, ensuring the viability of US firms in strategically important sectors. The same could be said of export control lists now under development, as well as US visa restrictions on Chinese citizens in STEM fields; these policies may be justified for national security reasons, but the US risks depriving itself of sources of innovation that ultimately strengthen the US economy.

US domestic policies to promote innovation and strengthen the global competitiveness and appeal of US products and technologies don't appear to feature in the overall US strategy with respect to China, at least outside of military-funded programs. This will need to change if the US is going to be able to compete with China, especially in the innovation-intensive, high-value and fast-moving strategic sectors. China's top-down industrial policies may be highly inefficient, but its dynamic private sector has already pulled even with the US, or even ahead, in some areas of AI and other technologies. There is much more that the US can do at the national level to promote coherence in domestic innovation programs and ensure their consistency with broader trade and national security policies toward China.

(3) Continue a results-focused approach with China, but don't dismiss the value of engagement. It is not practical to think that the US can move from China off its fundamental political and economic model. That model could change, but it is unlikely to be on account of US pressure. At the same time, this does not mean that the US should give up engaging with China directly on policies that the US finds problematic for the US economy and legitimacy of the multilateral trading system. The United States doesn't need to be naïve in believing that such engagement alone will be effective, but engagement does inform Chinese views. Recent US messaging on trade and technology issues has made it too easy for hawkish voices in China to paint US objectives as efforts to contain China, rather than as legitimate grievances about policies that harm the US economy and support for open trade and investment. That perception is hurting the ability of the two sides to reach agreement on key technology issues.

The US may be able to leverage a burgeoning debate in China over the structural problems facing the domestic private sector. Some Chinese officials have proposed establishing a clear principle of "competitive neutrality" in China to put SOEs, private firms, and even foreign firms on an equal footing. Such a proposal won't resolve the fundamental barriers that US firms face in China, but it is at least a debate worth encouraging.

Recommendations for Congress:

- (1) Ensure adequate funding, and insist on ample resourcing, for US agencies that track China's industrial policies.** China's industrial policies are extremely difficult to track. The central government and local governments release a flood of documents in a given month, and the ultimate impact of these policies often can only be gleaned through consultations with industry experts. New initiatives that appear significant may be largely hype, while esoteric industry regulations -- such as over cybersecurity -- can have a huge impact on US industry. Congress

should ensure that US agencies have the resources to effectively track these issues, identify the challenges posed to the US economy, and develop strategies to address them.

- (2) Consider establishing an independent expert advisory board that evaluates innovation challenges from China, based on national security, economics and technology.** US agencies are parsing through the complex issues posed by China's innovation and industrial policies, but these are deeply complex and require an understanding of technology, national security, and industry economics. There would be high value in bringing together a body of independent experts from industry, academia and the national security community to evaluate tough questions on a periodic basis. Which areas of China's advances should be worrying to the US, and which are more benign? How should US academia and industry work together to ensure competitiveness with China in frontier technologies? Would placing a certain technology under export controls hurt US innovation more than protect it? If the US decides to replace certain Chinese inputs into supply chains, does the US have the technical know-how and resources to provide substitutes?

OPENING STATEMENT OF NICHOLAS BORST, VICE PRESIDENT AND DIRECTOR OF CHINA RESEARCH, SEAFARER CAPITAL

SENATOR TALENT: I almost guarantee that. We always do.

Mr. Borst.

MR. BORST: Thank you to the Commission for inviting me to participate in this hearing. I think it's covering a lot of critical issues currently impacting the Chinese economy.

So, China is currently undergoing a difficult period of economic transition marked by strong concerns about the country's growth model and the resiliency of its financial system.

The domestic economy is still in the process of rebalancing, the leverage ratios are high among corporations and local governments, and the financial sector is failing to allocate credit efficiently.

At the same time, economic tensions with the United States are proving to be a significant drag on domestic sentiment.

Addressing this array of challenges will require difficult structural reforms that will take time to implement; however, none of these problems are intractable and Chinese policymakers are generally well-informed and capable.

If China succeeds in pushing through the necessary reforms, it will lay the groundwork for a period of more sustainable economic growth and development.

After the global financial crisis, China underwent a sharp external rebalancing. China progressed from running an enormous current account surplus during the mid-2000s to a slight deficit at the end of last year.

Though China runs large bilateral surpluses with certain countries, notably the U.S., on the whole, China's trade with the rest of the world has become significantly more balanced. China's internal economic rebalancing has progressed more slowly.

On the demand side of the economy, rebalancing is indicated by consumption accounting for, now, a larger portion of GDP growth and investment, and net exports have actually subtracted from Chinese economic growth in recent years.

On the supply side of the economy, the service sector has similarly eclipsed the industrial sector as the main driver of economic growth.

These trends are likely to continue, but they are progressing at a pace that means that China's internal economic rebalancing will be slower than what we've seen on the external front.

The desire of Chinese policymakers to move away from the previous unsustainable economic model is evident, but is hampered by a financial system that structurally prefers to make loans to large state-owned enterprises and the emphasis by local governments on investment-led growth.

It's my opinion that, as of present, the effect of the trade war on China's economy has been exaggerated.

China's exports grew robustly through 2018, and although the December trade numbers did display some weakness, as a whole, Chinese exports have held up pretty well.

The U.S. is undoubtedly still a large export market for China, but it still only accounts for one fifth of China's total exports.

Underpinned by initiatives like the Belt and Road, Chinese exports to emerging and frontier markets are expanding rapidly.

Where the trade war has had a bigger impact on China is via domestic sentiment, and this is most notably seen in the reaction of China's equity markets.

Chinese equity markets reacted sharply to the twists and turns of the trade negotiations throughout last year, and it's my opinion that Chinese investors appear to be not so much rattled by the threat of tariffs, but the prospect of a long-term shift towards a more contentious economic relationship with the United States.

China has a high leverage ratio for an emerging economy and overall debt levels have grown quickly since the global financial crisis.

China's overall credit-to-GDP ratio is now significantly higher than many emerging markets and is at the same level of the United States.

Within China's stock of debt, the largest risks center around highly indebted state-owned enterprises and the rapid growth of local government debt.

Many Chinese companies, particularly state-owned enterprises, have large, ongoing debt servicing requirements and are dependent on liquidity within the banking system to roll over their debts on a frequent basis.

Additionally, the stock of lending to state-owned enterprises is a misallocation of credit and a drag on China's growth potential.

For China's local governments, the root of the problem is an unreformed fiscal system.

Whereas the central government and local governments roughly split revenues amongst themselves, Chinese local governments are actually responsible for most of the expenditures.

Given this persistently large fiscal gap that local governments face, they have continuously sought new ways to borrow often in convention of the local government policy -- central government policies.

In recent years, the central government has cracked down on local government off-balance-sheet borrowing and opened up official channels for local governments to issue municipal bonds; however, there are still significant amounts of off-balance-sheet debt often hidden through the guise of public-private partnerships and China's local governments' debt levels continue to be a significant source of financial risk.

The risk of China's external debt has attracted considerable attention and China now has the highest levels of foreign currency debt of any emerging market.

Some analysts have argued that China is highly reliant on foreign borrowing and that a devaluation of the renminbi could have disastrous consequences; however, in my opinion, a closer examination of China's external debt levels reveal that foreign currency debt is both smaller than commonly thought, structured in less risky forms and should be balanced against China's significant foreign assets.

When measured relative to the size of the economy, borrowing by Chinese companies is significantly lower than levels seen in other emerging markets.

China has a large domestic debt issue, but external debt is not one of the chief concerns.

At present, the most pressing challenge to China's economic resilience stems from the financial crackdown and deleveraging campaign of the past several years. In an effort to stamp out financial risks, Chinese regulators have inadvertently cut off many private enterprises from the financial system.

The response from the government to this private sector financing crunch is heartening in that it shows a high degree of responsiveness to emerging problems; however, there is little evidence that the impact of these new initiatives are being felt by private enterprises.

Banks have been reluctant to fully embrace these policies to lend to small enterprises because they face the dilemma of being required to reduce risks, and yet also make loans to riskier private enterprises at low interest rates.

In order to truly level the playing field between private firms and state-owned enterprises, difficult reforms are needed.

This includes ending the implicit guarantee of government support enjoyed by many state-owned enterprises that lower their credit risk relative to private firms.

Only under these conditions can credit flow -- begin to flow back again to the more productive parts of the economy.

U.S. advocacy for economic reform in China is bolstered when it is perceived to align with existing Chinese domestic policies and initiatives.

All countries, including China, make economic policies primarily according to their domestic interests.

It would be very useful for American policymakers to take stock of the areas where U.S. demands intersect with existing Chinese initiatives.

Many of the policies that would be advantageous to U.S. interests overlap with the reforms China needs to successfully rebalance its economy and revitalize growth.

A rebalanced and revitalized Chinese economy is one that will contribute more to global growth and will be less likely to transmit financial shocks across its border.

At the same time, these reforms will create more opportunities for American businesses and investors to participate in and benefit from China's economic growth.

A rebalanced and more sustainable Chinese economy is strongly in the economic interest of both China and the United States. Thank you.

**PREPARED STATEMENT OF NICHOLAS BORST, VICE PRESIDENT AND
DIRECTOR OF CHINA RESEARCH, SEAFARER CAPITAL**

Testimony before the U.S.-China Economic and Security Review Commission

Hearing on China's Internal and External Challenges

February 7, 2019

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China is currently undergoing a difficult period of economic transition, marked by strong concerns about the country's growth model and the resiliency of its financial system. The domestic economy is still in the process of rebalancing, leverage ratios are high among corporations and local governments, and the financial sector is failing to allocate credit efficiently. At the same time, economic tensions with the United States are proving to be a significant drag on domestic sentiment. Addressing this array of challenges, will require difficult structural reforms that will take time to implement. However, these problems are not intractable and China's economic policymakers and financial regulators are generally well-informed and capable. If China succeeds in pushing through the necessary reforms, it will lay the groundwork for a period of more sustainable economic growth and development.

Progress of Economic Rebalancing

External Rebalancing: After the global financial crisis, China underwent a sharp external rebalancing. As shown in Figure 1, China's current account surplus as a percentage of gross domestic product (GDP) declined from in excess of 10% of GDP in the mid-2000s to -0.04% by the end of the third quarter of 2018. Though China runs large bilateral surpluses with certain countries, notably the U.S., overall, China's trade with the rest of the world has become significantly more balanced. Correspondingly, China's accumulation of foreign exchange reserves has slowed dramatically and continues to decline relative to the country's GDP.

Internal Rebalancing: China's internal rebalancing has been less dramatic. In the wake of the global financial crisis, China unleashed a large investment-driven stimulus. In the process, China was able to preserve a robust rate of economic growth during a period of collapsing global demand. Much of this stimulus occurred via the banking system, leading to a rapid expansion of the formal banking system and a burgeoning shadow banking system – a blanket term to describe financial activities that fall outside the well-regulated areas of the financial system.

Chinese policymakers have recognized the unsustainable nature of the country's growth model for many years now. Former premier Wen Jiabao frequently remarked that the country's growth was “unbalanced, uncoordinated, and unsustainable.”² Nonetheless, China's investment has remained elevated for a variety of reasons ranging from a high savings rate, relatively lax credit conditions, structural biases towards the

¹ The views discussed in this testimony are those of the author and are not those of Seafarer Capital Partners. The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles. Seafarer Capital Partners does not accept any liability for losses either direct or consequential caused by the use of this information.

² International Monetary Fund, “IMF Survey: China's Difficult Rebalancing Act,” 12 September 2007. <https://www.imf.org/en/News/Articles/2015/09/28/04/53/socar0912a>

industrial sector, and a nationwide infrastructure campaign that is amongst the most dramatic in human history.

Recent economic data show that China's efforts to promote internal rebalancing are starting to gain some traction. On the demand side of the economy, rebalancing is indicated by the growing importance of consumption as a share of GDP, as shown in Figure 2. Consumption is now a significantly larger portion of GDP than investment, and net exports have detracted from economic growth in most years. On the supply side of GDP, the service sector has similarly eclipsed the industrial sector as the main driver of growth, as shown in Figure 3. These trends seem likely to continue, but they are progressing at a pace that means internal rebalancing will be more gradual than what has occurred on the external front. The desire of Chinese policymakers to move away from the previous unsustainable economic model is evident, but it is hampered by a financial system that structurally prefers to make loans to large (often industrial) state-owned enterprises (SOEs) and an emphasis by both the central and local governments on developing infrastructure to boost growth.

Supply-Side Structural Reforms: In recent years, China's key economic policies have derived from a framework called Supply Side Structural Reform. 2015 was a pivotal year for the Chinese economy in which many economic problems came to a head. Risks in the financial system and property market appeared to be reaching a breaking point, the stock market collapsed and required a massive intervention by the government, and currency devaluation triggered large capital outflows. In this context, Supply Side Structural Reform emerged as a response to the immediate and pressing risks within the economy as well as a plan to revitalize economic growth.

Supply Side structural reform is often described as having five main overarching policy goals. These goals are:

- Cutting excess industrial capacity
- Reducing excess housing inventory
- Cutting excess leverage
- Reducing the cost of doing business
- Strengthening weak points in the economy

Cutting excess capacity has focused on a variety of industries, including steel, coal, cement, aluminum, copper, glass and others. Policies have aimed at reducing excess investment, improving capacity utilization, shutting down underused plants and factories, and decommissioning "zombie enterprises."³ These efforts have progressed relatively slowly as they touch upon many thorny domestic political issues, such as employment, recognition of bad debts, and local government finances. The enforcement of these policies may have also fallen disproportionately on private enterprises, as opposed to well-connected state-owned firms.

Reducing excess inventory is targeted towards eliminating high levels of housing stock within the property market. A major thrust of the policy has been to address problems in lower-tier Chinese cities where problems have been most acute. Across the entire national property market, policymakers have sought to reduce over-investment in housing, curb rapid price increases, and force deleveraging among real estate developers.

Cutting excess leverage is aimed at managing risks in the financial system. The policy aims to reduce corporate leverage, particularly amongst highly-indebted SOEs and zombie enterprises. Deleveraging is to

³ Zombie enterprise is a term used to refer to companies with recurring losses and limited prospects for returning to profitability. Zombie enterprises are able to continue operating through access to borrowing from banks and financial support from local governments.

be achieved through a series of new policies, including debt-for-equity swaps, debt restructuring, mergers and acquisitions, expanding equity financing channels, and tighter credits conditions across the economy.

Reducing corporate costs refers to a series of tax reforms, tax cuts, procedural simplifications, and financing cost reductions aimed at improving China's business environment. These policies are especially beneficial for small and medium enterprises and the private sector.

The final component of the supply-side structural reforms is strengthening "weak points." This refers to a desire to boost China's innovative capacities and develop indigenous sources for core technologies. These efforts are supported through initiatives like the Made in China 2025 plan.

Impact of the Trade War

As of present, the effect of the trade war has been exaggerated and the actual economic impact on China's economy has been limited. As seen in Figure 4, China's exports grew robustly throughout 2018, although the trade numbers did display some weakness. While the growth of trade may be driven in part by accelerated orders (to avoid anticipated U.S. tariffs), it also reflects China's increasingly diverse trade relationships. The U.S. is undoubtedly still a large market for China, but it only accounts for around 20% of China's exports. Underpinned by initiatives like the Belt and Road, Chinese exports to emerging and frontier markets are expanding rapidly. If the next round of U.S. tariffs are put into effect, it is possible that the direct effect of the trade war on China will become more pronounced.

The trade war has had a large impact on China's equity markets. These markets reacted sharply to the twists and turns of trade negotiations as well as a series of dramatic escalations in tensions between China and the U.S. The events included the imposition of U.S. sanctions on the ZTE Corporation in April; the breakdown of trade talks in May; the imposition of new tariffs in July, August, and September; the Bloomberg Supermicro hack story in October; and the arrest of Huawei executive Meng Wanzhou in December. More so than the direct impact of tariffs, Chinese investors appeared to be rattled by the prospect of a long-term shift towards a more contentious relationship with the U.S. By the end of the year, China earned the ignominious award of the world's worst performing major stock market.

The Structure of China's Internal and External Debt

Structure of Debt: China has a high leverage ratio for an emerging economy and overall debt levels have grown quickly since the global financial crisis. As shown in Figure 5, China's overall credit-to-GDP ratio is 253% as of June 30, 2018. This compares to an average of 183% for emerging markets, 267% for advanced economies, and 249% for the United States.⁴

China's debt stands out for several reasons: it's much closer to levels in advanced economies than the typical emerging market; the debt has grown rapidly over the past 10 years (80% relative to GDP over the past 10 years); and it is clustered amongst corporate borrowers (around 60% of the total).

Corporate debt is the largest debt category for China at \$20.3 trillion. China is an outlier in terms of corporate debt, posting numbers that are amongst the highest for any major country relative to the size of its economy. In contrast, household and government debt are more modest, accounting for \$6.6 trillion and \$6.2 trillion, respectively. China's government debt levels rank in the lower-tier for emerging markets; for household debt, China is in the mid-tier after several years of rapid borrowing by consumers.

⁴ Bank for International Settlements, "Credit to the Non-Financial Sector," 16 December 2018. <https://www.bis.org/statistics/totcredit.htm>

Local Government Debt: The rapid growth of local government debt in China is a potential threat to the country's financial stability. At the root of the debt problem is a severe fiscal imbalance that is driven by domestic politics. Local governments are responsible for the majority of total government expenditures but receive less than half of revenues. While the central government transfers some of the funds it collects back to the local governments, it is not enough to cover the ever-growing fiscal demands placed on these local authorities. Rebalancing the distribution of revenues is deeply political as it means a loss of power and control for the central government relative to the local governments.

Given the persistently large fiscal gap facing local governments, they have continuously sought ways to borrow, even if it contravenes central government rules. The most notable example of this is the proliferation of local government financing vehicles (LGFVs). These entities constitute a special purpose vehicle set up by local governments and are often capitalized with land. After the global financial crisis, LGFVs borrowed tremendously on behalf of local governments and financed a wide variety of investments on their behalf.⁵

Fiscal reform has been a consistent priority for the central government in recent years, and a modest amount of progress has been made. In response to the explosion in borrowing by LGFVs, the government took action to limit their access to credit and at the same time provide new legitimate avenues for borrowing to local governments. In 2014, the central government began a pilot program to allow local governments to directly issue debt. The following year, a swap program was created that allowed local governments to issue bonds and use the proceeds to retire bank debt. As of the end of 2017, over \$1.6 trillion in bank loans had been swapped into bonds. The number of local governments allowed to participate in bond issuances has expanded in recent years, leading to the creation of a large municipal bond market in China.

Explicit local government bonds are around \$2.7 trillion and LGFVs have around \$1.4 trillion in bonds.⁶ This compares to around \$2.3 trillion in central government debt. There are still significant amounts of off-balance sheet debt, often hidden through the guise of public-private partnerships and LGFVs with implicit guarantees from local governments. China's underlying fiscal problems have not been solved and will continue to be a source of financial risk and distortion.

External Debt: Claims about the size of China's external debt vary significantly. Some analysts put the figure at as much as \$3 trillion U.S. equivalent, nearly as much as China's entire foreign exchange reserves. If these figures are correct, China is highly reliant on foreign borrowing and a devaluation of the renminbi could have disastrous consequences. However, to understand the true extent of the risks, it is necessary to look at both the total amount of debt and the composition of borrowers.

According to the official statistics from the State Administration of Foreign Exchange, China has around \$1.91 trillion external debt as of September 30, 2018. Importantly, external debt measures all claims on Chinese borrowers from abroad, even those in renminbi. Around 35% of this external debt is denominated in renminbi, leaving around \$1.24 trillion in foreign currency debt, most of which is denominated in U.S. dollars. Figure 6 shows the share of China's gross external debt in all currencies owed by banks, corporates and NBFIs, the central bank, the government, and intercompany lending.

External Bank Debt: Chinese banks account for nearly half of China's external debt, around \$900 billion. However, there are several mitigating factors which reduce the riskiness of this debt. First, more than half

⁵ Logan Wright and Daniel Rosen, "Credit and Credibility: Risk's to China's Economic Resilience," Center for Strategic and International Studies. October 2018. https://csis-prod.s3.amazonaws.com/s3fs-public/publication/181003_CreditandCredibility_final.PDF

⁶ State Administration of Foreign Exchange. The Time-Series Data of China's Gross External Debt by Sector. Accessed 15 January 2018. <http://www.safe.gov.cn/en/2018/0329/1412.html>

of the external debt of Chinese banks is in the form of currency and deposits. Deposits are generally a stable and low-cost form of financing. Second, the amount of external debt held by Chinese banks needs to be balanced against their external assets. Over the past few years, Chinese banks have emerged as large overseas lenders. This boom in overseas lending is driven by the Belt and Road initiative and by Chinese firms expanding abroad. As of September 2018, Chinese banks have a net positive external debts equivalent to \$50 billion. The risks from the external debt owed by Chinese banks are lessened by the fact that, as a whole, they are larger lenders than borrowers.

External Government Debt: Another \$229 billion and \$40 billion of China's external debt is linked to the government and the central bank, respectively. Most of the increase in the government's external debt has come via greater purchases of renminbi-denominated government debt by foreign investors via the Bond Connect and other channels. The Ministry of Finance (MoF) has also issued some U.S. dollar debt in Hong Kong in order to improve the yield curve for offshore borrowing by Chinese corporates. The government's external debt is low risk because it is mostly denominated in renminbi and represents a small portion of its total balance sheet – around 10%. The People's Bank of China (PBOC) has external debt in the form of outstanding foreign currency, special drawing rights (SDR), and a few other small items. These amounts are dwarfed by the central bank's more than \$3 trillion in foreign exchange reserves.

External Corporate Debt: Chinese corporates and non-bank financial institutions (NBFIs) have over \$500 billion in external debt. This is a large amount, but it is tempered by the fact that 59% of the debt is in the form of trade credit, which tends to be relatively low risk because it is linked to the sale of goods. Only 13% of the total is accounted for by the riskiest type of borrowing, short-term loans and bonds. Some of this short-term borrowing may be to support working capital needs and therefore is not particularly worrying. While there may be clusters of risks among certain borrowers, Chinese companies and NBFIs are generally not reliant upon foreign financing. The \$521 billion in external borrowing is equal to less than 3% of the total credit extended to non-financial corporations. External borrowing is not an important source of finance for most Chinese companies.

Cross-Border Intercompany Lending: The final category, intercompany lending, accounts for around \$230 billion of China's external debt. Intercompany lending is classified as a type of foreign direct investment and consists of debt liabilities to subsidiaries and affiliated companies. An example of this type of activity would be a Chinese company issuing debt securities via offshore entities and then transferring the proceeds to their onshore parents via intra-company loans. Assessing the risks of this type of lending is difficult because the information regarding the terms and conditions of the debt is often not made public. The risks may be lower in some cases because the debt is owed within a corporate group and therefore more likely to be restructured if necessary. The more significant risk may be held by the offshore subsidiaries who are directly exposed to foreign investors.

While much of China's foreign debt is less risky than it initially appears, the aggregate amounts are still quite large. The Bank for International Settlements tracks foreign currency debt by non-bank borrowers across a variety of emerging markets. In this series, China has the largest amount of foreign currency debt by a wide margin. A sense of proportion, however, is critical for this type of analysis. The Chinese economy is nearly as large as the rest of the economies in the chart combined. When shown as a percentage of GDP, as in Figure 7, borrowing by Chinese companies is revealed to be significantly below the levels seen in other emerging markets.

The Probability of a Crisis and Economic Resiliency

Probability of a Crisis: The likelihood of a significant debt crisis in China is small, but it cannot be fully discounted. The vast majority of the country's debt is domestically held and in renminbi. China therefore

does not face the typical scenario of an emerging market debt crisis – a sudden devaluation that leads a default on foreign currency borrowing.

Financial risks in China center on high levels of corporate debt, both on and off-balance sheet. Many Chinese companies, particularly SOEs, are highly indebted. These companies have large ongoing debt servicing requirements and are dependent on liquidity within the banking system to rollover their debt loads on a frequent basis. Both of these corporate debt categories could come under stress during a protracted economic downturn.

Localized Defaults Scenario: The most likely scenario for a debt crisis in China would be a spate of corporate defaults in one of China’s less prosperous regions. This would, in turn, put pressure on the balance sheets of that region’s smaller banks. Faced with rising non-performing loans, these banks might then pull back on further lending and trigger a financing crunch, leading to additional defaults. If left unchecked, this type of negative feedback loop could grow to the point where it inflicts significant economic damage.

While possible, this scenario is dependent on an ineffective response from policymakers to the problem. Thus far, both the central government and local governments have been quick to provide support when pockets of financial stress have emerged. Some regions of China are facing severe economic pressure but have not yet produced the kind of spiraling debt crisis envisioned above.

Real Estate Downturn Scenario: Another unlikely, but potentially more severe scenario would involve a large downturn in the housing market. The property market plays a central role in the Chinese economy, serving as a major source of funding for local governments, an important source of collateral for borrowing by companies and sole proprietorships, and the largest store of household wealth. A generalized real estate downturn could put pressure on all these areas at the same time, leading to diminished local government spending, a deterioration in loan quality, and a decline in consumer spending.

The overall direction of government policy towards the housing market over the past several years has been a series of measures designed to curtail excessive investment, reduce demand and limit price appreciation. Given this context, the government has many tools available to boost activity in the housing market, making a generalized real estate downturn unlikely under current conditions.

Economic Resiliency: The Chinese economy is currently undergoing a test of its economic resiliency as policymakers attempt to balance the goals of deleveraging and rebalancing against the risks of a weakening economy. Despite a significant correction in the stock market and a general economic slowdown, Chinese policymakers have avoided a return to the old pattern of debt-fueled stimulus and aggressive intervention in the markets. Stimulus efforts have been modest and targeted, and credit growth continues to moderate. It is clear that China’s focus on reducing financial risks and restraining the property sector are not being abandoned in order to boost short-term growth.

The deleveraging and financial crackdown campaign that began in 2015 has been successful, almost too much so. In the process of stomping down financial risks, the entire financial system has become unduly risk averse. Many of the shadow banking channels, which served as a lifeline to private businesses, have been reduced or eliminated. At the same time, banks have directed lending flows back towards SOEs because they are perceived as less risky even if they are less productive than private enterprises.

The lack of credit flow to the private sector is having knock-on effects on consumption and investment and is one of the major drags on the Chinese economy.⁷ The official response to the private sector financing

⁷ Nicholas Lardy, “The State Strikes Back: Then End of Economic Reform in China?,” The Peterson Institute for International Economics, January 2019.

crunch has thus far been carefully calibrated as there is desire to avoid returning to the old days of rapid credit growth and accumulating of financial risks. Nonetheless, policymakers have begun implementing a multitude of new targeted measures designed to direct more credit to the private sector.

Over the past several months, the PBOC has been active in formulating new policies to support the private sector. The central bank cut the required reserve ratio four times in 2018 and a portion of the funds released were earmarked for small and medium-enterprise (SME) financing. The PBOC has also announced two separate tranches of 150 billion renminbi (\$22.4 billion) in relending and rediscount quotas to support SME lending. Other policies from the central bank include a tax exemption for interest income on loans to certain small borrowers and a new re-lending facility designed to provide discounted financing to financial institutions that lend to private enterprises.

Regulators have given banks window guidance to not increase interest rates on SME loans and to lend more to private enterprises. China's chief banking regulator, Guo Shuqing, even went so far as to suggest quotas for lending to the private sector: one-third of loans to large banks, two-thirds of loans to medium-sized banks, and reaching 50% of all corporate loans over the next three years. Implementation of such a proposal is likely to occur more via moral suasion than through explicit lending targets.

Steps have also been taken to address financing problems in the capital markets. Policymakers have called for simplifying the registration system for bond issuances, and the central bank has put together a guarantee fund to support debt sales by private companies. The restrictions on private share placements are being eased in order to revitalize this source of funding.

China's top leadership is trying through both words and actions to change the perception that the private sector plays second fiddle to SOEs. Both President Xi Jinping and China's top economic minister Liu He have declared "unwavering support" for the private sector. In early November 2018, Xi convened a meeting with private entrepreneurs to discuss issues impacting private firms. During that meeting, Xi acknowledged that the private sector is responsible for most of China's GDP, employment, and technological innovation. He announced several support measures for private firms including lowering taxes, increasing access to finance, leveling the playing field between private firms and SOEs, and protecting property rights. The State Council called upon government ministries and SOEs to promptly pay money owed to private firms. As the economy has slowed, many SOEs have extracted extended payment terms from their private suppliers, increasing the financial stress upon these firms.

The fallout from the deleveraging campaign exposes a fundamental challenge to China's economic resiliency: can China address economic risks without stamping out the private enterprises that have been responsible for so much of the country's growth? The "whole of government" response to the private sector financing crunch is heartening in that it shows a high level of responsiveness to emerging problems. At the same time, there is little evidence yet that the impact of these new initiatives is being felt by many private businesses. Banks have been reluctant to fully embrace these policies because they face the dilemma of being required to reduce risks and yet also make loans to riskier private enterprises at low interest rates. In order to truly level the playing field between private firms and SOEs, difficult reforms are needed. This includes ending the implicit guarantee of government support enjoyed by many SOEs that lowers their credit risk relative to private firms. Only under these conditions can credit begin to flow back to the more productive parts of the economy.

Risks for the United States and Recommendations

U.S. Exposure to China's Financial Risks: The United States has limited but growing direct exposure to China's financial system. Many analysts have catalogued the various financial linkages between the two countries via foreign direct investment, capital market investment, and cross-border banking. These studies

reveal that U.S. financial exposure to China is modest, particularly given the size of the Chinese economy.⁸ As such, the potential for direct transmission of financial risks from China to the U.S. is relatively limited.

While direct exposure to China's capital markets is still low, this may change in the near future. Recent policy reforms have led to an upsurge in cross-border portfolio investment. The Shanghai-Hong Kong Stock Connect program was established in 2014 and allows northbound and southbound purchases of the majority of the market cap listed on the Hong Kong and Shanghai Stock Exchanges. A follow-up program, the Shenzhen-Hong Kong Stock Connect, was launched in 2016 and provides foreign investors with access to many of the high-growth technology firms listed in Shenzhen. The aggregate quota for the stock connect programs has been scrapped and capital flows have increased steadily.

There have been corresponding reforms in the bond market that permit greater access for foreign investors. In 2015, foreign central banks and sovereign wealth funds were given direct access to the interbank market, the main venue for bond trading in China. This access was expanded in 2016 to include institutional investors, foreign banks, insurance companies, and securities companies. Altogether, more than 1,000 foreign institutional investors have now invested in the Chinese interbank market. A further opening of the bond market occurred in 2017 with the creation of the Bond Connect program. Similar to the stock connect programs, the bond connect allows cross-border access for investors in Hong Kong and China. China's Qualified Foreign Institutional Investor (QFII) program, which allows access to both the bond and stock markets, has also been recently reformed and expanded.

These capital market reforms have led to greater inclusion of Chinese securities within the major global stock and bond indices. As a result, the many global investors that track these indices will find themselves required to increase their exposure to China. This can already be seen in the significant growth of foreign holdings in Chinese bonds and equities over the past several years, as seen in Figure 8. Given these trends, it is not unreasonable to imagine that China will emerge a significant asset class for foreign investors over time. As such, the potential for the transmission of financial risks will increase significantly.

Recommendations: This is a period of heightened economic tensions between China and the U.S. On a variety of fronts, many American businesses and investors feel that China's economy has become less open and that China's state-directed policies undermine free market norms. These concerns also come at a time when China's commitment to reform and rebalancing are being tested by a weaker economy.

China's economy policymakers and financial regulators are generally very aware of the risks and distortions present across the economy. The deleveraging campaign of the past several years has been effective in reducing financial risks, but it has come at the cost of a less market-driven financial sector. Chinese regulators have significant capacity to resolve pockets of financial stress throughout the system but addressing the problems of moral hazard and implicit government guarantees is more difficult and touches directly upon sensitive political issues. It is also important to remember that in all instances of policymaking in China, implementation is frequently frustrated by local authorities and interest groups pursuing their own agendas.

Countries make economic policies primarily according to their domestic interests and China is no different. However, pressure from the U.S. can be helpful if it is perceived to align with the existing policies and initiatives of Chinese policymakers. It would be very useful for American policymakers to take stock of

⁸ See Cindy Li, "How Does China's Slowdown Impact the United States?," The Federal Reserve Bank of San Francisco, 9 May 2016. <https://www.frbsf.org/banking/asia-program/pacific-exchange-blog/how-does-china-slowdown-impact-the-united-states/> and Michelle Ker, "U.S. Financial Exposure to China," U.S.-China Economic and Security Review Commission," 9 May 2017. <https://www.uscc.gov/sites/default/files/Research/U.S.%20Financial%20Exposure%20to%20China.pdf>

areas where U.S. demands intersect with existing Chinese reform initiatives. A working familiarity with initiatives like Supply Side Structural Reform would help establish a better framework for negotiation. Fortunately, many of the policies that would be advantageous to U.S. interests overlap with the reforms China needs to successfully rebalance its economy. These reforms include:

- Addressing structural biases that hinder the development of both the private sector and foreign enterprises
- Increasing transparency around the implementation of economic rules and regulations
- Continuing to liberalize the service sector
- Further opening and liberalizing China's capital markets
- Establishing more a more balanced and sustainable fiscal system
- Opening more areas of the economy to foreign investment
- Continuing to adjust the exchange rate regime in a more market-driven direction
- Building a more robust social safety net to encourage consumption
- Allowing loss making state-owned enterprises to be shut down or restructured in a market-driven process

The policies outlined above will help ensure that the Chinese economy continues to make progress towards economic rebalancing. A rebalanced Chinese economy is one that will contribute more to global growth and will be less likely to transmit financial shocks across its borders. At the same time, these reforms will also create more opportunities for American businesses and investors to participate in and benefit from China's economic growth. A rebalanced and more sustainable Chinese economy is strongly in the economic interests of both China and the U.S.

Figure 1:

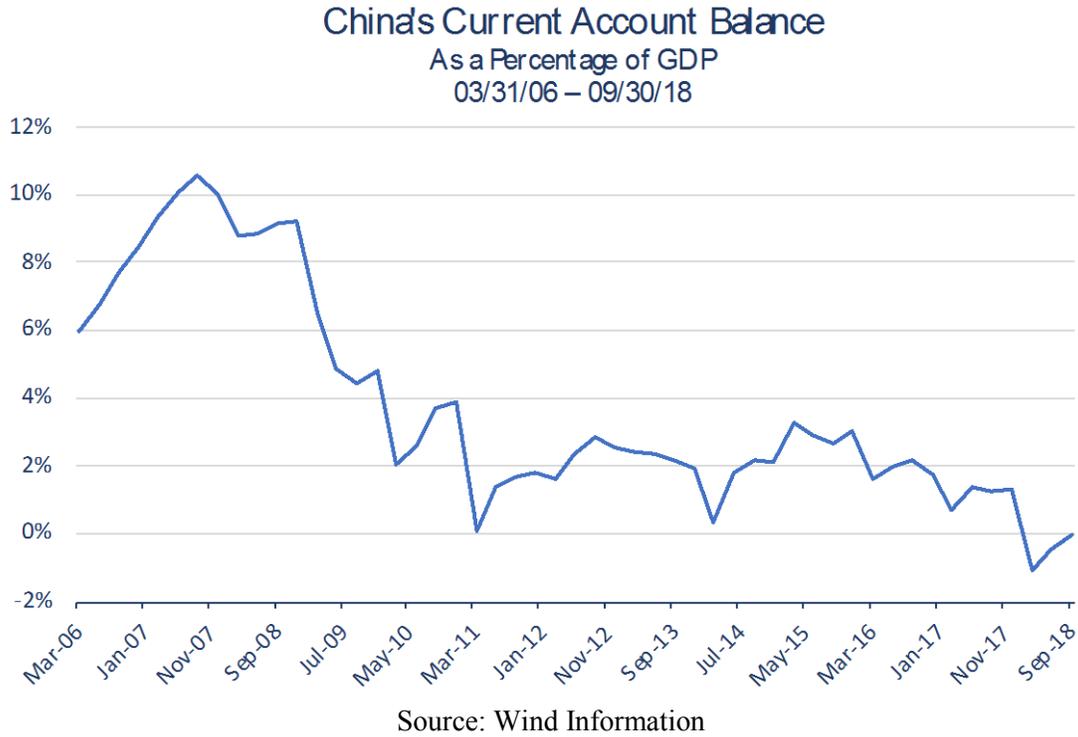


Figure 2:

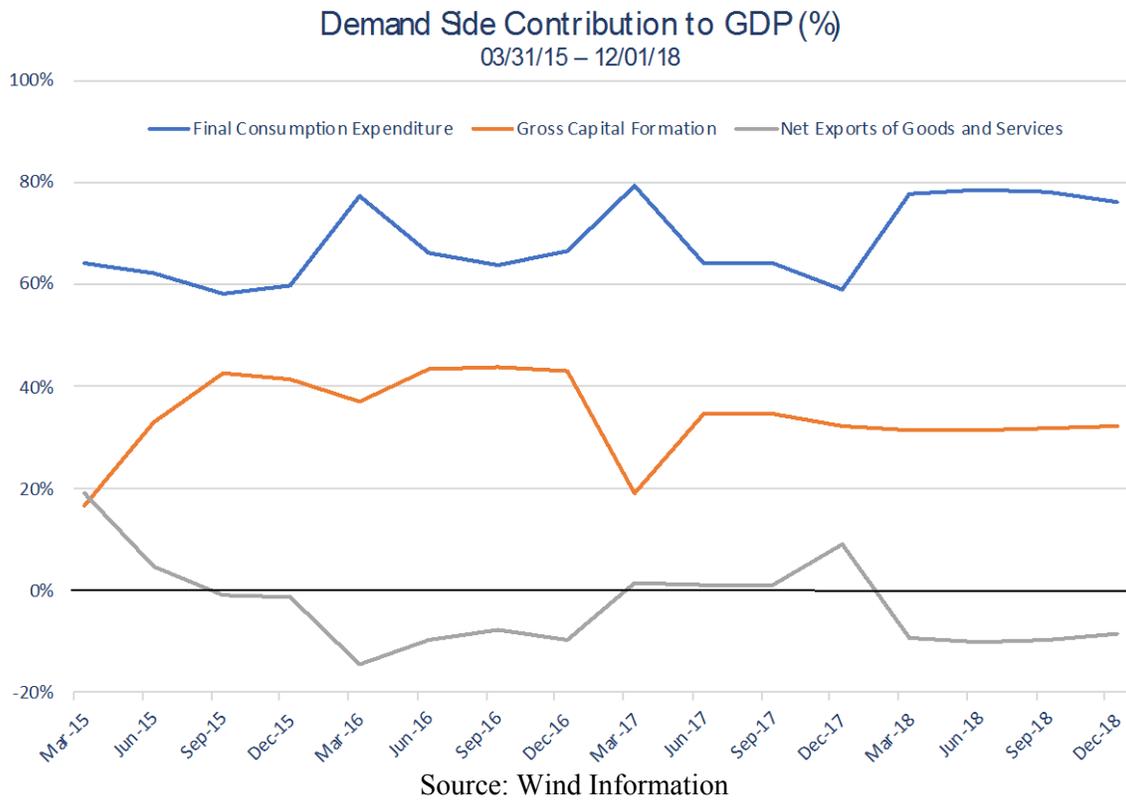
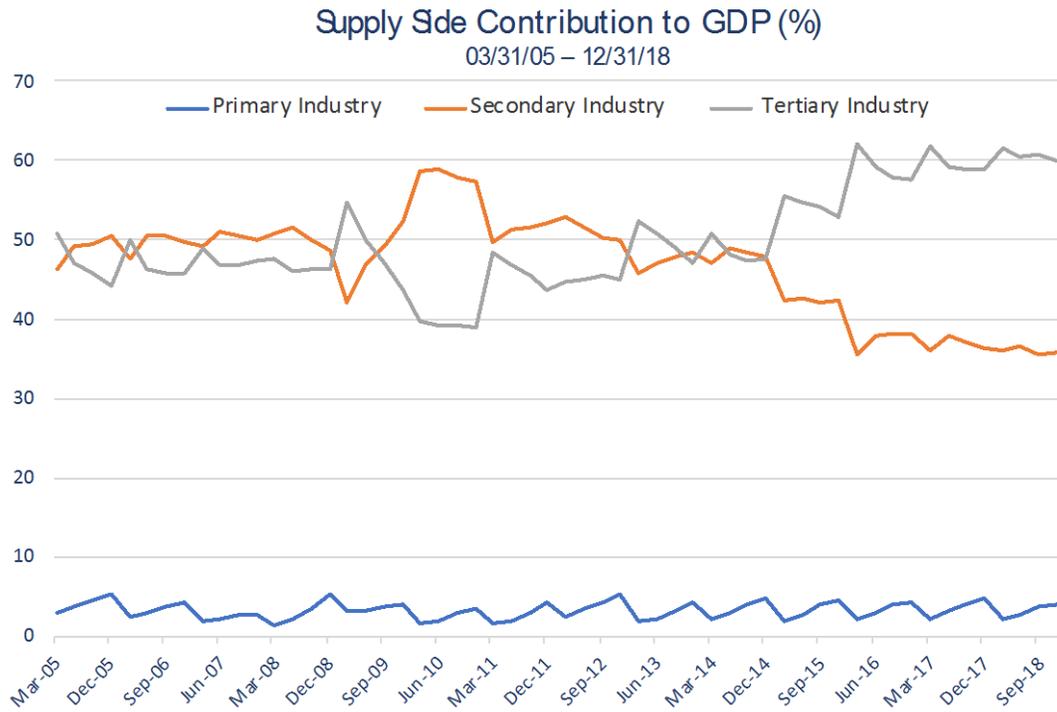
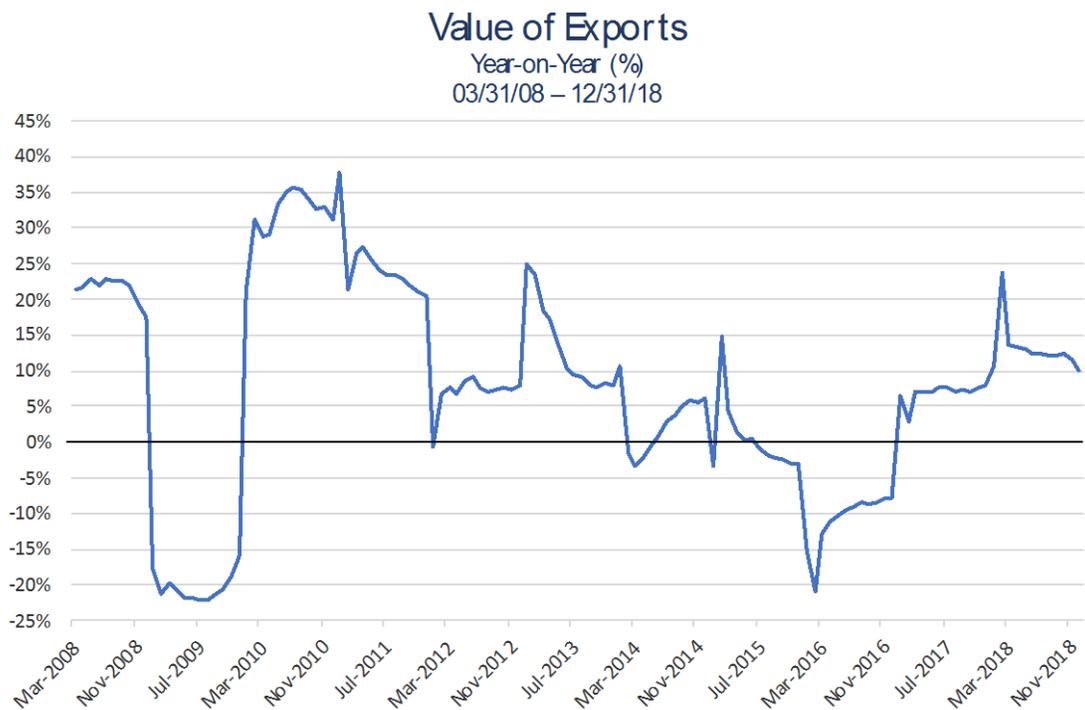


Figure 3:



Source: Wind Information

Figure 4:



Source: Wind Information

Figure 5:

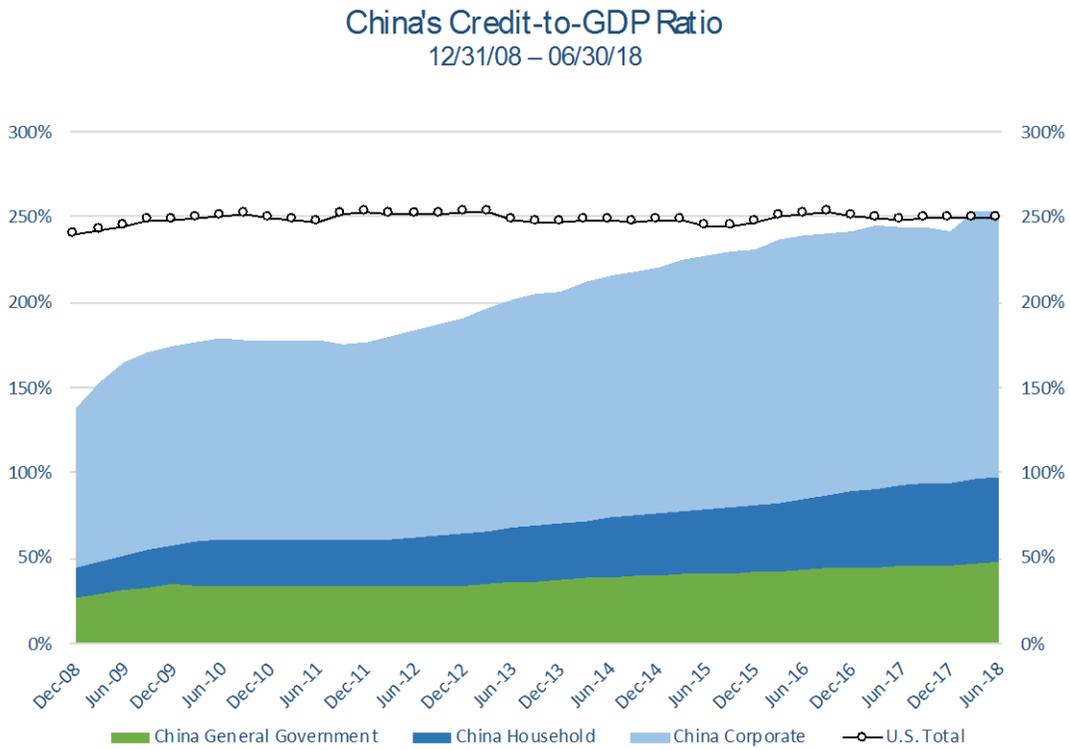


Figure 6:

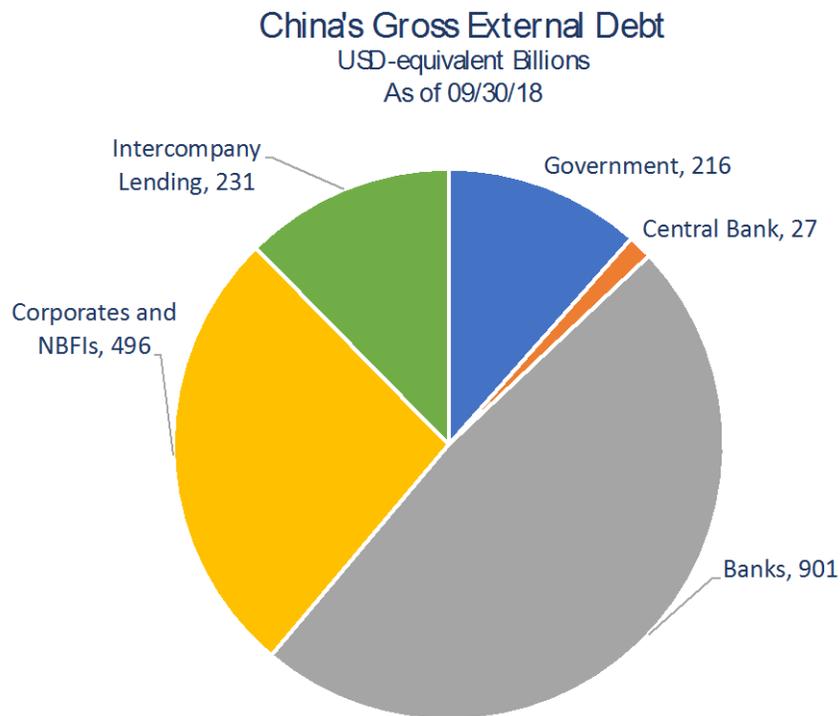
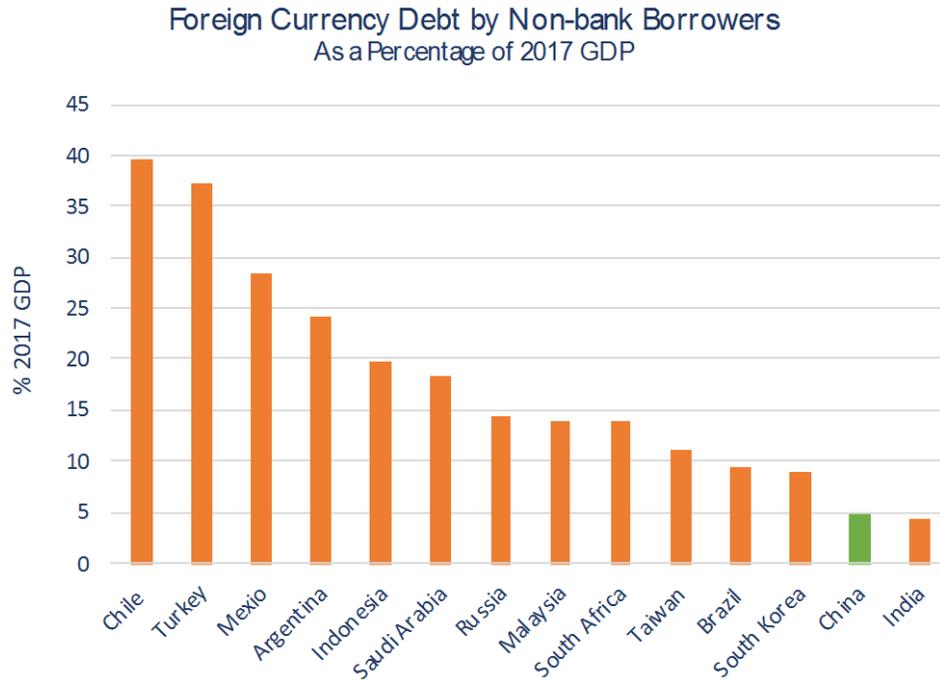
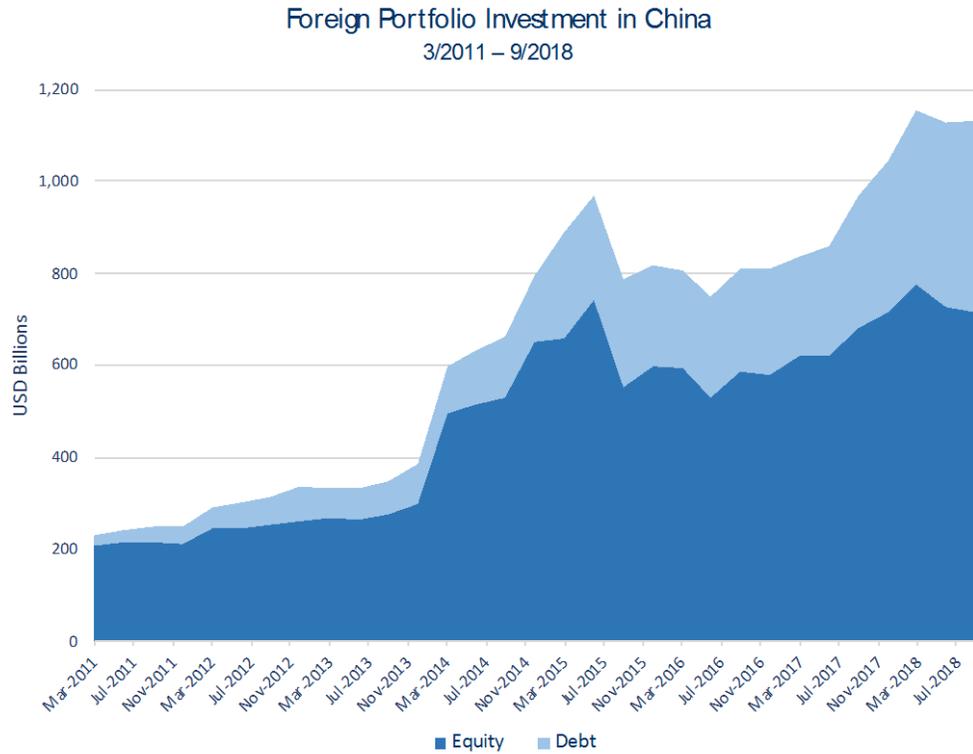


Figure 7:



Source: Bank for International Settlements

Figure 8:



Source: Wind Information

OPENING STATEMENT OF GREG LEVESQUE, MANAGING DIRECTOR, POINTE BELLO

SENATOR TALENT: Thank you.

Mr. Levesque.

MR. LEVESQUE: Chairman Bartholomew, Vice Chairman Cleveland, Commissioners, thank you for the opportunity to testify today.

The People's Republic of China's long-term national strategies to master disruptive technologies advance both economic and military development priorities.

These strategies also seize a shrinking window of opportunity to alter China's development model brought about by technological and strategic moment, as well as by Washington's recent efforts to curb PRC acquisition of technologies.

The scope and scale of Beijing's innovation drive presents immediate and long-term security risks to the United States and its allies.

My testimony today focuses on China's efforts to become an independent innovator, its continued reliance on foreign innovation resources, and the role of military-civil fusion in assisting the modernization of China's military.

Beijing's innovation drive is enshrined in its innovation-driven development strategy, a long-term plan to advance China's stated objective of becoming a science and technology power by 2050.

The innovation strategy is an information technology-based industrial policy. It calls for mastering disruptive technologies while introducing new legal, policy, and financial measures that will enhance China's capabilities to close gaps with foreign innovators.

As an overarching industrial policy, the innovation strategy integrates PRC technology industry and military modernization plans such as strategic emerging industries, Made in China 2025, and military-civil fusion.

When compared to previous state planning guidance, the innovation strategy promotes a more nuanced, market-led, government-guided approach to innovation that is both objective-driven and inherently opportunistic.

In practice, this means that the government identifies the priorities, such as the technology sector, while allowing for experimentation at the business level. This is a by-any-means-necessary approach to science and technology development.

For example, if an investment proves unsuccessful, the approach could instead shift to poaching talent or undermining the competition. Such tactics are particularly evident today in the semiconductor industry.

In a relatively short period of time, China's innovation strategy has led to impressive adjustments in industrial and defense planning as well as the modes by which state capital is allocated.

Government-guided investment funds deploy billions of dollars to advance disruptive technology sectors from new materials and artificial intelligence to integrated circuits.

We also see the proliferation of high-tech zones as well as the formation of industry alliances comprised of key corporate stakeholders and government agencies and even, at times, foreign companies to better coordinate their activities in China and abroad.

The innovation strategy turbocharges China's acquisition of foreign technology and know-how.

PRC state-connected entities are actively tapping foreign innovation resources, from

Silicon Valley and Boston to Stockholm and Tel Aviv, channeling overseas innovation resources to advance China's industrial policies.

This is described by authoritative Chinese sources as a, quote unquote, new international cooperative innovation model; but, in reality, it is simply a new spin on an old tactic, the acquisition of foreign technology and know-how.

As a key component of Beijing's innovation strategy, military-civil fusion demonstrates efforts to synchronize civilian and defense resources.

The goal is to create systematized capabilities enabling the military to leverage cutting edge scientific and technological advances from across the civilian economy.

New policies increase civilian participation in defense-related research, production and acquisition.

In particular, we see increasing use of civilian unmanned aerial vehicles in support of China's military logistics and combat missions.

The challenge for Washington posed by programs like military-civil fusion is that it blurs traditional notions of military, commercial and academic activity.

PRC companies collaborate with U.S. corporations and universities under civilian pretext to access technology and know-how that supports military programs and breaches U.S. supply chains.

Even more concerning, however, is that the U.S. military rules of engagement do not address China's military-civil fusion concept, hindering our military's effectiveness in any confrontation.

The PRC's innovation and military-civil fusion strategies position China as a contender in many disruptive technology sectors, including artificial intelligence, yet, despite rapid advances in introducing new policies and science and technology development programs, the PRC remains very reliant on foreign innovation resources.

This reliance is well understood by PRC leaders, including General Secretary Xi, as well as Chinese scientists.

It is also evident in cases where individuals steal cutting-edge technology from foreign companies and universities, as highlighted by two Department of Justice indictments in the last six months against Apple employees working on its autonomous driving vehicle program.

While the PRC today remains reliant on foreign innovation resources, China's innovation strategy is an evolving story.

Beijing is deploying significant political and financial resources to close the innovation gap with advanced foreign countries, which it views as essential to Chinese strategic competitiveness.

In closing, just as Beijing seeks to seize a window of strategic opportunity, Washington and its allies have a window of opportunity to craft meaningful responses to PRC strategies that pose both immediate and long-term risk to U.S. national security.

We must look beyond the horizon. This means putting in place dynamic threat management systems that includes allies and builds persistent scrutiny, discovery and access prevention into existing processes.

Look forward to answering any questions you might have. Thank you.

PREPARED STATEMENT OF GREG LEVESQUE, MANAGING DIRECTOR, POINTE BELLO

Testimony before the U.S.-China Economic and Security Review Commission Hearing on What Keeps Xi Up at Night: Beijing's Internal and External Challenges

February 7, 2019

Greg Levesque

Managing Director, Pointe Bello

Beijing Crafting a 21st Century Industrial Policy

The People's Republic of China (PRC) is implementing an ambitious strategy to rapidly enhance its innovation capabilities to close the scientific and technological innovation gap with more advanced economies such as the United States. A number of internal and external factors are motivating this effort, but at a macro-level, PRC leaders assess that the world has entered a fast-moving technological revolution characterized by "informatization and intelligentization" [智能化·] with implications for global economic and military affairs. Simultaneously, and arguably coincidentally, the 2008 Financial Crisis created further strategic opportunities¹ for China to expand its influence amid anticipated shifts in the global balance of power. The convergence of this "technological moment" and "strategic moment" are resulting in rapid changes to PRC industrial, innovation, and military modernization policies and capture the underpinnings of Chinese competitive strategy.

General Secretary Xi outlined this perspective in a 2013 speech to the Politburo, stating:

*"At present, from a global perspective, science and technology are increasingly becoming the main force driving economic and social development, and innovation is the general trend...Since the outbreak of the international financial crisis, major countries in the world have made great efforts to formulate new science and technology development strategies to seize the commanding heights of science and technology and industry. This trend deserves our high attention."*²

PRC industrial policy emphasizing development of "core technologies" [核心技术]³ appear strongly influenced by internal assessments of the 2008 Financial Crisis, leading to shifts in policy across economic, diplomatic, and military domains. A comparative analysis of the global crises of the 1930s and post-2008 by a team of Chinese technocrats from NDRC headed by Vice Premier Liu He, a leading architect of the Xi administration's economic strategy, offers direct insight into Chinese strategic thinking and a framework for contextualizing policies such as "Made in China 2025" and Military-Civil Fusion.

¹ Communist Party of China doctrine since Deng Xiaoping also refer to the opening of economic and diplomatic relations with the United States in the 1970s as a historical opportunity.

² Xi Jinping's Speech at the 18th Central Political Bureau's Ninth Collective Study Session, September 30, 2013

³ Also referred to by PRC government and tech sector documents "key core technologies," advanced technologies," "emerging technologies" or "disruptive technologies." For additional insight on official PRC perspectives on "core technologies" see, "Core Technologies Can't be Bought or Bargained for! Xi Jinping's Enlightening Remarks at the Academy of Sciences Meeting" [核心技术买不来讨不来!习近平院士大会这些金句振聋发聩], People's Daily website, May 28, 2018, accessed January 28, 2019 at http://app.peopleapp.com/Api/600/DetailApi/shareArticle?type=0&article_id=1778522

- Liu’s team concluded that redistribution of relative power, not just wealth, of all nations follows global crises and that the 2008 Financial Crisis created a strategic window of opportunity for China to become a global superpower. The redistribution of power is directly associated with the scientific and technological capabilities of a country and, according to the study, this, combined with economic scale, led to the emergence of the United States as the dominant global power after 1945.⁴
- Given these factors, Liu recommends China adopt a similar approach—leverage its economic competitiveness to enhance its scientific and technological capabilities and begin shaping global institutions in China’s interests.⁵ While the final objective is left unsaid, Liu recommends China “make long-term preparations for structural changes resulting from a crisis.”⁶
- Prior to 2008, PRC economic strategy emphasized overseas market expansion (“going-out”) and attracting foreign investment to build China into a global manufacturing base. The study found that the crisis “changed the implications of our [China’s] strategic opportunities” opening avenues to become a consumption driven economy, acquire technologies of developed countries, and invest in infrastructure while focusing on opportunities where Chinese and global interests align.⁷

21st Century Industrial Policy Enshrined as “Innovation Driven Development Strategy”

Responding to both the technological moment and strategic moment, Beijing has introduced an industrial policy focused on mastering core technologies and constructing requisite policies, incentives, and mechanisms to develop “original source innovation”⁸ ecosystems that serve economic, social, and military development priorities. This policy is enshrined in Beijing’s Innovation Driven Development Strategy (IDDS; [创新驱动发展战略]), mentioned in Communist Party of China (CPC) leader speeches at least as early as 2013. IDDS offers a long-term strategy for advancing China’s stated objective of becoming a “science and technology innovation power” [科技创新强国] by 2050.⁹ IDDS integrates what

⁴ Liu He, “A Comparative Study of Two Global Crises” [两次全球大危机的比较研究], *Frontiers of Economics in China*, Higher Education Press, 2015, vol. 10(3), pages 396-413. See also, Liu He, “Overcoming the Great Recession: Lessons from China,” Belfer Center, Harvard Kennedy School website, July 2014, accessed January 28, 2019 at <https://www.belfercenter.org/sites/default/files/legacy/files/Comparative%20Crises%20final-web.pdf>

⁵ Ibid.

⁶ Ibid. Liu highlights two low probability scenarios China should especially guard against: 1) huge external shocks from a deteriorating crisis and 2) wars waged by some countries to shift crisis-related disaster.

⁷ Ibid.

⁸ “Original source innovation” is the official PRC translation and hence English euphemism for a Chinese vernacular term which is more accurately translated as “China-origin innovation”. However, the term speaks to the importance of introducing, digesting, assimilating, and re-innovating discoveries and inventions, a long-standing PRC government practice. It is not accurate to think of foreign knowhow-assisted innovation as separate from PRC use of the term “indigenous innovation” or “original source innovation”. See “Li Zhimin: Independent Innovation is Mainly Integrated Innovation and Digestion and Re-Innovation” [李志民：自主创新主要是集成创新和消化吸收再创新], February 26, 2018, China Education and Research Network, observed January 17, 2019 at: http://www.edu.cn/rd/special_topic/zbwjt/201802/t20180226_1586652.shtml

⁹ “Central Committee of the Communist Party of China and the State Council Release the Outline of the Innovation-Driven Development Strategy” [中共中央 国务院印发(国家创新驱动发展战略纲要)], May 19, 2016, Xinhua News Agency, accessed January 24, 2019 at http://www.xinhuanet.com/politics/2016-05/19/c_1118898033.htm

had been vague “indicative planning” industry development programs initiated around 2006 with the release of the Medium-to-Long Term Plan for Science and Technology, which introduced the term “indigenous innovation,” into a unified plan to elevate the development of core technology sectors to a national strategy. In this way, IDDS integrates disparate technology industry and military modernization plans to include Strategic Emerging Industries, Made in China 2025,¹⁰ the Internet Plus Plan, Military-Civil Fusion, and the Artificial Intelligence Plan, among others.

- General Secretary Xi outlined the strategic nature of IDDS in a 2015 speech to the Central Committee of the CPC calling for elevating “scientific and technological innovations in important areas” to a “more prominent position” to support China’s pioneering major key core technologies in the field of strategic competition.¹¹
- IDDS calls for placing innovation at the core of “overall development of the manufacturing industry, improvement of the institutional environment conducive to innovation, promotion of cross-disciplinary and cross-industry collaborative innovation, breakthroughs in a number of core technologies in key areas, [and] promotion of the digitalization of manufacturing...”¹²
- Broadly speaking, IDDS aims to clarify the main focus of innovation and development in China to form competitive advantages, deepen reforms to build an institutional environment conducive to innovation, strengthen incentives to attract top talent, and expand the country’s opening to maximize the use of global innovation resources and position China to become a leader formulating international rules.¹³
- Compared to previous state planning, IDDS promotes a more nuanced “market led, government guided” [市场主导, 政府引导]¹⁴ approach to innovation development that is objective driven and inherently opportunistic. In this sense, the government identifies the priorities (e.g. technology) while allowing for experimentation at the operational level. In practice, it is a “by any means necessary” approach to S&T development. For example, if a foreign acquisition

¹⁰ Note that IDDS is the foremost guiding policy listed in the Made in China 2025 plan. See “Notice of the State Council on Printing and Distributing ‘Made in China 2025’” [国务院关于印发《中国制造 2025》的通知 国发〔2015〕28号], May 2015, State Council of the People’s Republic of China [国务院], accessed October 12, 2018 at http://www.gov.cn/zhengce/content/2015-05/19/content_9784.htm

¹¹ “Proposal of the Central Committee of the Communist Party of China on Formulating the Thirteenth Five-Year Plan for National Economic and Social Development,” October 26, 2015

¹² “Central Committee of the Communist Party of China and the State Council Release the Outline of the Innovation-Driven Development Strategy” [中共中央 国务院印发(国家创新驱动发展战略纲要)], Xinhua News Agency, May 19, 2016, accessed January 24, 2019 at http://www.xinhuanet.com/politics/2016-05/19/c_1118898033.htm

¹³ Ibid

¹⁴ This terminology is found across PRC policy and statements surrounding innovation. Examples include “Made in China 2025” and even descriptions of the National Integrated Circuit Industry Fund by the Ministry of Finance. See “Notice of the State Council on Printing and Distributing ‘Made in China 2025’”; and Ministry of Finance, Economic Construction Division, “The operation and investments of the National Integrated Circuit Industry Fund are running smoothly” [国家集成电路产业投资基金投资运营顺利], Ministry of Finance website, September 11, 2015, accessed January 29, 2019 at http://jjs.mof.gov.cn/zhengwuxinxi/gongzuodongtai/201508/t20150828_1438798.html

proves unsuccessful, the approach could instead shift to (or be combined with) poaching talent or undermining the competition.

PRC leaders judge that achieving the ability to independently innovate in science and technology is critical to “core national power” [国家力量的核心] and the realization of the “great rejuvenation of the Chinese nation [中华民族伟大复兴], and thus a national security imperative.”¹⁵ Moreover, Beijing hopes that by positioning China to ride this latest technological revolution it can generate new drivers of economic development, as traditional drivers are weakening.¹⁶

- In a 2013 speech, General Secretary Xi attributed gaps in PRC technological capabilities as “the root cause of backwardness” adding that “due to backward technology and low industrialization levels, China has been repeatedly defeated by countries with much smaller economies in recent years.”¹⁷
- More recently, General Secretary Xi, in July 2018, described “key core technologies” as “a national heavy weapon, which is of critical significance to promoting the high-quality development of China’s economy and safeguarding national security. It is necessary to effectively improve China’s key core technological capabilities and firmly grasp the initiative of science and technology development in our own hands and provide strong technical support for China’s development.”¹⁸

As a blueprint for building a national innovation system [国家创新体系], IDDS policies turbocharge foreign technology acquisition programs, introduce new tools for supporting innovation and more effectively channeling state, non-state, and foreign capital into priority emerging technology sectors to wrest dominance from foreign innovation leaders. In a relatively short period of time, an increasingly sophisticated innovation infrastructure is taking shape in the PRC under IDDS.

- New state financing mechanisms, specifically Government Guidance Investment Funds (GGIFs; [政府引导投资基金]), have grown rapidly in recent years—as of Q2 2018, the value of GGIFs totaled 10.3 trillion RMB (\$1.5 trillion).¹⁹

¹⁵ Ibid. (Original text: 国家力量的核心支撑是科技创新能力。实现中华民族伟大复兴的中国梦，必须真正用好科学技术这个最高意义上的革命力量和有力杠杆)

¹⁶ Ibid.

¹⁷ Xi Jinping’s Speech at the Joint Meeting of the Association for Science and Technology of the 12th Session of the National Committee of the Chinese People’s Political Consultative Conference, March 4, 2013

¹⁸ The PRC’s official news agency Xinhua, “Xi Jinping: Improving innovation capability in key core technologies to provide strong technical support for China’s development [习近平：提高关键核心技术创新能力为我国发展提供有力科技保障],” Xinhua News website, July 13, 2018, accessed January 17, 2019 at http://www.xinhuanet.com/politics/2018-07/13/c_1123123961.htm

¹⁹ Data collected from Zero2IPO. Total value is reflective of the total fundraising scope of each GGIF, not actual capital flows. Also, see “China Government Fund Ranking,” China Money Network, (undated, 2018), accessed January 28, 2019 at <https://www.chinamoneynetwork.com/china-government-fund-ranking>

- The PRC Ministry of Finance leads the GGIF program, issuing policy guidance on their formation and providing capital for central-level GGIFs.²⁰ GGIFs aim to more effectively channel state, non-state, and foreign capital and subsidize investment in priority sectors by providing interest free capital, matching funds, “signaling” to attract other investors following direct investments by GGIFs, and explicit and implicit guarantees for investors.
- GGIF investment strategies align with national industrial policy priorities, notably “high-tech” sectors and “new growth drivers.”²¹ The vast majority of GGIFs are controlled at the local level—1,335 local GGIFs have been announced with an average value of 10 billion RMB (\$1.45 billion).

State-Industry Innovation Alliances (SIAs, referred to in PRC media as industrial innovation alliances; 产业创新联盟) are emerging platforms for PRC government agencies, scientific research institutes, military industrial groups, academia, and non-state-owned enterprises, as well as foreign companies in some cases, to coordinate and collaborate to implement government technology and industry development priorities.

- SIAs serve as a bridge between the PRC government, companies, and the market to catalyze implementation of industrial development plans (e.g. Internet Plus, AI) and national policies such as military-civil fusion.
- For example, the Commercial Small Satellite Industry Innovation Alliance [“Smallsat Alliance”; 商业小卫星产业创新联盟], established in July 2018, organizes and guides member activities to promote investment cooperation and development in the commercial aerospace industry.²²
- The Smallsat Alliance has more than 100 members.²³ It prioritizes projects in regions under “One Belt, One Road”, organizes technical docking activities, serves as a bridge between the government, members, and the market, and “improves the efficiency of technology conversion” to accelerate the development of China’s aerospace engineering.²⁴
- Another example includes the “China Artificial Intelligence Industry Development Alliance (AIIA; 中国人工智能产业发展联盟在京成立) formed in October 2017 boasts more than 200-

²⁰ “Finance Ministry Notifications Regarding Provisional Management Measures for Government Guidance Funds” [财政部关于印发《政府投资基金暂行管理办法》的通知], PRC National Government Public Information Website, November 12, 2015, accessed January, 28, 2019 at http://www.gov.cn/gongbao/content/2016/content_5051233.htm

²¹ A random sampling of GGIF composition using data collected from Zero2IPO found that roughly two-thirds of funds focused their investments in sectors prioritized by central-level industrial policies such as SEIs and Made in China 2025.

²² “China Commercial Small Satellite Industry Innovation Alliance established” [中国商业小卫星产业创新联盟成立], People’s Daily, July 12, 2018, accessed January 19, 2019 at <http://scitech.people.com.cn/n1/2018/0713/c1007-30145948.html>

²³ Members include the Ministry of Commerce Investment Promotion Bureau, China Spacesat Co. [中国东方红卫星股份有限公司], a subsidiary of China Aerospace Science and Technology Co., and the Beijing Institute of Space Science and Technology.

²⁴ See “China Commercial Small Satellite Industry Innovation Alliance Established” [中国商业小卫星产业创新联盟成立], China Military Network website, July 13, 2018, accessed January 19, 2019 at http://www.81.cn/jfjbmap/content/2018-07/13/content_210835.htm

member companies including Alibaba, Tencent, and Baidu.²⁵ AIIA operates under the guidance of the National Development and Reform Commission, Ministry of Science and Technology, the Ministry of Industry and Information Technology (MIIT), the Central Network Security and Informatization Leading Group Office.²⁶

In addition, a new wave of “Silicon Valley-like” high-tech zones are rolling out across the country, combining talent acquisition programs, local economic and defense development policies, and venture capital-like financing mechanisms to fuel PRC start-ups and research institutes developing cutting-edge technologies, most often acquired from abroad.²⁷

- Eight regional “Comprehensive Innovation Reform Experiment Zones” [全面改革创新试验区]²⁸ and 120 “Double Innovation Demonstration Bases” [双创示范基地] were designated between 2015 to 2017 to serve as testing grounds for new innovation policies and pursue reform measures in talent acquisition, S&T research, economic development, and military-civil fusion.²⁹
- Double Innovation Demonstration Bases provide state-supported environments for “indigenous innovation” by offering “new service-driven models of government” to help central government policies bridge “the final kilometer” of implementation.³⁰ A 2016 State Council notice describes the thinking behind Double Innovation Demonstration Bases:

...[We must] effectively gather universities, scientific research institutes, and enterprises together with financial capital, IPR services, and the strength of social organizations...in order to implement a set of double innovation policy measures, supporting building a

²⁵ “China Artificial Intelligence Industry Development Alliance established in Beijing” [中国人工智能产业发展联盟在京成立], Xinhua News website, October 13, 2017, accessed January 27, 2019 at http://www.xinhuanet.com/2017-10/13/c_1121801129.htm

²⁶ Ibid.

²⁷ “The CPC Central Committee Office and the State Council Office Publish ‘General Plan for Advancing Comprehensive Innovation Reform Experimentation in District Systems’” [中共中央办公厅、国务院办公厅印发《关于在部分区域系统推进全面改革创新试验的总体方案》], PRC National Government Public Information Website, September 7, 2015, accessed January 27, 2019 at http://www.gov.cn/zhengce/2015-09/07/content_2926502.htm

²⁸ The eight zones include: 1) Jing-Jin-Ji (Beijing, Tianjin, and some surrounding areas of Hebei Province); 2) Shanghai; 3) Guangdong Province; 4) He-Wu-Beng (Hefei, Wuhu, and Bengbu); 4) Cheng-De-Mian (Chengdu, Deyand, and Mianyang); 5) Wuhan; 6) Xian; 7) Shenyang. See “The CPC Central Committee Office and the State Council Office Publish ‘General Plan for Advancing Comprehensive Innovation Reform Experimentation in District Systems’” [中共中央办公厅、国务院办公厅印发《关于在部分区域系统推进全面改革创新试验的总体方案》], September 7, 2015, PRC National Government Public Information Website, accessed January 27, 2019 at http://www.gov.cn/zhengce/2015-09/07/content_2926502.htm

²⁹ The “Double” [双] refers to “innovation in technology” and “innovation in business” (*aka* “entrepreneurship”), which both begin with the same character in vernacular Chinese. Double Innovation Demonstration Bases fall under three categories: 1) Regional S&T Demonstration Bases (62 designated); 2) University and Scientific Research Institute Demonstration Bases (30 designated); and 3) Enterprise Demonstration Bases (28 designated)

³⁰ “State Council Office Opinions Regarding the Implementation of Mass Pioneering Work and Mass Innovation Model Bases” [国务院办公厅关于建设大众创业万众创新示范基地的实施意见], PRC National Government Public Information Website, May 12, 2016, accessed January 28, 2019 at http://www.gov.cn/zhengce/content/2016-05/12/content_5072633.htm

group of double innovations support platforms, and explore the formation of different types of demonstration models [for technology development].”³¹

PRC Still Reliant on Foreign Knowhow Despite Rapid Policy, Infrastructure Development

Despite rapid advances in rolling out new innovation-driven policies, regulations, and financing mechanisms, the PRC remains reliant on foreign innovation systems, particularly the United States and Japan, for what it considers key core technologies.

- This reliance is well understood by PRC leaders and Chinese S&T professionals and has been made even more glaring by the U.S.-China “trade war”, notably the U.S. government’s initial decision to sanction PRC technology firm ZTE, essentially crippling its operations.³²
- According to a July 2018 Central Financial and Economic Leading Group meeting, “China’s scientific and technological development level, especially in key core technology innovation capabilities, is still far behind the international advanced level and still far from meeting the requirements for achievement of the goals of ‘the one-hundred-year [marathon] struggle’”.³³
- The PRC’s realization of “original source” innovation—or even effective mass production of appropriated foreign technology at its original foreign standards—continues to be hampered by structural flaws in governance and administration, notwithstanding efforts to address these systemic issues.³⁴
- A group of prominent PRC S&T professionals from the Chinese Academy of Sciences assess that the pursuit of “key core technologies” is “choked” by “foreign blockades of technology”, as well as persistent domestic institutional shortcomings, including administrative rigidities, immaturity of industry innovation ecosystems, and a lack of robust domestic supply chains.³⁵ In addition, Beijing openly acknowledges that it currently lacks leading and highly skilled talent at scale.³⁶

³¹ Ibid. (Original text: “依托双创资源集聚的区域... 有效集成高校、科研院所、企业和金融、知识产权服务以及社会组织等力量，实施一批双创政策措施，支持建设一批双创支撑平台，探索形成不同类型的示范模式。”)

³² For example, see Wu Yimian, “China Calls for Semiconductor Self Reliance Amid ZTE Import Ban,” China Money Network, April 18, 2018, accessed January 29, 2019 at <https://www.chinamoneynetwork.com/2018/04/18/chinese-media-calls-for-semiconductor-self-reliance-amid-zte-import-ban>

³³ “Xi Jinping: Improving innovation capability in key core technologies to provide strong technical support for China’s development [习近平：提高关键核心技术创新能力为我国发展提供有力科技保障],” Xinhua News website, July 13, 2018, accessed January 17, 2019 at: http://www.xinhuanet.com/politics/2018-07/13/c_1123123961.htm

³⁴ An investigation by Former Minister of Science and Technology Xu Guanhua, former Deputy director of the State Council’s Development Research Center Chen Qingtai, and renowned economist and former research fellow at the Development Research Center highlighted that the common obstacles to “original source innovation” are due to gaps in China’s national strategies and policies. See “Introduction to the Committee of Radical Innovation 100” [中国源头创新百人会], Tsinghua University Institute for Innovation and Development, undated, accessed on January 18, 2019 at <http://www.iid.tsinghua.edu.cn/p-60.html>

³⁵ “Key core technology: why are we “like choking on a fish bone caught in the throat” [关键核心技术，我们为什么“如鲠在喉”], China Science Daily Website, November 19, 2018, accessed January 17, 2019 at <http://news.sciencenet.cn/htmlnews/2018/11/420092.shtm>

³⁶ “Central Committee of the Communist Party of China and the State Council Release the Outline of the Innovation-Driven Development Strategy” [中共中央 国务院印发《国家创新驱动发展战略纲要》], Xinhua News Agency, May 19, 2016, accessed January 25, 2019 at http://www.xinhuanet.com/politics/2016-05/19/c_1118898033.htm

More recently, Miao Wei, Minister of MIIT, identified four specific areas hindering China’s innovation potential.³⁷ First, investment in basic research among PRC companies remains far behind advanced economy levels. Moreover, this investment focuses primarily on the application of technologies. Second, the supply of common technologies described as “basic, related, systematic, and open” and often inputs in core technologies are lacking. The issue is compounded by a lack of common technology R&D systems, insufficient funding, and uncoordinated policies. Third, structures supporting collaboration between industry and academia to accelerate technological breakthroughs are not in place. Finally, while China’s labor force is abundant, it faces a shortage of “high-tech talents” engaged in R&D on core technologies, especially in the manufacturing industry.

IDDS Supporting Advances in PRC Integrated Circuit Industry

Beijing’s intent to construct a self-sufficient integrated circuit (IC) industry demonstrates how new tools introduced under IDDS are enabling China to quickly mobilize to become a contender in emerging technology sectors. Formed in October 2014 by the Ministry of Industry and Information Technology (MIIT), the National Integrated Circuit Industry Investment Fund (“National IC Fund”)—the first and largest GGIF—is mandated to spend a massive amount of money to implement government IC industrial policies. The fund has already fully spent the money raised in its first round of fund-raising, committing nearly \$18 billion and deploying 81.8 billion RMB (\$11.8 billion) in at least 67 projects by mid-2018.¹ A second round of fund-raising set at 150 billion RMB (\$23 billion) was launched in mid-2018.to date with plans to raise a second \$31.2 billion fund.³⁸

- The National IC Fund is a “growth fund” investing in all stages of the IC production chain, including new chip fabs, chip design, packaging and testing, equipment and materials, and IC applications. It also funds industry consolidation through M&A.³⁹
- Though the PRC’s IC Industry lags foreign competitors, the National IC Fund has played a crucial role in advancing industry growth targets and the industry will likely continue to reduce foreign dependency as government policies and investments mature and encourage technological advances.

³⁷ “Miao Wei (Qiushi) Article: Strengthen efforts to master core technologies; promote the development of high quality manufacturing,”[苗圩《求是》撰文：加强核心技术攻关 推动制造业高质量发展], MIIT website, July 16, 2018, accessed January 29, 2019 at <http://www.miit.gov.cn/n1146285/n1146347/n1147601/n1147604/c6260533/content.html>

³⁸ Total invested dollars were calculated using PRC corporate records data. See “Second Phase of National Integrated Circuit Industry Fund, 100 Billion for Integrated IC Industry Chain” [国家大基金二期正募集 千亿布局集成电路产业链], Xinhua News website, April 5, 2018, accessed on January 25, 2019 at http://m.xinhuanet.com/ln/2018-05/04/c_1122781205.htm

³⁹ Information on the National IC Fund’s investment activities collected from an analysis of PRC corporate records data.

- 2017 IC industry revenues in China grew nearly 20 percent year-on-year (in-line with the national target) with similar estimates being put forward for 2018.⁴⁰ This is compared to an average revenue growth in the IC industry worldwide of 3.4 percent.

IDDS Systematically Tapping Foreign Innovation Ecosystems

Beijing’s increasing effort to establish inroads in foreign innovation hubs (e.g. Silicon Valley, Boston, Tel Aviv) provides an example of PRC reliance on foreign innovation ecosystems. These inroads encompass the physical establishment of operations in a foreign country, as well as research partnerships with universities that facilitate the transfer of technology and know-how. The Shenzhen-based “Committee of Radical Innovation 100” (“CRI 100”; [中国源头创新百人会]),⁴¹ founded in 2015, spearheads the combined efforts of PRC government, corporations, and academia to identify and absorb cutting-edge foreign research, technology, and talent in support of national S&T priorities.

- Comprised of former and current PRC central and local government officials, technology entrepreneurs, finance executives, and academics, CRI 100 serves as a “platform for exchange, services and resource integration” among China’s innovation forces to “promote the theory and practice of “Chinese original source innovation.”⁴²
- CRI 100’s stated mission is to connect overseas innovation resources [海外源头创新资源] with China’s industrial demand, advancing S&T development through what it describes as a “new international cooperative innovation model” [国际协同创新的新棋局].⁴³

To advance this mission, CRI, an affiliated organization of CRI 100, is forming overseas innovation centers in the United States, Israel, and Europe and pursuing collaborations with universities such as MIT, the University of Michigan, Carnegie Mellon and Oxford University.⁴⁴

⁴⁰ “Total Revenue of China’s IC Industry to Grow Above Global Average at Annual Rate of 19.86% for 2018, Says TrendForce,” Business Wire website, November 9, 2017, accessed January 25, 2019 at <https://www.businesswire.com/news/home/20171109005547/en/Total-Revenue-China%E2%80%99s-IC-Industry-Grow-Global>

⁴¹ The use of the term “radical” comes from the official English translation provided by CRI 100. Another translation of the vernacular Chinese name of the organization might be “The Committee of Original Source Innovation 100”.

⁴² Founding members include Tsinghua University Institute of Innovation and Development, China Association for Strategic Development Research Institute, Shenzhen Huada Gene Institute, Shenzhen Guangqi (Kuangchi) Institute of Advanced Science and Engineering, Shenzhen Space Science and Technology Southern Institute, and the Shenzhen City Peng Rui Investment Group Co. Ltd. Also, Chinese original source innovation is defined by CRI 100 as basic research in pursuit of new scientific discoveries and innovative activities that enhance national competitiveness. See

Zhao Qinghui, “Zhou Luming: The Method of Source Innovation Must Change, the Future will Focus on Artificial” [周路明：源头创新方式需要改变，未来会关注人工智能 | CCF-GAIR 2017], Leifeng Online, July 5, 2017, accessed January 27, 2019 at <https://www.leiphone.com/news/201707/GrtWoD6GEEtr3d6.html>

⁴³ “Committee of Radical Innovation 100 will be Established in Shenzhen” [中国源头创新百人会在深圳成立], Shenzhen municipal government website, July 29, 2015, accessed January 29, 2019 at http://www.sz.gov.cn/cn/xxgk/zfxxgj/zwdt/201507/t20150729_5302689.htm

⁴⁴ See “Cooperation Partners,” CRI Offshore Center website, accessed January 29, 2019 at <http://www.crioc.org/index.php?s=/sys/index/partner.html>

- In May 2017, CRI established the “Radical Boston Innovation Center” [源创力波士顿创新中心] to “link China’s industry, applications, and demands to source innovation in developed countries” focusing on advances in IT, intelligent and new energy vehicles, high-end manufacturing, and healthcare.⁴⁵
- The Radical Boston Innovation Center is part of the China Association of Science and Technology (Shenzhen) Overseas Talent Offshore Innovation and Entrepreneurship Base [中国科协(深圳)海外人才离岸创新创业基地], a joint initiative between the Shenzhen municipal government and CAST under its “Help Our Motherland Through Elite Overseas Intellectual Resources Program [“HOME Program”]; 海外智力为国服务行动计划].⁴⁶

Military-Civil Fusion: Turning Economic Scale into Military Might

Beijing’s Military-Civil Fusion program is a key component of IDDS and leading driver of PRC defense science, technology, and industrial (DSTI) system reforms under General Secretary Xi Jinping.⁴⁷ Often misinterpreted as a purely military modernization play, MCF is a creative gamble to turn the classic macroeconomic “guns versus butter” model on its head—into a dual-use “guns *and* butter” model—by synchronizing PRC industrial and defense planning. PLA military strategist Jiang Luming [姜鲁鸣], a leading MCF expert at the PLA National Defense University, describes MCF as “...the comprehensive planning of the two major systems of military and civilian resources, brings about a compatible economic and technical foundation for [resource] sharing, transforms limited social resources into bidirectional and interactive combat power and production power, and achieve multiple types of production from a single investment.”⁴⁸

⁴⁵ “About Us Section”, CRI Offshore Center website, accessed January 29, 2019 at <http://www.crioc.org/about.html>. [Original text: 我们的逻辑是连接中国的产业端、应用端、需求端和发达国家源头创新端]; and Shenzhen Source Innovation Offshore Center [深圳市源创力离岸创新中心] organization profile, accessed January 29, 2019 at

<http://company.zhaopin.com/CZ715693340.htm>. For additional detail on the role of PRC investments, incubators, and acquisitions in the U.S. aimed at tapping emerging technologies and talent, see Elsa B. Kania, “Testimony before the House Permanent Select Committee on Intelligence: China’s Threat to American Government and Private Sector Research and Innovation Leadership,” CNAS website, July 19, 2018 at <https://www.cnas.org/publications/congressional-testimony/testimony-before-the-house-permanent-select-committee-on-intelligence>

⁴⁶ Another translation of the vernacular Chinese name of the program is the “Overseas Intelligence for National Service Action Plan”. See “China Association of Science and Technology (Shenzhen) Overseas Talent Offshore Innovation and Entrepreneurship Base Formally Set Up” [中国科协(深圳)海外人才离岸创新创业基地正式入驻], Shenzhen municipal government website, September 28, 2017, accessed January 27, 2019 at http://www.sz.gov.cn/kxjsxh/zxzx_89860/kxxw/201709/t20170929_8894627.htm

“Overview of Overseas Talents Offshore Innovation and Entrepreneurship Base” [海外人才离岸创新创业基地概述], CAST website, May 12, 2016, accessed January 27, 2019 at <http://www.cast.org.cn/n200675/n202200/n202372/index.html>

⁴⁷ For additional insights, see Tai Ming Cheung, “How China’s Defense Innovation System Is Advancing the Country’s Military Technological Rise,” SITC Research Briefs, Series 10(2018-3), May 30, 2018, accessed January 29, 2019 at <https://escholarship.org/uc/item/7c75995r#main>

⁴⁸ Jiang Luming, “Comprehensively Planning an Overall Strategy for National Security and Development” [统筹国家安全和发展的总方略], PLA Daily, June 2, 2016, accessed January 29, 2019 at http://www.81.cn/gfbmap/content/2016-06/02/content_146372.htm

- MCF aims to enhance and introduce new “hard” and “soft” innovation capabilities to form a “national defense S&T industrial system with Chinese characteristics.”⁴⁹ These include new policies to streamline standards among civilian and defense entities, encouraging civilian participation in the defense economy, creating new state financing vehicles for MCF development, and forming MCF industry clusters.⁵⁰
- MCF prioritizes advances in maritime, space, cyberspace, biology, new power sources, and artificial intelligence while also introducing new modes of weapon and equipment procurement and talent development in support of national defense.⁵¹
- Additionally, MCF promotes the joint development and utilization of military and civilian infrastructure including scientific research institutes and labs, airports, ports, communications infrastructure, satellites, as well as joint exploration of the sea and outer space.⁵²

China’s DSTI system has historically relied on absorption and re-innovation of foreign technology and know-how.⁵³ By synchronizing civilian and defense resources, Chinese planners hope to encourage original advanced research and development in priority dual-use sectors that generate both economic and military returns. In order to do this, MCF calls for breaking down domestic institutional barriers limiting the PLA’s access to the civilian economy and vice versa. These barriers currently create disadvantages against adversaries able to leverage “systemized capabilities” that more effectively aggregate civilian resources during a conflict, especially a protracted one. Said differently, Chinese military strategists assess that they “have resources but not aggregation [and] have strength without capabilities [有资源无聚合、有实力无能力].”⁵⁴

Increasing civilian entities’ participation, especially technology companies, in national defense S&T and weapons research and production—a concept referred to in vernacular Chinese as *mincanjun* [民参军]—and converting military technology (spin-off) into civilian use—a concept referred to in vernacular Chinese as *junzhuanmin* [军转民]—are important components of MCF and China’s broader military reforms to develop cutting-edge defense technologies.⁵⁵

⁴⁹ For more in-depth research on key factors supporting defense innovation, see Tai Ming Cheung, “Critical Factors in Enabling Defense Innovation: A Systems Perspective,” SITC Research Briefs, Series 10(2018-2), May 30, 2018, accessed January 25, 2019 at <https://escholarship.org/uc/item/170219mp#main>

⁵⁰ “SASTIND Publishes 2017 Military Civil Fusion Special Action Plan” [国防科工局发布 2017 年军民融合专项行动计划], State Administration for Science, Technology and Industry for National Defense, June 23, 2017, accessed January 29, 2019 at http://www.gov.cn/xinwen/2017-06/23/content_5204695.htm#1

⁵¹ For additional information on MCF priority sectors, see Greg Levesque and Mark Stokes, “Military-Civil Fusion and the “Going-Out” of China’s Defense Industry,” Pointe Bello, December 2016 at https://pointebello.com/s/062017_Pointe-Bello_Military-Civil-Fusion-Report.pdf

⁵² “Full Text: China’s Military Strategy,” Ministry of National Defense of the People’s Republic of China website, May 26, 2015 at http://eng.mod.gov.cn/Press/2015-05/26/content_4586805_4.htm

⁵³ See Tai Ming Cheung, “How China’s Defense Innovation System Is Advancing the Country’s Military Technological Rise”

⁵⁴ See Jiang Luming, “Comprehensively Planning an Overall Strategy for National Security and Development” [统筹国家安全和发展的总方略]

⁵⁵ “Decision of the Central Committee of the Communist Party of China on Comprehensively Deepening the Reform of Some Major Issues” at the Third Plenary Session of the 18th CPC Central Committee in November 2013. “Interpretation of the

- *Mincanjun* calls for streamlining defense contractor licensing processes, military and civilian standards, and improving information exchange to encourage civilian entities (e.g. companies and universities) to participate in defense research and procurement thereby introducing competition and opening new avenues for the PLA to identify, capture, and develop disruptive technologies that could alter the rules of battle.⁵⁶
- The State Administration of Industry for National Defense (SASTIND), a leading agency for MCF development and implementation, reports that civilian enterprises participating in the defense industry is increasing with “private” companies accounting for two-thirds of civilian entities who have obtained weapons and equipment research and production licenses to date, though it’s unclear what these firms are doing with these licenses.⁵⁷ Additionally, civilian enterprises are reportedly increasingly involved in the development of weapons sub-systems and complete systems, as opposed to producing primarily ancillary products.⁵⁸
- Civilian logistics and unmanned aerial vehicle (UAV) manufacturers have become a focal point of *mincanjun* under MCF. In a major development, the first PLA reserve unit focused on operating civilian UAV platforms for “counter-terrorism, search and rescue, and information gathering” was formed in cooperation with JD.com in Shaanxi in May 2018.⁵⁹ PLA engagement with civilian logistics and UAV manufacturers to date takes three primary forms:
 - subcontracting of logistics support to civilian UAV operators (e.g. JD.com and SF Express)⁶⁰;

Important Measures of the Third Plenary Session of the 18th CPC Central Committee” [党的十八届三中全会《决定》重要举措释义], CPC News Online website, November 22, 2013 at <http://theory.people.com.cn>

⁵⁶ “Jiang Luming: A Scientific Guide to Promoting Deep Military-Civil Fusion [姜鲁鸣：推进军民深度融合发展的科学指南],” MIIT website, July 26, 2017, accessed January 29, 2019 at <http://www.miit.gov.cn/n1146285/n1146352/n3054355/n3057613/n3057641/c5741871/content.html> (Original text: 我们只有推动军民深度融合，实施军民协同创新，及早从源头上识别、捕捉和开发能够改变作战规则和科技发展方向的重大颠覆性技术，才能大规模获取军民融合战略红利，争取主动、赢得未来); and

“SASTIND Publishes 2017 Military Civil Fusion Special Action Plan” [国防科工局发布 2017 年军民融合专项行动计划]

⁵⁷ “SASTIND Holds Press Conference on the Situation of Military-Civil Fusion in the National Defense Science and Technology Industry” [国防科工局举行国防科技工业军民融合发展情况发布会], State Council Information Office website, December 6, 2017, accessed January 28, 2019 at <http://www.scio.gov.cn/xwfbh/gbwxwfbh/xwfbh/hfkgw/Document/1612885/1612885.htm>

⁵⁸ Ibid.

⁵⁹ “A Certain Shaanxi Reserve Anti-Aircraft Artillery Base Drives Ahead in Creating a UAV Support Unit” [陕西某预备役高炮师推进无人机保障分队建设], PLA Daily website, May 20, 2018, accessed January 30, 2019 at http://www.xinhuanet.com/mil/2018-05/20/c_129876747.htm; and

“Scouting, Search and Rescue, Delivering Materials -- The Military and JD.com Jointly Organize a UAV Military Reserve Unit” [侦查、搜救、送物资,军方联合京东组无人机预备役分队], Orient Today website, May 19, 2018, accessed January 30, 2019 at <https://news.mydrivers.com/1/577/577427.htm>

⁶⁰ See Luo Yu and Gao Hongxia, “Breakthrough! UAVs From Rapid Delivery Companies Provide Exercise Services to the PLA For the First Time” [新突破！快递公司无人机在演习中首次服务解放军], People’s Daily website, January 30, 2018, accessed January 28, 2019 at <http://sc.people.com.cn/n2/2018/0130/c345527-31198409.html>

- direct acquisition of UAVs from civilian manufacturers;⁶¹ and
 - joint ventures between state-owned defense groups and civilian UAV manufacturers to produce light armed UAVs for combined reconnaissance and strike functions.⁶²
- As part of *junzhuanmin*, SASTIND, MOF, and the State Intellectual Property Office have issued at least three sections of a “National Defense Science and Technology Intellectual Property Transformation Guide” containing intellectual property from state-owned defense industry groups for use in the civilian sector.⁶³ In addition, the PLA in March 2017 declassified for the first time more than 2,300 dual-use technology patents to encourage civilian application.⁶⁴

MCF industry funds, industry alliances, and technology parks are converging to promote MCF implementation, all as prescribed by the IDDS. The 30.2 billion RMB (\$4.8 billion) Central Military-Civil Fusion Fund [国华军民融合发展基金], which is managed by CASC Aerospace Investment Corp, along with at least a combined \$40 billion across local-level investment vehicles are helping to push forward MCF projects and initiatives.⁶⁵

- MCF industry alliances coordinate MCF implementation among government, military, and defense industry stakeholders and provide S&T intelligence and policymaking support. Notable alliances include the China National Defense Industrial Enterprise Military-Civil Fusion Alliance [中国国防工业企业军民融合产业联盟] and the China Association of Science and Technology Military-Civil Fusion Alliance (“CAST MCF Alliance”; [中国科协军民融合学会联合体]).⁶⁶
 - CAST MCF Alliance members include all state-owned defense industry associations as well as military research institutes, universities, and enterprises. Its mission involves supporting strategic decision-making and evaluation of major MCF policies, leveraging

⁶¹ See “Special Interview with Central Aviation Knowledge’s Vice-President: Walking Down the Innovation Road for China’s Own UAVs” [专访中航智副总：走出中国人自己的无人机创新之路], November 4, 2016, accessed January 30, 2019 at <http://mil.huanqiu.com/aerospace/2016-11/9635347.html>

⁶² See “Qingzhun Technology’s ‘Reconnaissance- Strike Combined UAV’ Takes the Stage, Taking the Lead in Striding Forward Down the New Road of Military-Civil Fusion” [轻准科技“察打一体无人机”亮相高交会 率先迈出军民融合新路], Shenzhen News Online, November 16, 2017, accessed January 30, 2019 at http://inanshan.sznews.com/content/2017-11/16/content_17773627.htm

⁶³ See “SASTIND, MOF, SIPO jointly issue ‘Guiding Opinions on Defense Science and Technology Industry Promoting the Construction of Strong National Intellectual Property Rights’” [国防科工局、财政部、知识产权局联合印发《关于国防科技工业推进知识产权强国建设的指导意见》], SIPO website, November 28, 2017, accessed January 30, 2019 at http://www.sipo.gov.cn/gwyzscqzlssgzbjlxkybgs/bwdt_zlb/1097850.htm

⁶⁴ Pei Yin, “National Defense Patents are Declassified for the First Time, can the ‘Treasure’ be Successfully Awakened?” [国防专利首次解密，“宝藏”能否被成功唤醒?], China Military News Online website, June 26, 2017, accessed January 28, 2019 at http://www.81.cn/2017jj90/2017-06/26/content_7669742.htm

⁶⁵ Pointe Bello has identified at least 10 local-level MCF investment vehicles with a combined fund size of more than \$40 billion established between 2012-2018. This does not represent an exhaustive list of MCF funds or the total amount of state capital being directed to MCF-related initiatives.

⁶⁶ “Introduction to the China Association of Science and Technology Military-Civil Fusion Association” [中国科协军民融合学会联合体简介], China Association of Science and Technology website, July 13, 2016, accessed January 20, 2019 at http://www.cast.org.cn/art/2016/7/13/art_558_39761.html

high-end scientific and technological talent, notably overseas returnees, and establishing a long-term mechanism for the conversion of military and civilian S&T achievements to serve the national economy and military modernization.⁶⁷

MCF demonstration bases integrate defense and civilian basic research, R&D, production, capital, and talent to drive down costs and accelerate technological breakthroughs in production cycles. They also serve to combine military S&T requirements with local economic development plans.

- Since 2009, 36 national MCF demonstration bases across China have been established under the “National New Industrial Demonstration Base Initiative,” [国家工业化产业示范基地], which is overseen by MIIT.⁶⁸ In addition, all major provincial and municipal governments have unveiled MCF industry development plans leading to the formation of local MCF research centers, bases, and parks.⁶⁹
- For example, Zhongguancun Science Park leads the integration of military-civil science and technology resources in Beijing and has established platforms to directly link military requirements with zone-wide scientific and technological advancements.⁷⁰ Qingdao’s West Coast New District, an important maritime defense hub, is accelerating MCF industry development in marine vessels, biomedicine, aerospace, IT, and new materials.⁷¹ Meanwhile Chengdu announced four MCF aviation industry parks in mid-2016 and plans to construct six more and form a local MCF industry alliance.⁷²

MCF blurs the lines between traditional notions of military, commercial, and academic activity creating challenges for U.S. policymakers, executives, and university administrators. For example, Beijing’s use of “commercial” state-owned enterprises to assert its territorial claims in the South China Sea, including the construction of reclaimed islands and military installations, exemplify military-civil fusion in action. Additional examples include:

⁶⁷ Ibid.

“National Defense Industry Association: Establishes Five Service Platforms to Support Military Civil Fusion Development” [国防工业企业协会：建五大服务平台 助力军民融合发展], Xinhua News website, January 8, 2017, accessed January 30, 2019 at http://www.xinhuanet.com/politics/2017-01/08/c_129436654.htm; and “Introduction to the China Association of Science and Technology Military-Civil Fusion Association” [中国科协军民融合学会联合体简介]

⁶⁸ Launched in 2009, the National New Industrial Demonstration Base Initiative promotes the restructuring and development of six high-tech industrial sectors: equipment manufacturing, raw materials, consumer products, electronic information, military-civil fusion, and software and information services. For more, see “National New Industrial Demonstration Base Initiative [国家新型工业化产业示范基地], MIIT website, undated, at <http://sfjd.miit.gov.cn/BasInfoAction!findListindustry.action>

⁶⁹ For example, see “Zhejiang Province Military-Civil Fusion Industry ‘13th Five-Year Plan’ Plan” [浙江省军民融合产业“十三五”规划], Zhejiang Provincial Government website, undated, accessed January 30, 2019 at <http://www.zjxw.gov.cn/module/download/downloadfile.jsp?classid=0&filename=80a04fdc0dbd4ab18c32f1e623e53857.pdf>

⁷⁰ Military-civil science and technology synergy becoming the engine of innovation development in Zhongguancun

Demonstration Park [军民科技协同成为中关村示范区创新发展引擎], Zhongguancun Science Park website, January 8, 2019, accessed January 18, 2019 at <http://zgcgw.beijing.gov.cn/m/dtq/gzdt5/181919/index.html>

⁷¹ “Qingdao West Coast New District Issues Opinions to Accelerate Promotion of Military-Civil Fusion Industry Development” [青岛西海岸新区出台意见 加快推进军民融合产业发展], Xingkong Observer Online website, April 28, 2018, accessed January 30, 2019 at <http://xingkonggc.com/a/news/guona/2018/0428/460889.html>

⁷² “Chengdu in Advance Starts Four Military-Civil Fusion Industry Parks” [成都先期启动四个军民融合产业园], Sichuan Provincial Government website, July 26, 2016 at <http://www.sc.gov.cn/10462/10778/13814/2016/7/27/10389670.shtml>

- The Aviation Industry Corporation of China (AVIC) since 2010 has acquired at least eight general aviation companies in the United States and Europe, including leading manufacturers of advanced piston engines with full-authority digital engine control.⁷³ These acquisitions led to domestic technological breakthroughs in modified gasoline and heavy fueled engines, electronic fuel injection technology, and turbocharging enhancing the performance and operability of PRC high-altitude UAVs.⁷⁴
- The state-owned China Railway Rolling-Stock Co. (CRRC) acquisition of UK-based Dynex Corporation led to the transfer of high-tech semiconductors, notably insulated-gate bipolar transistors (IGBT), to China. CRRC's IGBT manufacturing facility in Zhuzhou now reportedly supplies the PLA and is being used in its 2nd generation aircraft carrier integrated propulsion system and rail gun programs.⁷⁵
- Founded largely on U.S. Air Force funded research on metamaterials conducted at Duke University, Shenzhen-based Kuang-Chi Group is regularly referred to in PRC media as a “military-civil fusion enterprise” [军民融合企业].⁷⁶ The firm boasts close ties to the PLA and works with China Aerospace Science and Industry Corporation's Hunan Space Bureau (068 Base)—a R&D and production center for near space reconnaissance platforms.⁷⁷ In March 2018, Kuang-Chi

⁷³ For example, see “AVIC International Announces the Formation of Continental Motors Group and Expansion into China,” Continental Motors website, April 10, 2014, accessed January 30, 2019 at <http://www.continentalmotors.aero/xPublications/News%20Releases/AVIC%20International%20Announces%20the%20Founding%20of%20the%20Continental%20Motors%20Group/>

⁷⁴ “Heart of Chinese UAV made in China: accurate targeting nets top US and German manufacturers” [中国无人机心脏国产:精准出手 收购美德顶级制造商] Phoenix Military News, December 6, 2016, accessed January 30, 2019 at http://news.ifeng.com/a/20161206/50370941_0.shtml

⁷⁵ See Minnie Chan, “China's aircraft carrier conundrum,” South China Morning Post, November 19, 2017, accessed January 29, 2019 at <http://www.scmp.com/news/china/diplomacy-defence/article/2120391/chinas-aircraft-carrier-conundrum-hi-tech-launch-system>; and Mark Hookham and Richard Kerbaj, “Has China used British technology to build a rail gun?,” The Times, March 4, 2018 at <https://www.thetimes.co.uk/article/has-china-used-british-technology-to-build-a-railgun-n7blzkmkg>; and “Strength Burst Forth! She is a core member of Ma Weiming's innovation team” [实力爆表！她可是马伟明院士创新团队的核心成员], China Naval Network website, March 7, 2018, accessed January 29, 2019 at <https://mp.weixin.qq.com/s/pyQ3AZxg3mjQF3y8F90Neg?>

⁷⁶ For more information on Kuang-Chi founder Liu Ruopeng's role in transferring metamaterials research to China while at Duke University see “Chinese Talent Programs: Counterintelligence Strategic Partnership Intelligence Note,” Federal Bureau of Investigation, September 2015 at <https://compliance.fiu.edu/documents/SPIN%20-%20Chinese%20Talent%20Program.pdf>; and Neelesh Moorthy, “How one graduate student allegedly stole Duke research to create a billion-dollar Chinese company,” The Chronicle, Duke University, October 29, 2017, posted at <http://www.dukechronicle.com/article/2017/10/how-one-graduate-student-allegedly-stole-duke-research-to-create-billion-dollar-chinese-company>. Also, see Shen Yiran, “Kuang-Chi's Liu Ruopeng: Every Step of Kuang-Chi's Development Practice Follows the General Secretary's Two Sentences” [光启刘若鹏：光启发展每一步都在践行总书记两句话嘱托], Finance Sina website, December 28, 2017, accessed January 30, 2019 at <http://finance.sina.com.cn/chanjing/gsnews/2017-12-29/doc-ifyqchnr6974026.shtml>

⁷⁷ The agreement was signed by Shenzhen Guangqi Space Technology Co., Ltd. [深圳光启空间技术有限公司], a subsidiary of Kuang-Chi Science and Technology Co. [光启科学有限公司] providing big data, space wi-fi, and space exploration services. See “068 Base and 7801 Institute sign strategic framework agreement with Shenzhen KuangChi Space Technology Co., Ltd.,” [068 基地 7801 所余深圳光启空间技术有限公司签订战略合作框架协议], 068 Base [068 基地], February 28, 2015, accessed January 30, 2019 at <http://guba.eastmoney.com/news,002625,179107736.html>

and Houston-based NanoRacks, which is located near NASA’s Johnson Space Center and supports the International Space Station, announced a partnership leveraging Kuang-Chi’s near space technology platform and NanoRacks’ expertise in business development and marketing.⁷⁸

MCF Gaining Steam, But Persistent Impediments Remain

The PRC’s MCF system is increasingly optimized.⁷⁹ However, the PRC’s DSTI system remains reliant on the absorption of foreign technology and know-how.⁸⁰ MCF development priorities released annually by SASTIND suggest that there remain ongoing challenges to achieving independent military S&T advances, *mincanjun*, information exchange between the military and civilian entities, as well as weapons and equipment mobilization.⁸¹ A lack of institutional guarantees, tax policies, problems exchanging information between the military and commercial entities, high barriers to entry, and licensing issues are also regularly cited as issues inhibiting civilian participation in defense contracting.⁸² Longstanding institutional barriers and vested interests among state defense industry groups appear to be impeding MCF progress. According to SASTIND chief engineer Long Hongshan, four factors (“four insufficients”; 四个不够) in particular are hampering MCF progress:⁸³

- Insufficient top-level coordination—MCF S&T industry direction and policies are decentralized hindering resource allocation and administrative effectiveness.
- Insufficient opening—high barriers to defense industry entry remain. Lack of collaboration with non-traditional defense entities by state owned defense enterprises. Difficult for civilian entities to obtain defense RD&A licenses and contracts.
- Insufficient sharing—Information exchange is lacking and a mechanism for sharing and using military and civilian resources has not yet been formed.
- Insufficient transformation—military technology spin-off remains low compared to other militarily powerful countries.

⁷⁸ “Kuang-Chi and NanoRacks Announce Agreement on Near Space ‘Traveler’ Program,” NanoRacks, March 22, 2018, accessed January 30, 2019 at <http://nanoracks.com/near-space-traveler-program/>

⁷⁹ For example, see Dong Qiang et al, “2018: What New Changes Will Occur in China’s Military-Civil Fusion Deep Development” [2018年: 我国军民融合深度发展将会呈现哪些新变化], China Military Network website, January 27, 2017, accessed January 30, 2019 at http://www.81.cn/jmywyl/2018-01/27/content_7923020.htm

⁸⁰ In “Critical Factors in Enabling Defense Innovation: A Systems Perspective,” Tai Ming Cheung notes that the primary types of innovation outcomes in China’s defense innovation system “are advanced imitation and incremental innovation, although there are growing signs of higher levels of innovation outcomes and crossover and architectural innovation.”

⁸¹ For example, see “SASTIND Publishes 2017 Military Civil Fusion Special Action Plan” [国防科工局发布 2017 年军民融合专项行动计划]

⁸² “Military-Civil Fusion: Lowering the Threshold for Mincanjun, Breaking Through the Defense Conversion Barrier” [军民融合：降低民参军门槛 破除军转民障碍], Xinhua News website, December 10, 2017, accessed January 30, 2019 at http://www.xinhuanet.com/2017-12/10/c_1122085690.htm

⁸³ See “SASTIND Holds Press Conference on the Situation of Military-Civil Fusion in the National Defense Science and Technology Industry” [国防科工局举行国防科技工业军民融合发展情况发布会]

Addressing systemic impediments and advancing MCF priorities has taken on a greater sense of urgency since the 19th Party Congress, judging from authoritative PRC media reports.⁸⁴ Most notably, this includes the creation of the Central Military-Civil Fusion Development Committee (CMCFDC; [中央军民融合发展委员会]), a Communist Party of China (CPC)-led body formed in mid-2017 headed by General Secretary Xi.⁸⁵ As the highest level “decision-making and coordination mechanism” for MCF development, the CMCFDC reflects the importance of MCF to top PRC leaders and their commitment to harnessing the collective force of the CPC to break down institutional barriers to MCF progress across the government, military, and industry.⁸⁶

- The CMCFDC has sought to tackle systemic impediments head on, quickly expanding MCF strategic guidance to provide “top-level coordination” amongst CPC, government, military, and industry stakeholders. In turn, provincial and municipal MCFDCs have been formed providing an interlocking CPC-led mechanism for MCF implementation from central to local levels.⁸⁷
- Since its first plenum meeting in June 2017, the CMCFDC has approved 11 MCF policies defining near-term work priorities, establishing local-level leadership and work structures, and even new strategic guidelines for MCF development.⁸⁸
- Statements by General Secretary Xi at CMCFDC meetings demonstrate a sense of urgency in implementing MCF as PRC leaders see the near-term period as critical to constructing a national MCF architecture.⁸⁹ Additionally, CMCFDC meetings focus on mobilization and applying MCF in infrastructure to support national defense.⁹⁰

⁸⁴ “Xi urges efforts to boost integrated military and civilian development,” Xinhua News website, June 21, 2017, accessed January 30, 2019 at http://www.xinhuanet.com/english/2017-06/21/c_136381507.htm

⁸⁵ “Military-Civil Fusion Development Committee Established” [军民融合发展委成立], Xinhua News website, January 23, 2017, accessed January 30, 2019 at http://www.xinhuanet.com/2017-01/23/c_129458492.htm;

⁸⁶ “The Central Committee Political Bureau Holds a Meeting” [中共中央政治局召开会议], Xinhua News website, January 22, 2017, accessed January 30, 2019 at http://www.xinhuanet.com/politics/2017-01/22/c_1120363831.htm

⁸⁷ For example, the Zhejiang Provincial Military-Civil Fusion Development Committee held its first meeting in November 2017. See “Che Jun Presided Over the First Meeting of the Zhejiang Military-Civil Fusion Development Committee” [车俊主持召开浙江省军民融合发展委员会第一次会议], People’s Daily website, November 22, 2017, accessed January 29, 2019 at <http://cpc.people.com.cn/n1/2017/1122/c117005-29661492.html>

⁸⁸ Notable CMCFDC-approved policies include the Strategic Doctrine of Military Civil Fusion Development [军民融合发展战略纲要], the 13th Five-Year Plan for National Defense Science, Technology, and Industry Development [“十三五”国防科技工业发展规划], and the Law for Managing National Defense Requirements and Joining Programs in Economic Buildup and National Defense—Trial Version [经济建设与国防建设密切相关的建设项目贯彻国防要求管理办法-试行]

⁸⁹ For example, at the first CMCFDC plenum meeting General Secretary Xi called on members to “do better, faster” [更好一些、更快一些] to push forward MCF priorities. See

“Xi Jinping Chairs the Central Military-Civil Fusion Development Committee’s First Plenum Meeting” [习近平主持召开中央军民融合发展委员会第一次全体会议], Xinhua News website, June 20, 2017, accessed January 30, 2019 at http://www.xinhuanet.com/politics/2017-06/20/c_1121179676.htm

⁹⁰ See “Opinions on Advancing and Deepening Implementation of MCF in Military Logistics during the Period of the 13th Five Year Plan,” [“十三五”期间推进军事后勤军民融合深度发展的实施意见], National Development and Reform Commission and CMC Strategic Planning Office website, December 27, 2017, accessed January 30, 2019 at <http://www.ndrc.gov.cn/zcfb/gfxwj/201801/W020180109331797564216.pdf>

In short, MCF represents an all-in gamble on Beijing’s part to introduce new concepts challenging traditional notions of centralized economic and defense planning to enhance its national competitiveness. In the minds of PRC leaders, achieving a full scope MCF innovation system [军民融合创新体系] is critical to strategic competition and securing China’s future as not only an economic, but also a military superpower. Jiang Luming makes these stakes clear, stating:

“In this competition, not moving forward—or proceeding slowly—means falling behind and failing to carry out fusion—or doing so slowly or superficially—will lead to failure. If the military-civil fusion development strategy is unable to be deeply implemented, our country’s predicament of following an imitation-style development model cannot be fundamentally altered, and national security development will lose its most central supporting power; if we are defeated in this particular competition, an entire era will be lost.”⁹¹

Conclusion and Recommendations

PRC leaders perceive a window of strategic opportunity to revamp China’s innovation system, enabling it to become a global superpower second to none. PRC national strategies such as IDDS and military-civil fusion—which are long-term plans—are still in relatively early stages. These strategies invariably take form slowly, often in a seemingly uncoordinated manner, gaining momentum as they proliferate across the system. More importantly, these are not static dictates.

- National strategies evolve quickly as Chinese policymakers adapt and successful outcomes are replicated. Moreover, the total volume of resources going into China’s industrial policy is accelerating rapidly.
- Ultimately, the outcome of China’s industrial policy will significantly impact the direction of PRC economic and military power over the next 20-30 years with potentially profound implications for global innovation and power dynamics.

Just as Beijing sees a window of strategic opportunity, Washington and its allies have a window of opportunity to meaningfully respond to PRC activities that present national security and economic threats. At the moment, Beijing’s reliance on foreign S&T make it vulnerable to stepped-up enforcement of U.S. law. An effective competitive strategy should adopt a dynamic threat management process that includes allies and builds persistent scrutiny, discovery, and access prevention into existing processes without compromising U.S. core principles. More specifically, Congress might consider:

- **Creating a “claw back” mechanism**—Conducting reviews of past U.S. government approved scientific and technology exchanges with PRC government, corporate, and academic entities to protect cutting-edge research and talent. This review should include science and technology

⁹¹ See Jiang Luming, “Comprehensively Planning an Overall Strategy for National Security and Development” [统筹国家安全和发展的总方略]. (Original text: 如果不能深入实施军民融合发展战略, 就不可能根本改变我国跟踪模仿型发展模式的困境, 国家安全发展就将失去最核心的支撑力, 一旦我们在这场特殊竞争中败下阵来, 输掉的将是整整一个时代)

collaboration under the U.S. Department of State managed U.S.-China Consultation on People-to-People Exchange (2009-2017).

- **Establishing an interagency team on China with support from private sector, academia**—Form a cross-functional interagency team supported by stakeholders from the private sector and academia to monitor, assess, and report to Congress adaptations in PRC strategy and tactics to inform U.S. government actions.
- **Tightening U.S. government funding provisions**—Introduce provisions enhancing the ability of U.S. government sponsors to protect tax payer dollars and ensure the requiring recipients of U.S. government funding for basic research or start-ups in emerging technologies to report investment by PRC-connected entities
- **Expanding SEC reporting requirements**—Require publicly listed companies to report participation in PRC core technology development programs, SIAs, MCF programs, physical operations within MCF bases, and the potential for technology diversion to PRC military entities.
- **Reviewing rules of engagement**—Military-civil fusion blurs the lines between traditional notions of military, commercial, and academic activity. This blurring has serious implications for the U.S. Department of Defense and requires an evaluation of U.S. military rules of engagement within a MCF context.
- **Enhancing public awareness of PRC strategy and tactics**—Increase resources for open source research and analysis within and outside of government to drive public awareness and understanding of the asymmetry in U.S.-China systems.

PANEL II QUESTION AND ANSWER

SENATOR TALENT: All right. Thanks to all three of you, and first up to ask questions is Commissioner Wessel.

COMMISSIONER WESSEL: Thank you, gentlemen. Appreciate your testimony. I'm a little troubled, though.

(Laughter.)

COMMISSIONER WESSEL: You know, we seem to be involved in a sort of Waiting for Godot strategy of China wants to change, China believes that the metrics we view as important to measuring success -- you mentioned current account, et cetera, et cetera, Mr. Borst - that they view things the same way we do. I think they view themselves as being pretty successful.

Mr. Hirson, you talked about that tariffs shouldn't be the approach, that we should be relying on other tools, multilateral, et cetera.

We're now 18 years into China's WTO membership. It seems to me that China has no real intention of following the rules, and the system hasn't been terribly good at requiring them to act by those rules. Often, you know, other countries have held our coat while we bloody our noses.

Certainly the tariffs imposed by the President have gotten people's attention, but we have yet to see any multilateral broad engagement around overcapacity.

Where we've had the Global Forum and other activities for years, we've only just begun to see the WTO with the filing by the U.S., EU and Japan of an industrial subsidies case that, you know, again, 18 years in looking at solving issues that, you know, have persisted throughout.

So my question is, why should we believe that any of the existing tools are going to work?

Why do we believe that China wants to be judged by western metrics? They're doing pretty damn good, you know. They've got the two fastest supercomputers in the world.

On 5G, Huawei has 9.2 percent of the essential patents. And if you judge the other companies, it might be 40 percent of what is expected to be a \$12.3 trillion ultimate economic benefit.

Self-driving vehicles, AV, AI, biotech, et cetera, go down the list -- Mr. Levesque, you talked about some of this -- you know, they're innovating legally and illegally, but, again, they're measured by different metrics and we think they want to change -- or your comments seem to think that ultimately they want to change.

I don't buy it. Convince me I'm wrong. Mr. Borst, do you want to start? And it will be hard to do.

(Laughter.)

MR. BORST: I would just say on the economic side of things there are deep concerns amongst China's economic policymakers about the current state of the economy, and it's shifted very rapidly over the course of the last year.

I think China started 2018 on a very strong note and was actually, you know, somewhat combative about the impact of the trade war, that China was well-situated for a trade war, China could wait out the U.S. during a trade war.

Throughout the course of 2018, you had both the worsening of the external environment, but more importantly, in my opinion, the worsening of the internal environment where you had a huge stock market correction in China that wiped off trillions of dollars' worth of market

capitalization.

You started to see a bit of pressure on the currency again. You saw significant decline in consumption of certain goods that people were worried was the harbinger of, you know, overall downgrade of consumption across the economy. You started to see elements of stress within the property market. So, it --

COMMISSIONER WESSEL: Let me interrupt, and I appreciate and agree with all that, but what policy changes do you see China engaging in to address that to truly reform, if you will, in our sense, the improvement sense?

Seems they're doubling down on the SOEs, right?

It seems that, you know, at 2025, despite not talking about it with President Trump because it's a bad word, you know, they've allocated two thirds of their market to Huawei and ZTE for 5G. They're not changing, they're doubling down.

MR. BORST: It's a good point and I think many people have been worried about the recent trends in China over the past couple years of, at least at a rhetorical level, a lot of support for strengthening the role of state-owned enterprises.

And as I discussed in my written remarks, I think there has been a palpable negative shift in the environment for private enterprises in China.

However, it's my opinion that a lot of that is actually an unintended consequence and that the financial -- the leveraging campaign which was targeted at actually addressing some real and significant risks that had developed within the Chinese financial system, has now had the effect of pushing the entire banking sector into risk-off mode and its set back the sort of market-driven reforms that we saw over the past couple years in China where up until about 2015, actually on a flow basis, private enterprises were getting more credit than state-owned enterprises.

That has all completely retrogressed and it's having a huge impact on the economy in the process.

And I think one thing that sort of dispels the notion that the current Chinese policymakers only care about state-owned enterprises, is this real whole of government response we've seen to the private sector financing crunch that really catalyzed around Q3 of last year.

And since then, there's been a new policy almost every other week designed at getting more credit to private enterprises.

So, to me, that shows that Chinese policymakers do recognize the important role that private enterprise has made, and they're trying to offset some of the unintended negative consequences of some of these policies they put forward in recent years.

COMMISSIONER WESSEL: Mr. Hirson.

MR. HIRSON: Thank you.

I agree with several of the points in your questioning, so let me just respond because I do think you made good points.

I'm certainly not suggesting that business as usual or the status quo is the right way to go.

I really do give the Trump administration credit for taking a more serious approach and understanding some of the unique challenges.

So, for example, when we think about state capitalism, forced technology transfer is a key issue.

It recognizes that when U.S. firms go to China and negotiate agreements, their counterparty is not just a Chinese company as part of that transaction, it is China, Inc., so to say, it is the strategic objectives that the government is seeking to achieve in terms of technology transfer.

So, for me, it's more of an issue of emphasis. It's not less in one area, it's more. And what I mean, is tariffs, I think the risk -- well, now that tariffs are in place, we certainly need to use them wisely, which I think is to actually, you know, derive real structural changes from China; but as I said, I worry that tariffs are not a comprehensive and sustainable strategy.

So, to your point about WTO, as you said, I think the fact that the U.S. is now working with Japan and EU on WTO reforms is really important.

And one of the problems here is that we could be doing an even more effective job if we were to resolve some of the trade disputes that we have with the EU and Japan, which, to my mind, are not as important as the trade disputes that we have with China.

So, the WTO reforms that USTR is working on, I think, are a really important part of addressing state capitalism.

Another solution is a TPP. I mean, TPP does provide provisions against SOEs and against some of the other barriers that are part of what you could call state capitalism like a trade in digital services.

So, from my view, I would view TPP as really a critical tool that the U.S. has to use here.

And then the other aspect of doing more, is on the U.S. domestic economy. If we take a strictly defensive approach to dealing with the challenge from China in terms of economic competitiveness as well as national security issues, then I think we're going to be in really tough shape.

I think we need to have a much more comprehensive way of knitting together what we're doing on the trade side with what we're doing with the U.S. domestic economy.

So, that would be -- I agree with your approach. Status quo is not going to work. For me, it's about doing more across all lines of effort here.

COMMISSIONER WESSEL: Just as a quick note, and I realize my time -- I'm over time. Perhaps later we'll have a discussion about the inadequacies of the TPP SOE model where both business and labor publicly authored comments saying that the provisions were inadequate in the acting report. Thank you.

SENATOR TALENT: Thank you. Okay. Just the lineup so far is Commissioner Goodwin, and then Bartholomew, Kamphausen and Cleveland so far.

Commissioner Goodwin.

SENATOR GOODWIN: Thank you, Senator Talent.

So, to really follow up on Commissioner Wessel's questions, what does reform mean?

Does it mean something different to our ears than it does to the Chinese?

I think a charitable view would be that there's a recognition of the need for reform in China and a commitment, or at least a passing interest in it, but it's difficult, it's hard, it has to be incremental and a lot of factors have inhibited that progress.

A more skeptical view, perhaps a more accurate view like that expressed by my colleague, is that it's simply paying lip service and there's not a commitment to making these sorts of reforms.

Alternative view expressed by some commentators, is it simply means something different to the Chinese than it does to us.

When we hear it, we think of market liberalization and competing on commercial terms. When they say it, they mean something different. They mean improving efficiency. They mean doing some of the consolidation and centralization of power that we've heard about from our first panel.

So, my question to you gentlemen, is when we hear the need for reform, when we hear

their leader say over a decade ago that their existing growth model is unsustainable, do we take the wrong message that reform is inevitable?

I'll open it to the panel.

MR. LEVESQUE: When we look at the commentary within Chinese official sources about reforms and adjustments, the focus on disruptive technology sectors as new vectors of economic growth, I mean, fundamentally what this is coming down to is a recognition that, you know, past models of economic growth and power projection are unsustainable, right, given information technology developments underway.

In addition, Chinese policy documents while they do reference things like market share and profit margins and things like that, fundamentally they focus on control, right, controlling strategic markets that have strategic importance to the Chinese economy and to their priorities both from an economic and military standpoint.

And I think that's where, you know, applying a western construct of market analysis fails oftentimes when looking at some of these policies and commentaries around reform.

That's something that we're closely tracking particularly around emerging technology sectors.

Even with the ongoing trade frictions, the talk around reform is nonexistent, really. It's about doubling down, increasing the pace of implementation, the speed of implementation before a strategic window closes.

The other challenge, from a policy standpoint, is these grand national strategies like Made In China 2025, military-civil fusion, you name it, they're extremely sticky, right, meaning these are codified not only in government policy documents, but also in the Communist Party of China's constitution. So, they're deeply intertwined with the CPC.

So, from a U.S. standpoint or a western standpoint, asking them to remove these policy priorities is, in effect, asking them to remove that from the identity and, you know, priorities that they have set forward.

MR. HIRSON: Just a couple points.

I think, you know, one, we do have to remember, of course, China is not a monolithic system. There are voices out there that are in favor of more market reform.

But I think to your request, and I completely agree with -- I don't remember if it was the first or the second option you gave, but China is reforming, their view of reform is quite different from ours.

And what I think is most important here is that, for China, it's not necessarily a question of relaxing state control and market liberalization. In practice, it may come down to that, but what they're trying to do is both.

And what I mean here is -- and I discuss this in my paper -- what I think we're seeing is a shift from -- state capitalism in China is moving into what you could call Party capitalism, which is the Party extending its political reach into the corporate sector in China, which gets to the theme of your earlier panel, but this is not all about control.

What I think Beijing is trying to do, is move closer to the private sector, actually give SOEs a bit more discretion in terms of how they run the business, but by tightening control over both private firms and SOEs it wants to make sure that these companies are carrying out the strategic objectives of the Party.

So, it's sort of looking to have everyone aligned behind China's grand strategy, but, at the same time, give them a bit more discretion and a closer partnership with the private sector. It's a combination of political tightening and modest economic liberalization.

Now, I think there are real questions as to whether or not this can work. I think it's a real question, can you tighten political control without introducing the distortions that are already such a big part of state capitalism.

So, I think there is a number of risks as China tries to do this and it's creating some issues for the private sector, it's leading to, I think, increasing barriers against private firms overseas because now they're seen as working in closer partnership with the state, so this is an important trend.

But to get to your point, I think it's an example of how, for China's leadership, these aren't necessarily mutually exclusive choices. They're trying to pursue both.

MR. BORST: I would just add on the economic side of things, I think they've been relatively transparent on what reform means, and it's really all revolved around this policy framework called supply-side structural reform that really was implemented at the end of 2015.

So, the key tenets of that policy framework is reducing excess industrial capacity, reducing excess inventory in the housing market, reducing high levels of leverage throughout the economy, cutting business costs through things like tax reductions and simplifying bureaucracy, and, finally, improving weak parts of the economy, which really refers to China's lack of domestic indigenous innovation capability.

I think there was some hope particularly at the beginning of this current Chinese administration that these types of policies would be pursued mostly through liberalization of prices and greater involvement of market forces in determining outcomes.

We've seen a bit of progress on that, but the current method of implementation of supply-side structural reform has been very interventionist.

And so, I think it's easy, for me, to see that, in general, they're targeting the right areas that need to be addressed for Chinese economy to really rebalance, but the methods of going through with it are highly interventionist and, in the process, can lead to some unintended distortions.

SENATOR TALENT: Commissioner Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you. Thank you very much, gentlemen.

Just an observation that in the, what, 30-some odd years I've been focused on U.S.-China policy, I would say that there's always hope at the beginning of new Chinese leadership, and we have been consistently disappointed. So, maybe it's time for us to temper our own expectations.

I think it's important that we've been trying to dig into reform and what reform means because one of the issues, I think, we've had all along, even in our trade negotiations, is we go on thinking that everybody thinks about the world the way that we do, and that's a problem for us.

But, Mr. Hirson, I'm going to start with you. I hesitate to go back in to defining terms, but I'm going to.

And I have a lot of trouble with this whole concept of state capitalism or even Party capitalism, because capitalism is about the private ownership of the means of production and profit.

And I wonder if we are just doing a huge disservice to the entire debate by using terms like state capitalism or private capitalism, because it gives people some belief that it's of open -- it's a free market economy, and it isn't.

So, can you address that? I mean, there's just this inherent contradiction in calling something state capitalism or private capitalism. That's not what capitalism is.

MR. HIRSON: Right. Well, so I'm using state capitalism, in part, because that's the term -- that's the term of art. And what we mean here, really, is -- and what I'm trying to flesh out, is

the role that the government plays actively in the economy.

It's true sometimes these terms, we can -- they can be more misleading than they are helpful.

I mean, the point that I was trying to bring out is that they're -- you know, much of -- most of China's economic activity at this point in time is based on market transaction and is done by the private sector, but there is a very important role that the state plays through SOEs and through shaping these industrial policies into particular innovation policies.

The question of state-owned enterprises and how they fit into capitalism is interesting.

I mean, many SOEs do behave in ways that are, you know, that are quite commercially minded; others don't -- or really better to say it's kind of a mix of looking for a profit, but also, you know, following the political incentives that these executives have.

So, you know, I agree with you that the terms can be more misleading than they are helpful, but it is -- you know, it is important to understand that I think even though the leadership, to some extent, is blurring the lines between the private sector and the state sector in China, they still remain quite different.

And, you know, there is a thriving private sector that's out there that's still suffering from some systemic biases against it in terms of how credit is allocated, you know, their treatment in the legal system, security of property rights, these issues.

So, it is important that we not think of China's economy only as SOEs or think of it monolithically, because there is a very interesting active debate right now about what role the private sector should have.

And, you know, to the point that Mr. Borst made, many of the policies that the private sector and reform-minded economists are calling for right now are policies that would also help U.S. interest in China. So, it's a reason to be part of this debate and to engage the reformers in China.

I'm not naive to think that that is going to be the solution to our problems, but it is part of it.

CHAIRMAN BARTHOLOMEW: So, I don't mean to be combative with you, and there's certainly other issues, and, Mr. Levesque, thank you very much.

We've been thinking and talking more about military-civil fusion. I think you did a great job in laying it out both strategically and operationally.

That's one of the best descriptions I have seen, but, Mr. Hiron, I'm going to go back to you because I can't believe unchallenged this concept that there is a private sector in China the way that we think of a private sector.

First, the SOEs are a significant part of the economy, but a lot of these so-called private companies are companies that have been built because China has kept U.S. companies -- e-commerce is the most recent and really good example, but the Chinese, they're protectionists.

They have protected these sectors of their economy. They have prevented America and other companies from going in. They have provided subsidies.

Even though it's the five-year plan, we see that this is a state-managed economy, but, also, I think a lot of people don't recognize the power that the Chinese government has over private companies and over the private sector both through the Communist Party cells that they have and their naming of people on boards, their controlling of who a human resources person is.

So, again, I guess I just sort of caution and ask, do you think that the Chinese private sector is the same as we would think of a private sector?

MR. HIRSON: No, I don't think it's the same, necessarily, as we would think of it

because the environment that they face is very different.

Like you said, a private sector doesn't necessarily mean an open economy. You can have a very -- you know, you can have Japan, which has a private-run economy, but a very closed economy.

So, I don't mean to suggest that because there's a private sector, China's economy is open. I think it's a mix.

I mean, what we see at the very top level, the strategic level, I would say, is Beijing moving closer to these private firms, kind of a tightening embrace.

And so, I think the new -- we tend to think of China's national champions, those that receive state support, in the old days, it was SOEs.

Well, now that China is looking to dominate areas like AI, Beijing knows that you can't get there with Petro China. You have to get there with Alibaba and Baidu and Huawei.

So, these are becoming the new national champions, which means they have more -- a closer relationship with Beijing. They don't always want to have that relationship, but that's the reality.

But then when we look deeper, you know, into the smaller private firms, the SMEs, you know, your typical exporter in Guangdong Province, on the day-to-day level, you know, the Party has nothing to say in terms of what they're doing.

And these are fiercely competitive firms that are, you know, that are out to do the same things that U.S. companies are, which is to make a profit and pay their workers and pay their shareholders. So, it's -- I'd say it's differentiated.

Where it's becoming most complex is in all these areas that are strategically important to Beijing, and that's where all of this blurring is taking place in terms of the Party's influence, civil integration.

That's where I would say this is becoming, you know, particularly complicated to think about this as a pure private sector.

CHAIRMAN BARTHOLOMEW: I know I'm over time, but I wonder, Mr. Borst or Mr. Levesque, do you have anything you want to add on this?

MR. BORST: Sure.

I would just add a little bit to Michael's comments that I think when you go and you meet Chinese companies and talk about their business, you see the entire spectrum of what exists with respect to government control in China.

So, you see very traditional, old-school, state-owned enterprises that, you know, look into a government bureaucracy; you see the more marketized, state-owned enterprises; you see private companies that have kind of strategic investment from a local government or some other quasi-state body; and then you see, you know, almost completely private, market-driven enterprises in China that are as entrepreneurial as any company you'll see anywhere.

And I think it's important to recognize that all companies operate within a political environment, and in China that's more true than most places, but, you know, for me, the proof is really in the pudding.

When you actually look at the financial results of private companies versus state-owned enterprises, you can see that private enterprises in China are widely more efficient.

They have a return on assets that's three to four times what's typical on the state-owned sector.

So, you know, these enterprises will, from time to time, have to pay heed to whatever the official policy push is at the moment -- I think, you know, the old Chinese saying is that the

market economy is a bird in a cage, and that's still very much true -- but, in general, I think there are a wide variety of Chinese enterprises that are very market-driven, very competitive and mostly pursuing normal business activities.

MR. LEVESQUE: We're talking about a lot of companies right now and I wouldn't say that -- we care about all of them, right? The strategic high-tech companies are particularly significant in these discussions and Chinese policy developments.

When you look at the, quote/unquote, private, you know, high-tech companies in China, they receive a lot of government support.

Individuals who have taken technologies back to China, have their businesses incubated, the government helps them grow their business.

Yeah, there is competition for resources and for attention, but that competition takes place at a competitive market level, but also right in getting those resources from the government.

We've even seen cases of, quote/unquote, venture capital firms in China receiving government subsidies and grants, which, from a U.S. standpoint, is quite odd, right?

So, I think we need to better understand the relationship between corporations and the government in China before we start getting to are they state-owned, are they private because fundamentally, right, they -- corporations exist, in large part, right, in these strategic sectors to implement policies to drive forward government objectives. That's part of the reason they get the funding.

CHAIRMAN BARTHOLOMEW: Thank you, and thank you for your forbearance.

SENATOR TALENT: That's okay. Commissioner Goodwin is a sterner task master as chairman than I am, but I'm going to be a little bit more careful to make sure we get through in time.

Commissioner Kamphausen.

COMMISSIONER KAMPHAUSEN: In keeping with the theme of the hearing, which is to ask the question, and hopefully get some answers, on what keeps Xi up at night, I'd like to ask two questions about implications of your testimony.

For Mr. Levesque, appreciate your description and analysis of the IDDS. I think you've coined the term.

But in any case, the question is, to what extent is there political risk, in your view, for Xi if the current policies of the U.S. government and others are successful in even modestly decoupling the acquisition of foreign technology and IP from China's approach to strategic growth?

So, is there political risk if we have even modest success? And, Mr. Hirson, I think you'll have thoughts on that as well.

For Mr. Borst, this is maybe an unfair question, but to the extent you have interaction or insight from Chinese economic planners, financial analysts, to what degree is there political risk with some of the efforts at internal balancing that you have enumerated and the laydown of debt and other -- the supply-side reforms you've talked about?

That's unfair, but perhaps you've heard some -- you've heard some chatter or insights from those who work in that sector and would appreciate any thoughts you have there. Thank you.

MR. LEVESQUE: So, to answer the question, I want to start, first, kind of at a bit of a macro level.

When you look at the innovation-driven development strategy, the origins of it, how

Chinese leaders, including Xi Jinping, talk about it, it is attempting to position China to ride what it perceives as a technological revolution.

Chinese assessments of historical trends suggests that riding technological revolutions take powers from -- or take countries from kind of a normal power status to superpower status.

This is something that I presented in my testimony, particularly in an assessment that was done by Liu He and fellow members from the NDRC, that essentially, you know, looked at the U.S. and its transition to great power status and found that it followed a financial crisis, shifts in the power dynamics globally, and a technological revolution.

So, you kind of have to look at this macro level here, first, when kind of getting into what's the risk factors for them.

Judging by PRC leadership statements even as early as mid-2018 -- or as recent as mid-2018, there seems to be some real sense of urgency to implement this innovation-driven development strategy more quickly.

Part of that is the perception that the window is closing for them to obtain some of the foundational materials necessary to build, you know, in their mind, an innovation system that supports not only economic growth, but military modernization plans.

So, you know, we talk about historical Chinese economic industrial policy just focused on heavy industry, steel, and shipbuilding. There's a real recognition and you see it in these policy documents that those are no longer the growth drivers of the economy, it's not what's going to make China a, quote/unquote, powerful country, right, it's innovation and it's information technology-based technologies that are helping to drive that.

So, to the extent that U.S. policies are effective in hindering those advances, it starts to position China in a, I think, difficult scenario, right?

Because ultimately, according to their own commentary, their objective is to become a superpower, and becoming a superpower means achieving these objectives.

So, this is where I think there is a real risk for them if the U.S. is able to implement some of these policies not only in the short-term, but keep them in place over the long term, but fundamentally it's also going to require cooperation from allies and other more advanced innovation economies. Thank you.

MR. HIRSON: I just want to offer a quick thought.

I agree. I do think there are risks, political and economic, to decoupling, including hampering, you know, China's ability to continue to move up the value chain because foreign firms/foreign technologies do play a really important role there. I don't know that it will make a difference.

I think the drive for self-reliance has just gone on hyperdrive in China. Part of it reflects, you know, Beijing's policy orientation.

I mean, this has been the case for several years now; but especially over the last year post-ZTE that's really, I think, accurately described in China as something of a Sputnik moment in terms of crystalizing their reliance on U.S. technologies.

And so, it has just, as I said, gone into hyperdrive and I think that Beijing is likely willing -- the leadership is willing to tolerate lower growth and some significant economic consequences in order to further the self-reliance drive which they view as critical to national security.

So, I would say that that's -- the willingness to sacrifice in order to achieve that is increasing.

MR. BORST: I would just add that I think the question on political risk isn't unfair at all. It is actually a very pertinent issue and I think it helps explain why there's some -- if we can say,

in general, the list of policy goals is correct, but the implementation is suboptimal, I think it's precisely because of these political constraints that have pushed implementation into these suboptimal channels.

So, you know, on a couple different areas if you look at the effort to reduce leverage among state-owned enterprises and cut excess industrial capacity, this then suddenly gets into really thorny issues of who's going to recognize and bear the cost of those bad debts, what's going to happen to the laid off workers, you know, who's going to bear the social safety net cost to, you know, retransfer/retrain these people?

That's a very difficult political issue that's often well above the pay grade of a financial regulator.

It's the same with local government financing in China. I think everyone understands that local governments need a more sustainable and balanced source of revenue; but, at the same time, you're getting into this very contentious issue of, you know, center local relations and who has the power within that relationship.

And, finally, on the property market, I think policymakers are well aware of the risks of letting a property market grow too quickly and letting it collapse.

And they're trying to find the delicate balance between the two, but some of the really long-term solutions that need to be put in place, like creating a property tax and a more market-based system for land allocation, there's just this fear that they will touch on all these political issues that have pushed them to kind of take the easy road to choose the more interventionist path.

I think all that explains a lot of the suboptimal implementation of these policies, but I also think there's just this underlying fear of volatility amongst Chinese policymakers, this concern of, you know, when the currency starts to devalue and there's capital outflows and the stock market is crashing, that's what they fear more than anything.

So, back to the title of our panel, I think economic volatility is a key concern of Chinese policymakers, and a lot of the reason why policies have been implemented in an inefficient manner has been concerns over the possible creation of additional volatility within the economy.

SENATOR TALENT: Okay. I think we're done anyway, but I'm going to end it there. Commissioner Cleveland.

VICE CHAIRMAN CLEVELAND: I thought you were going to say we're going to end it there and I was --

SENATOR TALENT: We were ending Commissioner Kamphausen's turn at the mic.

VICE CHAIRMAN CLEVELAND: Okay. So, I have two completely different areas of interest. The first is, I think, Mr. Borst and Mr. Hirson, you talked about the emphasis that the government has placed on injecting capital and reducing reserve requirements and quotas and trying to emphasize support for small and medium enterprises starting last year.

And I'm wondering -- granted it's only been the last year or so, but I'm wondering why it doesn't appear to be working notwithstanding the highest level leadership emphasis. So, that's one set of questions.

And then, Mr. Levesque, I really want to compliment you on your testimony. I think it's probably unique and really lays out an extraordinary case in terms of what the nature of civil-military fusion is.

I think it's groundbreaking work and I really appreciate it because I think it's something the Commission wants to emphasize this year.

If you could speak to -- and I was fascinated by the fact that the PLA reserve units are

working with JD.com on UAVs and some of the examples that you've laid out.

Could you speak to sort of a quick summary of where you see the strengths in terms of this civil-military fusion?

And, then, you mentioned in your recommendations that you think that we ought to improve SEC reporting requirements for publicly listed companies to report participation in PRC core technology development programs, MCF programs and operations within these MCF bases.

If you could elaborate on that, I'd appreciate it. So, if we could do the SME piece first and then turn to civil-military, please.

MR. BORST: I think you're exactly right on the fact that despite all these different government initiatives to push more credit out to the private sector, it's really not showing up yet, and I think it all comes down to just what are the incentives of banks at the current moment.

So, the government has told them to lend more to these small enterprises, but, at the same time, there's still this enormous focus on reducing financial risk.

And so, they know, well, if I go out and I loan to all these SMEs and suddenly a lot of those loans go bad, I'm still going to get in trouble with the regulator for that. And at the same time, there's this emphasis on reducing the cost of SME financing.

So, banks aren't allowed to charge a market-based interest rate for these loans, which are generally riskier.

So, in my opinion, it's very obvious what the incentives of the banks are. Instead of making a hundred small risky loans, they'd rather make a few big loans to state-owned enterprises that they know, at the end of the day, if those loans get into trouble, they'll get restructured.

So, it's a difficult issue to solve, it's exacerbated by the current kind of tight credit environment China is in, but the key, in my opinion, is really addressing the moral hazard issue and breaking this assumption of implicit guarantee of debts for state-owned enterprises.

And I think there's been a bit of progress on this, but I still think there's this overriding concern about we don't want to set off a chain reaction that might disrupt the markets.

And so, they're trying to introduce just the right amount of defaults and bankruptcy without kind of unleashing a chain of actions that they're uncomfortable with.

MR. HIRSON: I couldn't have said it better. I think that really captures it.

The financial derisking campaign and, in some ways, now, the push to get credit to the private sector is very top-down and it's very political.

And so, what you see with the financial derisking campaign is even the use of the anti-corruption authorities to discipline regulators or banks who are not getting with the message.

So, it's a much tighter political environment, really, to derisk and now they're getting a somewhat contradictory top-down message of you have to lend to the private sector.

And so, the result, I think, is sort of some degree of stasis, but I think the factors that Nick pointed to structurally are absolutely key.

So, they're taking many different efforts slowly trying to allow SOEs to go bust and break the moral hazard.

New instruments, you know, new tools -- every day there's a new tool for getting money to the private sector, but I think the -- it's going to be very difficult because of the structural factors.

MR. LEVESQUE: So, military-civil fusion has made some rapid advances in the last two years particularly since the 19th Party Congress.

I've been following it pretty closely for a number of years now and was actually quite

shocked at the developments that have been made both in terms of the amount of funding going towards it, but also the proliferation of this concept across the Chinese system to the point where now there's concerns of illegal activity under the name of military-civil fusion, which I think is a great marker of, you know, the marketing success of it from the central level.

Some of the strengths of military-civil fusion really come down to the creation of mechanisms both in terms of communication and synchronizing standards between the civilian economy as well as the defense industry. That's a gap that has yet to be filled in China. Similar efforts were pursued under previous Chinese leaders and they've all failed.

I think there is reason to believe that this particular effort under Xi Jinping is going to make more progress just given the consolidation of power and the formation of new leading small groups that are using the Party as a battering ram here to break down vested interests and systemic barriers that have historically impeded that progress.

You know, I was pleasantly surprised to see -- you know, I shouldn't say "pleasantly." I was surprised to see that JD.com and other Chinese companies are now involved in supporting PLA military units at least domestically.

You know, there seems to be the emergence here, now, of an ability to tap innovative companies that have capabilities not present in the PLA to enhance their own capabilities. I think right now we're in the early days of that.

There are not, I would say, like, a long list of examples of other companies like JD.com and Sohu and others that are participating in that. The real advances seem to be taking place in the UAV sector on that front.

One of the real strengths, and this goes into why I think there needs to be some reporting on this on the corporate level within SEC filings, is that military-civil fusion provides a level of cover, I would argue, of Chinese strategic activity.

You know, this is not information that -- you know, proprietary information to you, but if you look at, for example, the placement of Chinese commercial ports or infrastructure, the use of commercial satellites for military and public security purposes, all of this fits nicely into this concept of military-civil fusion.

In essence, it is how do we enhance and drive forward commercial activity that most folks in the west are very much open to; and then in the time of confrontation or conflict, turn it on to support military advances. I'd say that's a real strength of the concept.

Getting into the SEC piece, you know, when we were looking more into military-civil fusion's progress, what we started to see was that U.S. companies, as well as European companies, are actively involved in military-civil fusion programs. The problem, I see those -- and I'm not aware of -- I don't see that they are aware of it.

For example, Zhongguancun is a high-tech zone in Beijing. There are a number of U.S. companies who have set up research and development bases there likely, you know, with support from the municipal government.

Zhongguancun has a vibrant military-civil fusion system in place that identifies, incubates and helps to transfer technologies derived in the base into the military.

That, to me, seems to be a real blind spot for U.S. companies.

SENATOR TALENT: Mr. Levesque, could you wrap it up?

MR. LEVESQUE: Yeah.

SENATOR TALENT: It's really interesting and --

MR. LEVESQUE: Sorry.

SENATOR TALENT: -- we'll have a second round if we have time, but I need to get

everybody in here.

MR. LEVESQUE: Sure. I'll stop there. Thanks.

VICE CHAIRMAN CLEVELAND: Can I just ask one -- is anybody tracking this on any kind of organized or consistent basis that you're aware of?

MR. LEVESQUE: I would say just us.

VICE CHAIRMAN CLEVELAND: Okay.

(Laughter.)

VICE CHAIRMAN CLEVELAND: Thank you.

SENATOR TALENT: Commissioner Lee.

COMMISSIONER LEE: Thank you very much, and thanks to the panel for your testimony. Very interesting.

I had two questions, and one was for Mr. Levesque, and I think it is actually follow-up on Commissioner Cleveland's question. So, we can delve a little bit deeper.

In your policy recommendations, you talk about some things that are, you know, fairly straightforward, you know, enhanced public awareness, but there are a lot of areas in which you talk about ways in which current U.S. measures are inadequate, including the SEC reporting requirements, but also the new claw-back mechanism, tightening U.S. government funding provisions and reviewing the rules of engagement.

Those all seem like pretty important things, and you also say that, at the moment, at the current moment, Beijing's reliance on foreign technology makes it vulnerable.

So, it seems like we have a short window, so I guess two things for you. One, is how long is that window?

And the second is, do you see any kind of -- any evidence that U.S. policymakers are acting with the urgency that is required given that we have a short time frame to address some pretty important things and the kinds of changes that are needed seem pretty large.

The second question is for Mr. Hirson, and this is just, really, a broader question, you know.

The big point that you made about the China state capitalism or the SOEs' industrial policy are very inefficient, and yet that sort of coexists with the fact that they still create a lot of competitive issues for U.S. firms.

And those two things seem to be a little bit in contradiction and I think you note that in your testimony, but I was just interested in sort of how you see -- I mean, I think one of the issues is, where does the money come from?

You know, you can waste money subsidizing a firm that's not using it very well and it can still create a lot of competitive issues.

So, I just wanted to hear a little bit more from you on those topics. Thank you.

MR. LEVESQUE: I promise to be much briefer this time.

So, part of the outline here for putting together these recommendations, is if we approach this from a strategic competition standpoint, what are the pieces that are missing in U.S. strategy, right?

Because as you see from the testimony and primary source pieces, the Chinese certainly view this from a strategic competition standpoint.

Historically, that has not been the case here. There are a number of science and technology collaborations going on between U.S. and Chinese entities that maybe historically did not present any national security issues, but under today's scenario are concerning.

At least I'm not aware of any tools that are in place to review those, let alone to say that

those can no longer occur. So, that really drives some of the thinking here in terms of the recommendations.

This also includes, right, funding, U.S. government funding for research in emerging technologies that we've seen a number of cases where that technology has then spun off, commercialized and falls into the hands of Chinese companies or other actors.

So, needing to really tighten up -- okay, if we're in a competition, then what are the measures that need to be put in place to help us compete fundamentally?

I think there are actions underway on the U.S. government side. I know the 2019 NDAA outlined, you know, measures to put together an all-of-government strategy for responding to China. I thought it was quite detailed.

I think there's been things in the press that focus on, you know, the U.S. government trying to align its activities with allies particularly around 5G encountering some of the activities of Chinese firms that are perceived to be implementing Beijing's policies that run counter to U.S. interests. Thank you.

MR. HIRSON: And just to your question, I think -- I mean, that's, to me, one of the interesting issues here, is that a lot of the focus is on, you know, whether or not China's industrial policies will be successful -- or I should say the fear comes from that they will be successful.

And that is, you now, I think, legitimate in some cases, but it's also that there's major fallout even when they're not effective in the sense of creating excess capacity.

And we've seen that, you know, clearly in steel, aluminum, you know, solar photovoltaics, and now there are concerns that we could be seeing excess capacity in areas of the semiconductor market, in automation.

You know, we've been joking with colleagues, is it theoretically possible to have excess capacity in AI? Well, we might find out.

And I think that's, to my mind, is actually an underemphasized set of concerns on the U.S.

And what I mean here is that you'll frequently hear Chinese interlocutors say, don't worry about the Made in China 2025 Initiative, you know, it's not going to be the threat that you think it is.

And I think, in my view, we've also failed to make the secondary point, which is even if it doesn't succeed and become a competitive threat, the excess capacity and the distortions that it creates causes real harm to the U.S. economy.

So, I think we need to -- in my view, I think we need to really emphasize that point in how we engage China, and also how we work with the other countries that are really deeply concerned about this like, in particular, Germany and France, Japan, South Korea.

SENATOR TALENT: Commissioner Lewis, it's your turn.

COMMISSIONER LEWIS: My colleague before said that he wasn't convinced -- you asked, convince you you're wrong.

What recommendations would you make, which implemented, would convince him he's wrong?

MR. BORST: I'm sorry, can you repeat the question?

COMMISSIONER LEWIS: What recommendations would you have to make to Congress which, if implemented, would prove him wrong that China really wants to make changes?

MR. BORST: Yeah. I think there's a whole list of reforms that Chinese policymakers have talked about for a while that there is some support amongst Chinese economists for that

haven't actually been implemented as fully as they should be.

And a lot of that comes to more market-based reforms in the financial sector really allowing credit-based pricing of risk, reducing some of the excess controls on the property market, really letting a more natural cycle develop within that market.

COMMISSIONER LEWIS: Yeah, but what would make the Chinese do these things? You say there have been recommendations to do them.

What would make them do them? Can we do this alone or do we need allies so it's a multilateral approach?

MR. BORST: I think that U.S. pressure can be very effective under the right circumstances.

And I think precisely when it aligns with what some of the existing factions within China are already pushing for, then that type of pressure is sort of a force multiplier and can actually push things through in China.

And I think we've seen that under a variety of different historical episodes, such as WTO accession, where there were some significant reforms made.

I think, in general, that type of pressure is even more effective when it comes multilaterally. And I think to the extent that it's -- China is trying to adhere to global norms or to join a global trading community rather than the U.S. specifically pushing China to do something.

I think given the current state of the economic relations, it's very difficult for China to make direct concessions to the U.S. that are counter to Chinese interests.

And I think to the extent that we can frame what we're asking China to do in a way that many people within China are already saying are within the country's interests, I think we will be much more effective in getting things passed.

COMMISSIONER LEWIS: And better if it's done multilaterally?

MR. BORST: Yeah. Multilateral is even better. Then you really remove that element of this is the U.S. demanding China to do something.

COMMISSIONER LEWIS: Thank you.

Do either of you have any other things to add?

MR. HIRSON: I completely agree with that point.

If you look, for example, you know, earlier last year there was a very active debate in China domestically over industrial policies. Do they work? How are they distorting the economy?

That debate got shut down as U.S.-China trade tensions increased because Chinese economists were viewed as unpatriotic if they criticized industrial policies.

So, to Nick's point, working in a multilateral way means that China can -- Chinese -- those within China who do view changes as necessary can say, okay, this is not just a concession to the U.S., this is a structural problem that we face. These are barriers that are going up not just in the U.S., but in Europe and other markets. And that, I think, strengthens their argument.

And, I think, just broadly it's more effective if we're working multilaterally because it's just -- it's a force multiplier.

COMMISSIONER LEWIS: Thank you very much.

Do you have anything to add?

MR. LEVESQUE: Based on what I have seen, the Chinese appear to need some amount of pain in order to be willing to adapt and to change some of these policies.

I don't disagree that tariffs may not be a great long-term strategy, but blunt force generates attention and, I think, generates a willingness to, you know, look internally a bit more.

So, to the extent that that is part of any kind of discussion, right, rather than just having a conversation about what we like and don't like, I think it's more likely to yield results over the long run.

COMMISSIONER LEWIS: Thank you very much.

SENATOR TALENT: Commissioner McDevitt is next and last on the list, so we may have some time for a second round.

COMMISSIONER MCDEVITT: If we're in a strategic competition with China and their goal is to become a superpower, at least conceptually we would hope that they fail. We don't want another superpower, right, strategically.

And so, the question I have for you is one of these almost counterfactual -- the things that the U.S. government is pressing the Chinese to do about their economy and the things that you're talking about, will that help them succeed?

If strategically we want them to fail, are we, in fact, urging them to take the very steps that they need to be successful?

And the other flip side of that coin is, is Xi Jinping on the road to shooting himself in the foot with the continued focus on the Party, the Party, the Party?

Is, in fact, that going to -- is that going to make sure they don't make their objective of becoming a superpower?

Go for it, please.

MR. BORST: I'll leave the political and strategic considerations to others who have studied that more closely, but I will say I do feel it's strongly in the economic interest of the U.S. to have a sustainable, balanced Chinese economy.

And that the idea that we can completely wall ourselves off from the Chinese economy and that the fate of the Chinese economy will not impact the U.S., I think, is completely out of date these days.

And I think there are so many U.S. businesses, U.S. investors, trade links that are intricately wrapped up in the Chinese economy, and China has emerged as such a significant source of global economic growth that it is fundamentally in the interest of the United States for Chinese economy not to fail.

I think the strategic considerations can be something entirely different and it may be the case that the U.S. and China decide that a little bit of separation and divergence between our two economies is actually healthy for us even if it's economically less efficient, but I think the idea that we could have -- that we should be rooting for a complete failure of the Chinese economy would be a mistake.

COMMISSIONER MCDEVITT: No, I wasn't suggesting we root for a complete failure, but your answer implies to me that you think that unless China does what Americans like yourselves are suggesting they do, they will.

Is that what you think?

MR. BORST: I think my point is that if China is able to adopt some of the policies that they have already described as in their own interests, it will be not only advantageous for a lot of the private enterprises in China that are struggling right now, but it will also, in the same way, open up more opportunities for U.S. businesses and U.S. investors and we could see that -- an opportunity for U.S. companies to share more in China's economic growth.

And I think China's economy is going to continue to develop, it may be slowing down relative to what we've seen in the past, but it's hard to envision a scenario where China's economy does not emerge right alongside the U.S. as one of the two most important global

drivers of the economy.

MR. LEVESQUE: I'll slightly pivot.

You know, what's interesting is that when you look at Chinese government documents and statements, you know, outlined here, there's a lot of emphasis on innovation as the driver of future power, economic power, military power.

What I find ironic about all of this is that from a U.S. standpoint, from an American standpoint, we view innovation as part and parcel with the protection of private property rights.

That's really not baked into these policies, right. It is we are going to innovate, we are going to become innovators because we are going to lay down the structural changes, we're going to create these new financing mechanisms that are going to deploy capital into startups and provide them with government grants and open up market access and then, you know, support their overseas market expansions and so on and so forth, right, but very little, you know, about private property rights comes into the conversation.

To me, right, if we're talking about China becoming a superpower and cracking the code, as it were, on innovation, I don't know where that fits into the cultural construct, but it seems to be a real missing gap at the moment.

SENATOR TALENT: That's the kind of question when you were on active duty, Admiral, and testifying before the Senate Armed Services Committee, if you got asked a question like you just asked, you would have said, that's above my pay grade, I'm not answering that one.

(Laughter.)

SENATOR TALENT: We have reached our time and I thank all the witnesses.
Excellent testimony.

We're going to take an hour-long break, reconvene at 1:45, right -- is it 1:45 -- yes -- for lunch -- after lunch, and then we'll take our third panel. Thank you all.

(Whereupon, the above-entitled matter went off the record at 12:44 p.m. and resumed at 1:46 p.m.)

PANEL III INTRODUCTION BY SENATOR CARTE P. GOODWIN

SENATOR GOODWIN: Thank you. Our final panel today will explore China's external challenges focusing on the PLA shortcomings and the limits of Chinese soft, sharp and hard power.

We'll begin with Dennis Blasko, an independent analyst and a retired U.S. Army lieutenant colonel with 23 years of service, including tours as a military intelligence officer and a foreign area officer specializing in China.

He served in infantry units in Germany, Italy and Korea, as well as in Washington at the Defense Intelligence Agency, Headquarters Department of the Army, Office of Special Operations and the National Defense University, War-Gaming and Simulation Center.

From '92 to 1996 he was Army Attaché in Beijing and Hong Kong. And today, Mr. Blasko will provide testimony on the PLA's weaknesses as well a President Xi's concerns about Chinese military capabilities. Welcome.

Additionally, we'll also hear from Rush Doshi. Dr. Doshi is a Brookings-Yale Postdoctoral Research Fellow at the Brookings Institute and Yale Law School's China Center.

He's also the research director for the McCain Institute's Kissinger Fellowship Series on U.S.-China Relations and an adjunct fellow at the Center for a New American Security. Today, he will provide testimony on the limits of Chinese economic statecraft.

Finally, we welcome Lindsey Ford, director for political-security affairs at the Asia Society Policy Institute.

Previously, Ms. Ford served in a variety of roles within the Office of the Secretary of Defense, including as the senior advisor to the assistant secretary of defense for Asian and Pacific security affairs where she managed a team of advisors overseeing maritime security, multilateral security affairs and force management planning.

Today, Ms. Ford will address challenges to China's geopolitical ambitions. Welcome.

And welcome to you all and thank you all very much for the written testimony you've already submitted. I'd like to remind the witnesses to keep their remarks to seven minutes.

Mr. Blasko, we'll begin with you.

OPENING STATEMENT OF LIEUTENANT COLONEL DENNIS BLASKO, U.S. ARMY (RET.), INDEPENDENT ANALYST

LTC BLASKO: Thank you very much.

I've written about the PLA's self-assessments of its own military capabilities for many years, but this is the first time that I've addressed the issue exclusively since 2013.

My testimony today concerns a large body of open-source evidence indicating that China's senior leaders recognize significant shortcomings in the PLA's warfighting and command capabilities.

The number of these appraisals has increased during Xi Jinping's tenure as CMC chairman casting doubt over senior leader confidence in the PLA's ability to prevail in modern war and likely moderating how China pursues its near-term and midterm national security objectives.

Since becoming CMC chairman, Xi has sought to raise the PLA's combat readiness to enhance China's deterrence posture and to achieve its political objectives without fighting.

Current reforms aim to improve PLA warfighting capabilities through changes in command and control and force structure by 2020.

Beyond that, Xi has set 2035 as the new date to complete military modernization, and mid-century to build the PLA into a world-class military.

Identifying and overcoming problems has been a major component of the PLA's deliberate modernization program for the last four decades.

As new technologies enter the force and restructured units train, more problems will be identified and additional corrective actions required.

Much of this process is reported in the Chinese medium highlighting progress, but often these reports include nuggets that mitigate positive elements found elsewhere.

Chinese language articles containing self-assessment likely are shared throughout the PLA, but only rarely is bad news published in English language material originating in China.

As a result, while the world's attention is attracted or distracted by the PLA's new weapons, parades and firepower demonstrations, China's Party and military leaders are well aware of the many challenges facing the force.

The practice of reporting both the good and bad is the PLA's way of talking to itself praising units for advances they have made, but also encouraging everyone to work harder.

It's the PLA's method of knowing itself and not a deception operation to hide capabilities.

PLA's self-evaluations take two forms, general assessment and specific critiques of discreet functions.

General assessments often are abbreviated in slogans or formulas usually attributed to a CMC chairman. Some have a life span of years such as the PLA's lack of combat experience described by the terms peace disease, peacetime habits and peacetime practices, all of which have been seen hundreds of times since 2012.

In 2006, Hu Jintao formulated the Two Incompatibles which states, the PLA's level of modernization is incompatible with winning local wars and performing the PLA's historic missions.

After Xi took over, new assessments, including the Two Inabilities, Two Big Gaps and Three Whethers, continue to refer to shortfalls in relative military capabilities and have been expanded to question the PLA's combat leadership and its loyalty to the Party.

These critiques have also appeared in hundreds of Chinese-language articles, but Xi's

Five Incapables formula is particularly significant stating that some commanders cannot judge the situation, understand the intention of higher headquarters, make operational decisions, deploy troops and deal with unexpected situations.

These are the fundamentals of combat leadership and this scathing indictment of some leaders actually means too many officers cannot perform these basic tasks.

Since 2015, the Five Incapables has occurred, on average, in over 40 PLA daily articles per year, the highest rate of all the general assessments.

Internally, these assessments have been used to justify many leadership and training events and specifically for updating the military training outline.

Notably, none has appeared in any of the defense white papers directed toward external audiences.

Innumerable Chinese-language examples of specific problems in personnel units and systems provide evidence to support the general evaluations.

My written testimony includes many examples from all services regarding training, logistics and equipment.

In conclusion, it's absolutely certain that Xi Jinping understands the implications of these self-evaluations.

If anything, the assessments have become more acute during the Xi era particularly concerning the quality of the PLA's combat leadership.

The totality of these criticisms reflect a lack of confidence in PLA capabilities and a failure of the PLA's educational and training systems to prepare officers for war.

Based on this evidence, I assess the senior Chinese military leadership has little or no appetite to commit the PLA to combat against a modern force in the near to midterm and prefers to achieve China's national objectives through deterrence and actions short of war.

Based on its own time line, the PLA would prefer to continue experimentation and troubleshooting until 2035.

However, should deterrence fail and the PLA be compelled to fight, its leadership will respond with all the capabilities on hand to defend China's national interests.

As a former intelligence officer, I reluctantly end with two policy recommendations. First, though the PLA's assessments of its shortcomings are subjective in nature, they need to be incorporated into objective foreign analysis of China's intentions and growing military capabilities.

Finally, given the PLA's long-term deliberate modernization process, the governments of the United States and its friend in Asia should undertake comprehensive interagency decision-making analyses potentially including international consultation before implementing policies or taking actions that cause the Chinese leadership to increase the pace of modernization or justify its use of military force.

Without actual combat experience, proving or disproving the effectiveness of the PLA's new weapons and force structure, some degree of uncertainty in the Chinese leadership's collective mind likely will exist for many years and may serve as a break in moving from assertiveness to overt military aggression. Thank you.

**PREPARED STATEMENT OF LIEUTENANT COLONEL DENNIS BLASKO, U.S.
ARMY (RET.), INDEPENDENT ANALYST**

“PLA Weaknesses and Xi’s Concerns about PLA Capabilities”

Testimony before the

U.S.-China Economic and Security Review Commission

Panel on

“Backlash from Abroad:
The Limits of Beijing’s Power to Shape its External Environment”

February 7, 2019

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The author is indebted to Dr. Alastair Iain Johnston
for assistance in research and statistical analysis.

A large body of evidence in China's official military and party media indicates the nation's senior civilian and uniformed leaders recognize significant shortcomings in the warfighting and command capabilities of the People's Liberation Army (PLA). The increasing scope and frequency of these self-critiques during the tenure of Xi Jinping as chairman of the Central Military Commission (CMC) casts doubt over the senior party and military leadership's confidence in the PLA's ability to prevail in battle against a modern enemy. The limitations illuminated by these internal assessments likely moderate China's near- and mid-term national security objectives and the manner by which they are pursued.

Since becoming CMC chairman in 2012, Xi has sought to raise the overall level of the PLA's combat readiness, embodied in the slogan "be able to fight and win" (能打仗、打胜仗).¹ By raising its warfighting capabilities and demonstrating them to the world, the PLA seeks to enhance a deterrence posture directed at an array of threats to China's national interests and achieve China's political objectives without fighting.² The current tranche of military reform aims to improve PLA warfighting capabilities by addressing command and control and structural shortfalls by 2020. Beyond that, Xi has set 2035 as the date to complete the modernization of military theory, organization, personnel, and weapons and "mid-century" (2049) to build the PLA into a "world-class military" (到本世纪中叶把人民军队全面建成世界一流军队), a phrase that has yet to be defined officially.³

Identifying and overcoming specific operational problems has been an essential component of the PLA's deliberate, long-term modernization process for the last four decades. As new technologies continue to enter the force and recently reorganized units train with advanced equipment, many more problems will be identified and additional efforts will be required to correct them. Much of this process will be reported by the Chinese media in a context that highlights progress made in specific areas or functions. But hidden within the glowing prose, readers may uncover nuggets of negativity that reveal insights into problems in the PLA's developing capabilities, mitigating to some extent the positive aspects found elsewhere.

Chinese-language articles containing internal self-assessments likely are shared within the force during mandatory unit political training sessions. However, only rarely is bad news publicized in English-language publications originating in China. Thus, while the PLA's new weapons, uniforms, parades, and firepower demonstrations attract (or distract) the world's attention, the party and military itself is well aware of the many persistent and evolving challenges facing the PLA.

1 "努力建设一支听党指挥能打胜仗作风优良的人民军队" [Strive to Build a People's Army that Can "Obey the Party, Fight and Win, Have a Good Work Style"], *PLA Daily*, August 1, 2017, http://www.81.cn/jfjbmmap/content/2017-08/01/content_183732.htm.

2 Peng Guangqian and Yao Youzhi, eds., *The Science of Military Strategy*, Beijing, Military Science Publishing House, 2001 (Chinese edition), 2005 (English edition), pp. 213 – 229.

3 "决胜全面建成小康社会 夺取新时代中国特色社会主义伟大胜利" [Decisive Victory, Build a Well-Off Society in an All-Round Way, Win the Great Victory of Socialism with Chinese Characteristics in the New Era], *PLA Daily*, October 19, 2017, http://www.81.cn/jfjbmmap/content/2017-10/19/content_189964.htm. Xi's objective to complete PLA modernization by 2035 moves forward by 14 years the previous date i.e., 2049, identified in the white paper "China's National Defense in 2008."

The practice of reporting both the good and bad is the PLA talking to itself, aimed at praising units for advances they have achieved, but also encouraging everyone to continue to work hard to raise PLA capabilities over the long term. In Hegelian terms, well-understood by PLA communists, successes represent the thesis, while the problems are the antithesis. When the two are merged, synthesis (progress) results and the process is repeated. The Chinese media's identification of these general and specific problems is a PLA method for "knowing itself," and is not a vast deception operation to hide its capabilities from inquiring eyes.

Types of Self-Assessments

Based on analysis of Chinese military media reporting, PLA self-evaluations take two forms: 1) general assessments of capabilities and 2) specific critiques of discrete functions in individual units.⁴ General assessments frequently are attributed to and referred to by CMC chairmen (going back to Deng Xiaoping), indicating knowledge of their content and approval by the highest level of the party and military. Some formulas have a lifespan of years, appearing scores or hundreds of times in various publications. The method by which these evaluations are developed is unclear, but probably includes consensus among senior leaders after staff work involving elements of at least the CMC, Joint Staff Department, and Political Work Department (or their predecessor organizations).

General self-assessments are abbreviated in slogans or formulas, such as the "Two Incompatibles" or "Five Incapables." Early in their "life," they are spelled out in full sentences, but later they appear most often in their short-form abbreviation, without full explanation. Readers not familiar with the terms may skip over them, consider them propaganda or boilerplate fluff, or may have to search previous reporting to determine their meaning. Since 2006, generalized appraisals have expressed skepticism about the PLA's ability to prevail in modern combat; more recently they have questioned the combat leadership ability of "some" leaders and the PLA's loyalty to the party. None of these assessments has been included in any of the white papers on national defense, whose target audience is external to China; only infrequently do English-language editions of Chinese publications include the text of some of these evaluations.

Specific critiques about particular capabilities and units often address problems in the abilities of commanders and staff, the execution of tactics and techniques discovered on the training field, and systemic organizational and equipment shortfalls. Training in every service and every unit, particularly during force-on-force confrontational exercises, constantly seeks to identify and resolve problems and thereby increase combat capabilities and readiness.⁵ Following every major training event, units conduct after-action reviews (referred to as 复盘总结, 复盘推演, 反思检讨会) to highlight successes and to detect specific shortcomings and weaknesses (短板, 底板, 弱项

⁴ Undoubtedly, in addition to the problems publicized in the media, the PLA has a classified evaluation system to assess unit readiness and capabilities for individual units that is not available to the Chinese press or public in general.

⁵ "我们到底需要什么样的假想敌" [What Kind of Imaginary Enemy Forces Do We Need], *PLA Daily*, January 8, 2019, http://www.81.cn/theory/2019-01/08/content_9399595.htm.

).6 Based on these after-action reviews, units may conduct remedial training (复训补训) or program training for the coming training season to correct shortcomings.⁷ These details serve as the basis for the larger generalizations found in slogans and formulas and contribute to the rationale behind changes in the PLA's organization, structure, doctrine, and training.

As might be expected in any results-oriented organization, once people understood that “discovering problems” was a command emphasis, “some” units attempted to game the system by finding problems for the sake of finding problems – often the same problems as identified in prior training – to “show off” to their superiors. This phenomenon, known as the “problem show” (问题秀), was identified in early 2015 and has resulted in a number of articles aimed at guarding against the phenomenon.⁸

General Assessments

One of the most common general critiques about the PLA is its lack of recent combat experience. Current vice chairman of the CMC General Zhang Youxia identified this weakness in 2009 when he was Shenyang Military Region commander:

Today, the PLA hasn't been in actual combat for many years now, yet the fires of war are burning throughout the world. In this area, the gap between the PLA and foreign militaries is growing day by day. This is an actual problem.⁹

The problem persists and the PLA media frequently urges the troops to overcome the “peace disease” (和平病), “peacetime habits” (和平积习), and “peacetime practices [or problems]” (和平积弊).¹⁰ If soldiers have a peacetime attitude (not expecting to go to war during their period of service), take shortcuts and develop bad habits, or just “go through the motions” during training,

6 “联教联学促进联演联训” [Joint Education and Schooling Promotes Joint Training], *PLA Daily*, January 18, 2018, http://www.81.cn/jfjbmap/content/2018-01/18/content_197230.htm; “对训练落实不力的要‘有个说法’” [“There’s a Saying” About the Ineffective Implementation of Training], *PLA Daily*, December 6, 2017, http://www.81.cn/jmywyl/2017-12/06/content_7856614.htm; “联勤保障部队，请收5封“用户来信”” [Joint Logistics Support Force, Please Accept Five Letters], *PLA Daily*, May 2, 2017, http://www.81.cn/jmywyl/2017-05/02/content_7583691.htm.

7 “野外陌生地域补齐训练短板” [Remedying Training Defects in the Field in an Unfamiliar Area], *PLA Daily*, January 13, 2019, http://www.81.cn/jfjbmap/content/2019-01/13/content_225138.htm.

8 “纠正“问题秀”，问题清单不能只列不改” [Correct the “Problem Show,” The Problems List Cannot Only Be Listed and Not Change], *PLA Daily*, August 31, 2018, http://www.81.cn/jmywyl/2018-08/31/content_9268150.htm; “树立问题导向力戒“问题秀”” [Establish Problem-Oriented Guidance, Guard Against “Problem Show”], *PLA Daily*, February 27, 2015, http://www.81.cn/jfjbmap/content/2015-02/27/content_103181.htm.

9 “沈阳军区司令员张又侠解读新时期军事训练新革命” [Commander of the Shenyang Military Region Zhang Youxia Interprets the New Revolution in Military Training in the New Era], *China.com.cn*, November 20, 2009, http://www.china.com.cn/military/txt/2009-11/20/content_18925256.htm.

10 Based on email correspondence with Dr. Alastair Iain Johnston, July 4, 2018, the term “peace disease” was first observed in the late 1980s. These three terms appeared roughly 565 times in the *PLA Daily* from 2012 to mid-2018. They continue apace in 2019, with a recent example found in “用聚焦中心消除“干扰源”” [Focus on the Center to Eliminate “Sources of Interference”], *PLA Daily*, January 13, 2019, http://www.81.cn/jfjbmap/content/2019-01/13/content_225134.htm.

then unit readiness is compromised. Rectifying this attitude is a leadership challenge at all levels and is an important reason behind Xi's emphasis on raising combat readiness.¹¹

In early 2006, CMC chairman Hu Jintao was credited with formulating the “Two Incompatibles” (两个不相适应) or “principal contradiction” (主要矛盾) assessment of PLA capabilities: the PLA's “level of modernization 1) does not meet the requirements of winning local war under informatized conditions and 2) its military capability does not meet the requirements of carrying out its historic missions at the new stage of the new century.”¹² In short, this evaluation questions the PLA's capabilities to fight and win wars and perform the many other missions it may be assigned, such as military operations other than war (MOOTW). Though this assessment uses terminology from Hu's tenure as CMC chairman, such as “local war under informatized conditions” and the “historic missions,” it continues to be seen, though less frequently, after Xi took over as CMC chairman.¹³ The formula also has been modified to describe specific problems, such as Navy training and logistics.¹⁴ More recently, in July 2018, a member of the Army Staff wrote that the size of the Army Aviation air assault force was incompatible with its missions and tasks and that its overall operational capabilities were incompatible with the requirements for victory.¹⁵

After Xi began his term as CMC chairman, several new formulas reflecting assessments of PLA capabilities have been used to augment and expand on the “Two Incompatibles” problem. Like the “Two Incompatibles” they question the PLA's current ability to fight and win a modern war, but, perhaps more importantly, also emphasize leadership shortcomings among “some” combat officers and question the PLA's loyalty to the party.

11 A few examples of these terms' usage includes: “强化政治自觉，下决心根治“和平病”——一谈纠治和平积弊、聚力备战打仗,” [Strengthen Political Consciousness, Be Determined to Cure the “Peace Disease,” A Talk About Rectifying Peacetime Practices, Concentrate on Preparing for Battle], *PLA Daily*, July 2, 2018, http://www.81.cn/jfjbmap/content/2018-07/02/content_209857.htm; “战场险情处置嵌入日常训练” [Deal With Battlefield Dangers through Daily Training], *PLA Daily*, June 20, 2018, http://www.81.cn/jfjbmap/content/2018-06/20/content_208948.htm; and “聚焦主战主业 强化使命担当” [Focus on the Main Business of Fighting, Strengthen Mission Responsibility], *PLA Daily*, February 9, 2018, http://www.81.cn/jfjbmap/content/2018-02/09/content_199258.htm.

12 “我军加紧战争准备 当务之急是造“撒手锏”武器” [The PLA Steps Up Preparation for War, the Most Urgent Task is to Build “Assassin's Mace” Weapons], *China.com*, March 22, 2006, http://news.china.com/zh_cn/domestic/photo/11026066/20060322/13186012.html, which states “对于着力解决我军现代化水平与打赢信息化条件下局部战争的要求还不相适应，军事能力与履行新世纪新阶段我军历史使命的要求还不相适应这一主要矛盾，具有极其重要的指导作用。” Except for the “Two Incompatibles,” the author is not aware of other generalized assessments during the Hu era. If any others can be identified, I will incorporate them into this analysis.

13 “惟改革创新者胜” [For Reform and Innovation to Win], *PLA Daily*, March 14, 2018, http://www.81.cn/jfjbmap/content/2018-03/14/content_201556.htm; “大力推进新时代军事管理革命” [Vigorously Promote the Revolution in Military Management in the New Era], *PLA Daily*, September 26, 2018, http://www.81.cn/jfjbmap/content/2018-09/26/content_216670.htm.

14 “海军贯彻十八大精神勇闯大洋苦练硬功” [The Navy implements the spirit of the 18th National Party Congress], *China Navy*, December 12, 2012, http://navy.81.cn/content/2012-12/12/content_5137665.htm; “Liao Xilong Stresses at Enlarged Conference of Party Committee of General Logistics Department Making Efforts To Open Up New Situation of Comprehensive Development of Modern Logistics,” *PLA Daily*, January 12, 2008.

15 “从空中打赢地面战争” [Winning Ground Wars From the Air], *PLA Daily*, July 12, 2018, http://www.81.cn/jfjbmap/content/2018-07/12/content_210771.htm.

The “Two Inabilities” (两个能力不够) was revived in 2013 and states that 1) the PLA’s ability to fight a modern war is not sufficient and 2) the ability of cadres (officers) at all levels to command modern war is insufficient.¹⁶ The intention of the first half of the formula is similar to the first part of the “Two Incompatibles,” but the second portion is a general criticism of PLA combat leadership capabilities. A prominent flaw reported in some commanders is that they “do not dare” or are “not willing” or “not able” to use the “new-type combat forces” (新型作战力量) that they have been assigned.¹⁷ Though leadership training has been emphasized for many years using the formula, “train generals/officers first [before training troops]” (练兵先练将/练兵先练官), the “Two Inabilities” suggests that efforts to date have not been as effective as necessary.¹⁸ The “Two Inabilities” was cited specifically as a reason to improve realistic training when the updated Military Training Outline was issued in 2018.¹⁹ Last December, *PLA Daily* reported that after three years of reforms (many of which were reiterated in the article), Xi pointed out multiple reasons that the “Two Inabilities” remain prominent: the leadership management system is not scientific enough, the joint operations command system is not sound enough, the force structure is not rational enough, and policy system reform still lags relatively behind.²⁰

Also from 2013 the “Two Big Gaps” (两个差距很大) acknowledges there are big gaps between the PLA’s military modernization level and 1) the requirements for national security and 2) compared to the level of the world’s advanced militaries.²¹ The “Two Big Gaps” reiterates a lack of confidence in PLA fighting abilities in general, but also specifies that a *relative* capability gap in exists between the PLA and other advanced militaries. Previously senior PLA leaders had publicly acknowledged such a gap in general terms. For example, in a January 2011 meeting with the U.S. Secretary of Defense Robert Gates, Defense Minister General Liang Guanglie stated that though the PLA has demonstrated certain advanced weapons, “I also firmly believe that in terms of the level of modernization of the PLA, we can by no means call ourselves an advanced military

16 “学习习近平总书记关于强军目标的重要论述” [Study General Secretary Xi Jinping’s Exposition on the Goal of Strengthening the Military] *People’s Daily*, July 22, 2013, <http://theory.people.com.cn/n/2013/0722/c40531-22275029.html>, which states “军队打现代化战争能力不够,各级干部指挥现代战争能力不够。” The “Two Inabilities” is attributed to Deng Xiaoping and was seen a few times during the CMC chairmanship of Jiang Zemin and Hu Jintao. There may be other general self-criticisms in the Xi era in addition to the four identified here.

17 “推进新型作战力量融入联合作战” [Promote the Integration of New-Type Combat Forces into Joint Operations], *PLA Daily*, July 31, 2015, http://www.81.cn/jfjbmap/content/2016-07/31/content_152147.htm.

18 “强军先强将 练兵先练官” [For a Strong Army First Train Generals, In Training Soldiers First Train Officers], *PLA Daily*, January 17, 2016, http://www.81.cn/jfjbmap/content/2016-01/17/content_135485.htm; “紧盯打赢仗练兵先练将” [Concentrate on Winning Battles Training Soldiers First Train Generals], *PLA Daily*, June 30, 2018, http://www.81.cn/jfjbmap/content/2018-06/30/content_209742.htm.

19 “新军事训练大纲来了，我们该怎么办？” [The New Military Training Outline Has Arrived, What Should We Do?], *PLA Daily*, January 1, 2018, http://www.81.cn/jmywyl/2018-01/30/content_7926395.htm.

20 “体系重塑，波澜壮阔开新局” [Remodeling the System, Waves Open a New Bureau], *PLA Daily*, December 18, 2018, http://www.81.cn/jfjbmap/content/2018-12/18/content_223416.htm.

21 “学习习近平总书记关于强军目标的重要论述” [Study General Secretary Xi Jinping’s Exposition on the Goal of Strengthening the Military], *People’s Daily*, July 22, 2013, <http://theory.people.com.cn/n/2013/0722/c40531-22275029.html>, which states, “目前,我军现代化水平与国家安全需求相比差距还很大,与世界先进军事水平相比差距还很大。”

force. The gap between us and that of advanced countries is at least two to three decades.”²² Xi has since tasked the PLA to close this gap by establishing the goal to build a “world-class military” by mid-century.

One of the few instances of a Chinese-origin, English-language reference to the “Two Big Gaps” and “Two Inabilities” was published in 2016. However, it does not include the two slogans themselves and casual readers could miss the larger context and history behind this passage:

Improving the army’s combat strength has become a major focus. But the modernization level of the Chinese army is inadequate to safeguard national security, and it lags far behind advanced global peers. The Chinese army is not capable enough of waging modern warfare, and officers lack command skills for modern warfare.²³

The “Three Whethers” (三个能不能) is a less-frequently noted assessment first seen in 2014. It repeats misgivings about the PLA’s fighting and leadership capabilities, but begins by raising doubts about the PLA’s loyalty to the party: 1) Whether our armed forces can constantly maintain the party’s absolute leadership, 2) whether they can fight victoriously when needed by the party and the people, and 3) whether commanders at all levels are competent to lead forces and command in war.²⁴ The question of PLA loyalty to the party is of utmost importance to China’s senior civilian leaders and for it to be acknowledged in this slogan indicates adds a political dimension to concerns about the military’s operational leadership abilities.²⁵

The “Five Incapables [Cannots]” (五个不会) from 2015 highlights the problems “some” individual officers have in making battlefield judgments and decisions necessary to succeed in combat: Some commanders cannot 1) judge the situation, 2) understand the intention of higher authorities, 3) make operational decisions, 4) deploy troops, and 5) deal with unexpected situations.²⁶ These five tasks are the fundamentals of combat leadership, required at all levels of command. Though no percentage of leaders is defined in the “some” (一些指挥员) who cannot perform these functions, the prevalence of this critique suggests that “some” is “too many” and the

22 “Joint Press Conference with Secretary Gates and General Liang from Beijing, China,” U.S. Department of Defense, January 10, 2011, <http://archive.defense.gov/transcripts/transcript.aspx?transcriptid=4750>.

23 “Xi brings strength, integrity to Chinese armed forces,” English-language *PLA Daily*, July 30, 2016, http://english.chinamil.com.cn/news-channels/china-military-news/2016-07/30/content_7182049.htm.

24 “破解一支军队所向披靡的脉动密码” [Crack an Army’s Password], *PLA Daily*, July 28, 2014, http://www.81.cn/2014-content_18620/2014-07/28/content_6173099.htm, which states “在党和人民需要的时候，军队能不能始终坚持党的绝对领导，能不能拉得上去、打胜仗，各级指挥员能不能带兵打仗、指挥打仗？”

25 Several other formulas, such as the “Five Excesses” (五多) and “Four Winds [or Four Bad Styles]” (四风) address ideological, discipline, corruption, and political problems and will not be examined in this testimony. For a few examples, see “用聚焦中心消除“干扰源”” [Focus on the Center to Eliminate “Sources of Interference”], *PLA Daily*, January 13, 2019, http://www.81.cn/jfjmap/content/2019-01/13/content_225134.htm; “中部战区陆军出实招纠治作风积弊” [CTC Army Move to Rectify Evil Trends], *PLA Daily*, January 17, 2018, http://www.81.cn/jfjmap/content/2018-01/17/content_197142.htm.

26 “破解“五个不会”难题要从源头入手” [To Crack the “Five Incapables” Problem Start with the Source], *PLA Daily*, October 13, 2015, http://www.81.cn/jfjmap/content/2015-10/13/content_125880.htm, which states “一些指挥员离开了机关就不会判断形势、不会理解上级意图、不会定下作战决心、不会摆兵布阵、不会处置突发情况。”

problem is widespread. This appraisal, along with the “Two Inabilities,” which also mentions leadership, is now one of the most frequently repeated slogans in the Chinese military media. As could be expected, at about the same time as the appearance of this scathing indictment, units began emphasizing “Five Abilities” (五会) leadership training to correct the problem.²⁷

In its short existence the “Five Incapables” has been utilized to justify many training activities. For example, in 2016 the Army stated that the 17 Stride and Firepower-series trans-regional exercises for the year to were aimed at resolving the commanders’ “Five Incapables” problem.²⁸ Following Xi Jinping’s 2017 visit to the CMC Joint Operations Center, a *PLA Daily* staff commentator article began by stressing the need to solve the two problems of the “Two Inabilities” and “Five Incapables.”²⁹ *PLA Daily* staff commentator articles to promote the annual training mobilization orders for 2018 and 2019 both reference the “Five Incapables.”³⁰ In the summer of 2018 all four services held training for senior officers on overcoming the “Five Incapables”:

- The Army held six and a half days of training for commanders and staff of the five TC Armies and 13 group armies focused on the “Five Incapables.”³¹
- During four rounds of preparatory training sessions for senior officers of the Navy headquarters and the Theater Command Navies, Commander Shen Jinlong, his deputy, and chief of staff addressed the “Five Incapables” and set training guidance that “officer training takes priority over crew training.”³²
- During a group training session for Air Force commanders and staff of all levels, Commander Ding Laihang and Political Commissar Yu Zhongfu began the meeting by discussing the “Five Incapables.”³³
- Over 200 Rocket Force generals and field grade officers examined the problem that the Rocket Force has never fought a war along with Xi’s emphasis on resolving the “Five Incapables” and “Three Whethers.”³⁴

27 “From Here to Actual Combat, From Here to Victory,” *Zhanshi Bao*, August 28, 2015. This report specifically links the “Five Incapables” and “Five Abilities” in a review of the exercise “Joint Action 2015C.”

28 “陆军7至9月组织17场跨区演习 7条新规推动真打实抗” [The Army Organizes 17 Trans-Regional Exercises from July to September, 7 New Regulations to Promote Realistic Combat], *PLA Daily*, August 4, 2016, http://www.81.cn/sydbt/2016-08/04/content_7189782.htm

29 “军报评论：领导干部要做备战打仗带头人” [JFJB Commentary: Leading Cadre Must Prepare Leaders to Win], *PLA Daily*, November 11, 2017, http://www.81.cn/jmywyl/2017-11/06/content_7813078.htm.

30 “在解决突出短板弱项中提高备战打仗能力” [Solve Shortcomings and Weaknesses to Improve Combat Readiness Capabilities], *PLA Daily*, January 8, 2019, http://www.81.cn/jfjbmap/content/2019-01/08/content_224764.htm; “坚定不移把军事训练摆在战略位置” [“Firmly Place Military Training in a Strategic Position”], *PLA Daily*, January 4, 2018, http://www.81.cn/theory/2018-01/04/content_7894870.htm.

31 “新时代强军战歌：着力打造中军帐‘最强大脑’” [Strive to Build the “Strongest Brains” in Command Posts], *Xinhua*, July 15, 2018, http://m.xinhuanet.com/mil/2018-07/15/c_129913697.htm.

32 “ Closely Centering on Ability to Fight and Win, Navy Organizes Preparatory Training Ahead of Operational Assembly Training; Focusing on Studying and Resolving ‘Five Incapables,’ Establishing ‘Officer Training Before Crew Training’ Guidance,” *Renmin Haijun*, June 25, 2018.

33 “Air Force Group Training in Combat Operations and Combat Readiness Thoroughly Implements Xi Jinping’s Strong Armed Forces Ideology,” *Kongjun Bao*, July 4, 2018.

34 “砥砺大国长剑锋芒” [Sharpening the Blade of the Long Sword of a Major Power], *PLA Daily*, July 18, 2018, http://www.81.cn/jfjbmap/content/2018-07/18/content_211178.htm.

Since 2006 when the “Two Incompatibles” was first promulgated, these five assessments have appeared in over 500 articles in the *PLA Daily* alone. Table 1 summarizes the content of these five assessments. In Charts 1 and 2, Harvard Professor Alastair Iain Johnston graphs the number of articles in which one or more of these terms each has been observed annually in *PLA Daily*, tallied by their individual usage through 2018:³⁵

- “Two Incompatibles”: 120 articles
- “Two Inabilities”: 169
- “Two Big Gaps”: 78
- “Three Whethers”: 27
- “Five Incapables”: 163
- Total: 557

The “Five Incapables” leads with highest average per annum occurrence of articles (40.75) followed by the “Two Inabilities” (28.17). Both of these formulas highlight problems in PLA operational leadership and the frequency of their usage indicates the CMC underscores this as a major unsolved problem. The appearance of the “Three Whethers” has grown annually over the past four years, perhaps suggesting that in addition to fighting and leadership shortcomings, the senior party and military officials are increasingly concerned about the PLA’s loyalty.

Recognizing that leaders will make mistakes during the course of reform and in training, on January 1, 2019, the CMC issued an opinion on motivating cadre to assume new responsibilities. The opinion differentiates between those who commit *intentional* violations of regulations and those who make *unintentional* errors, especially grassroots cadre serving in operational units or in remote areas. In the latter case, the opinion suggests that promotions and assignments should not be affected for those who were granted amnesty or served punishment for unintentional mistakes made while taking the initiative and trying to solve problems.³⁶ This opinion seeks to encourage leaders to take risks in the pursuit of raising PLA capabilities. If implemented fairly, such a policy could hasten the growth of a competent officer corps.

Specific Problems

The body of open source Chinese-language evidence enumerating the various types of specific problems that support the general assessments above is overwhelming, dating back over decades. Only a small sample is included below, selected only from the past three years of reform. Examples in the Chinese-origin, English-language occur much less frequently, but one insightful observation by an unidentified researcher in the Human Resources Department at the then-Xi’an Political Academy covers multiple problems:

³⁵ Email correspondence with Dr. Johnston, January 15, 2019. In many cases, multiple slogans appear in the same article, so the total number of articles will be less. These numbers do not include the instances when the assessments are spelled out in full without mentioning their abbreviated slogan format.

³⁶ “中央军委办公厅印发《关于进一步激励全军广大干部新时代新担当新作为的实施意见》” [General Office of the Central Military Commission Releases the “Implementing Opinion on Further Motivating All-Military Cadres to Assume New Responsibilities and Attain New Achievements in the New Era”], *PLA Daily*, January 2, 2019, http://www.81.cn/jmywyl/2019-01/02/content_9393126.htm.

[The PLA] must address the shortage of officers who have a deep knowledge of joint combat operations and advanced equipment. We have developed and deployed many cutting-edge weapons, including some that are the best in the world, but there are not enough soldiers to use many of those advanced weapons. In some cases, soldiers lack knowledge and expertise to make the best use of their equipment.³⁷

A major component of the PLA's effort to increase its joint warfighting capabilities was the creation of the five Theater Command (TC) headquarters in 2016. However, when these organizations were established, there was a shortage of qualified "joint officers" and many personnel assigned to the TC headquarters were uncomfortable in their new positions, necessitating on-the-job training for them to become proficient in their new tasks. One staff officer in the Northern TC headquarters complained that he and his comrades had been topnotch officers in the former Shenyang Military Region, but in their new positions they were elementary students of joint operations. Accordingly, the headquarters set up a "Three-Year Program for Building Joint Operation Command Personnel" (联合作战指挥人才建设3年规划), which requires personnel to be tested before they receive job certification.³⁸ Nonetheless, over two years later shortly after Xi visited the Southern TC headquarters, an October 2018 *PLA Daily* staff commentator article recommended that Theater Commands must improve their warfighting command capabilities as soon as possible and increase efforts to resolve the problems of the "Two Inabilities" and "Five Incapables."³⁹

Similar troubles have been reported in the Army at brigade and battalion levels for both commanders and staff. Recently, in a summary of unit training conducted after several units had relocated to barracks at higher elevations, a leader from the Western TC Army stated that though a new foundation had been laid, "our practice is still in the preliminary stage; we must strive for a long time before we can reap maximum dividends of reform to build combat effectiveness."⁴⁰ The commander of the 81st Group Army Artillery Brigade observed, "We commanders still work with traditional methods and we have not changed training methods and concepts for informatized and digitized equipment."⁴¹ Similarly, a battalion commander, whose unit was equipped with the

37 "PLA restructuring changes focus at military schools," English-language *PLA Daily*, April 28, 2016, http://english.chinamil.com.cn/news-channels/china-military-news/2016-04/28/content_7028544.htm. The Xi'an Political Academy is now the National Defense University's Political Institute Xi'an Campus.

38 "联战联训，千军万马看指挥" [Joint Operations and Training, A Strong Force is Led by Commanders], *PLA Daily*, May 5, 2016, http://www.81.cn/jfjbmapp/content/2016-05/05/content_143593.htm. Similar training programs have been reported in the Southern and Central TCs and operational units. See "组织强则军队强，这个旅政委狠抓基层党建工作" [Strong Organization then Strong Unit, This Brigade Political Commissar Effectively Directs Grassroots Party Building Work] *PLA Daily*, October 29, 2018, http://www.81.cn/2018jddjgzdx/2018-10/29/content_9325677.htm; 陆战新锐乘风起航 [The Cutting Edge of Ground Combat Takes Off], *PLA Daily*, October 2, 2017, http://www.81.cn/jfjbmapp/content/2017-10/02/content_189166.htm.

39 "加快把指挥能力搞过硬" 本报评论员 [Speed Up Solid Command Capabilities], *PLA Daily*, October 27, 2018, http://www.81.cn/jfjbmapp/content/2018-10/27/content_219136.htm.

40 "从“上山训练”到“山上训练”" [From "Mountain Climbing Training" to "Training on the Mountain"], *PLA Daily*, January 18, 2019, http://www.81.cn/lj/2019-01/18/content_9408195_2.htm.

41 Military Report CCTV-7, December 9, 2018, <http://tv.cctv.com/2018/12/09/VIDEVRWt0EDOb4UaWQAYhVwci81209.shtml>.

newest Type 99A tanks, but was defeated in a 2018 training exercise, explained “We only studied the capabilities of older tanks, but have not completely understood new ones.”⁴²

With the creation of permanent combined arms battalions, which command companies and platoons from up to 10 different branches (such as infantry, armor, artillery, air defense, etc), many new battalion and company commanders have not received formal training in the capabilities and requirements of each branch and how to effectively train and employ them.⁴³ Therefore, training for these officers must be conducted within the brigade, with some brigades issuing qualification certificates for commanders.⁴⁴ Moreover, the newly formed combined arms battalions have been augmented with several staff officers and noncommissioned officers (NCO) to assist the commander; however, most battalion staff officers/NCOs have had no experience in their new jobs and also must receive on-the-job training.⁴⁵ In many cases, battalion commanders are unfamiliar with how their staff can support them and try to be a “one-man show” (独角戏) as they were prior to reforms, finding it difficult to adjust to the new organization.⁴⁶ It appears that individual brigades are establishing their own internal guidelines on the degree of authority given to battalion staff officers, to include delegating authority to deploy and direct certain battlefield functions.⁴⁷ Though the Army has been experimenting with battalion-level combined arms operations for the past decade, it likely will take several more annual training cycles to troubleshoot the new structures and tactics and procedures to standardize command and control functions throughout the force.

Though the Navy has not undergone the same amount of organizational turmoil as the Army, it confronts similar problems in some areas and unique ones in others. At the beginning of the recent reforms, the deputy political commissar of the South Sea Fleet stated (in an article translated into English), “Despite the fact that the Navy’s strength, weapons and equipment continue to improve, we have weaknesses at the technological level. Our researchers have made breakthroughs in many fields, and what we need now is the government’s determination and investment, otherwise the Navy will lag behind others.”⁴⁸ In late 2018, Eastern TC Navy leaders identified multiple

42 “PLA moves to integrate techniques, tactics with new weapons systems,” English-language *PLA Daily*, January 21, 2019, http://english.chinamil.com.cn/view/2019-01/21/content_9409397.htm.

43 “一名合成营营长的新年“台账”” [A Combined Arms Battalion Commander’s New Year’s “Ledger”], *PLA Daily*, January 8, 2019, http://www.81.cn/jfjbmap/content/2019-01/08/content_224806.htm; “Making Up for ‘Capabilities Deficiency’ in Combined Arms Battalion Commanders: a Brigade of the 83rd Group Army Steps Up the Building of Its Corps of Combined Arms Battalion Command Talent,” *Renmin Lujun*, July, 18, 2017. This situation is particularly vexing for artillery officers who are assigned to command combined arms battalions.

44 “合成营营长上岗先考“资格证”” [Before Taking up Post Combined Arms Battalion Commander Must Obtain ‘Certificate of Qualification’], *PLA Daily*, September 27, 2016, http://www.81.cn/jfjbmap/content/2016-09/27/content_157597.htm. It does not appear that there are centralized standards for battalion command.

45 “合成营参谋纳入首长机关集训” [Combined Arms Battalion Staff Included in Headquarters Training], *PLA Daily*, June 3, 2018, http://www.81.cn/jfjbmap/content/2018-06/03/content_207669.htm; “找准新时代练兵备战发力点” [Identify Points for New Era War Preparedness Training], *PLA Daily*, January 12, 2018, http://www.81.cn/jfjbmap/content/2018-01/12/content_196789.htm; “士官参谋之问：上士吴坚的喜与忧” [On Non-Commissioned Staff Officers: The Joys and Pains of Staff Sergeant Wu Jian], *PLA Daily*, January 1, 2018, http://www.81.cn/jmywyl/2018-01/03/content_7893231.htm.

46 “一场对抗演习“打痛”指挥机构” [“Pain” Strikes a Command Organization in a Confrontation Exercise], *PLA Daily*, April 20, 2018, http://www.81.cn/jfjbmap/content/2018-04/20/content_204240.htm.

47 “Reduce Command Levels, Enhance Command Flexibility,” *Renmin Lujun*, March 20, 2018.

48 “PLA officer: Navy needs more punch,” English-language *PLA Daily*, March 21, 2016, http://english.chinamil.com.cn/news-channels/2016-03/21/content_6968724.htm. This, of course, is a blatant call for greater funding for the Navy.

weaknesses (“peacetime practices”) constraining training and combat readiness, such as too much redundant low-quality training, more assessments of single platform capabilities than systems-of-systems assessments, unrealistic training plans, infrequent research and analysis of the enemy threat, and out-of-date information on the enemy.⁴⁹ As the Army seeks to give more authority for independent operations to brigade and battalion commanders, there are rumblings in the Navy to allow ship captains greater independence from instructor captains (教练舰长) – senior officers assigned to ships to guide the captain and staff. Last April, in response to a recommendation to discard this “baby-sitting” model (“保姆”模式), a destroyer flotilla (支队) commander stated, “we must allow captains to independently take command, but steps should be taken prudently, and it is also necessary to thrash out a feasible evaluation program and a set of detailed rules for practice.”⁵⁰ If the Navy decides to take this important step, many preparatory actions will be necessary and the transition will take time.

The Air Force faces its own set of challenges. In 2017, the commandant of the Air Force Command Academy opened a training session for division, brigade, and regiment commanders with the observation that substantial differences exist in the thought and knowledge between personnel from combat units and those from non-combat units, between personnel from units using new equipment and those from units using obsolete equipment, and between personnel engaged in operations training and those from support units. The Academy must, therefore, “update its thought” to bring new concepts, ideas, methods, and experiences into the curriculum and classroom as soon as possible.⁵¹ A *Kongjun Bao* commentator article shortly followed stating the “Five Incapables” exist to varying degrees in units, noting particularly “the gap between us and the air forces of the strong powers of the world.” In order to build “a first-rate strategic air force,” leaders must develop “first-rate work habits.”⁵²

The Rocket Force commander and political commissar acknowledged that its units share the “Five Incapables” problem in their 2017 training mobilization order.⁵³ Leadership training at brigade level is a priority as demonstrated in 2018 reporting that notes, “To strengthen the force, it is essential to first strengthen commanders and staff officers,” as one brigade sought methods to overcome training weaknesses.⁵⁴ Likewise, a Rocket Force base pointed out a series of problems, embarrassing brigade and regiment staff officers, during an on-line training session.⁵⁵

49 “纠治和平积弊，来一场向自己开刀的“手术”” [Correcting Peacetime Practices, Performing “Surgery” on Yourself], *PLA Daily*, November 1, 2018, http://www.81.cn/jmywyl/2018-11/01/content_9328247.htm.

50 “舰长“放单”，前路是鲜花还是荆棘” [With Ship Captains Being Allowed to Independently Exercise Command, Will the Road Ahead Be Flowers or Thorn Bushes], *PLA Daily*, April 9, 2018, http://www.81.cn/jfjbmap/content/2018-04/09/content_203379.htm.

51 “Improve the Training System, Enhance the Personnel Qualities,” *Kongjun Bao*, June 2, 2017.

52 “Adapting to the New Structure and Building a First-Rate World-Class Strategic Air Force -- A Complete Discussion on Studying the Spirit of Implementing Assembly Training for Air Force Division, Brigade, and Regiment Commanders,” *Kongjun Bao*, June 6, 2017.

53 “Rocket Force Military Training Mobilization Order for 2017,” *Huojianbing Bao*, January 1, 2017.

54 “Rocket Force Brigade Firmly Adheres to the Actual Combat Orientation, Enhancing the Capabilities of the Command and Staff Organ,” *Huojianbing Bao*, August 4, 2018.

55 “Rocket Force Base Drives Command Organs to Enhance Capabilities of Studying and Planning Military Operations Through Exposing and Settling Problems,” *Huojianbing Bao*, March 14, 2018.

Many articles refer to longstanding troubles with training, logistics, and equipment, especially when compared to advanced militaries. In November, 2016, the director of the CMC Training and Administration Department identified multiple systemic contradictions and problems with the PLA's training regime, including a lack of emphasis on the centrality of training, the divergence between training and operations, insufficient officer training, insufficient training innovation, and lack of compatibility between training and support.⁵⁶ More recently an officer from the National Defense University Military Culture College wrote "There is a gap in aspects of our military's management of joint logistics support compared to the armed forces of developed nations. Our system of big data management is not yet good enough."⁵⁷ Despite the large amounts of new equipment entering the force, *Xinhua* and *PLA Daily* jointly published an article that stated, "In many respects there clearly are gaps in the level of the PLA's weapons and equipment to protect our country's security and developmental interests compared and the requirements to fight and win informatized wars compared to the world's strong military powers."⁵⁸ A factor exacerbating this problem is that new equipment sometimes arrives at units unexpectedly with no training manuals and no personnel able to operate and maintain the new gear.⁵⁹ The Rocket Force's first DF-26 brigade was established before it was issued missiles and with no manuals to guide the troops in preparation for their arrival. Consequently, the unit itself had to write its own teaching material to satisfy these basic requirements.⁶⁰

The items described above only scratch the surface of the specific problems identified in the official Chinese media that can be found in every service and in every battlefield operation. Despite (or because of) structural reorganization and the introduction of new equipment and technologies, commanders, staff, and enlisted personnel constantly are in the process of adjusting existing tactics, techniques, and procedures. Nearly all of the PLA is in a state of experimentation and will be for several years into the future.

Analysis and Recommendation

Analysis: It is absolutely certain that Xi Jinping and his predecessors understand the meaning and implications of the self-evaluations of PLA capabilities memorialized in multiple slogans and

56 “锲而不舍破解实战化训练现实难题” [Unflagging Efforts to Solve Real Difficulties With Combat-Realistic Training], *PLA Daily*, November 29, 2016, http://www.81.cn/jfjbmap/content/2016-11/29/content_162839.htm.

57 “用大数据补齐管理短板” [Use Big Data to Make Up for Management Shortfalls], *PLA Daily*, December 25, 2018, http://www.81.cn/jfjbmap/content/2018-12/25/content_223960.htm.

58 “新华社、解放军报推出长篇综述：《科技创新，迈向世界一流军队的强大引擎》” [Xinhua and JFJB Release the Long Overview: Scientific and Technological Innovation is the Mighty Engine to Advance Toward a World-Class Military], *PLA Daily*, September 14, 2017, http://www.81.cn/sydbt/2017-09/14/content_7757090.htm.

59 “陆军某旅：十余万发弹药“打”出新质作战力量” [Army Brigade: Fires More Than a Hundred Thousand Rounds to Generate New-Type Operational Force], *Xinhua*, January 31, 2018, http://www.xinhuanet.com/mil/2018-01/31/c_129802957.htm; “Deng Jiangtao: Missile Expert in His Thirties,” *Huojianbing Bao*, March 3, 2017; “短短4年从连长到营长“三级跳”，他如何做到的” [“Three Level Jump” from Company Commander to Battalion Commander in Just Four Years, How Did He Do It], *PLA Daily*, June 29, 2016, http://www.81.cn/lj/2016-06/29/content_7125210_2.htm. The lesson taught in articles like these is that unit leaders have devised methods to overcome these systemic problems. The lack of training material in units can be traced back for nearly two decades in official reporting.

60 “雷霆方阵驭剑人” [Swordsman Commands a Thunder Square], *PLA Daily*, January 21, 2019, http://www.81.cn/jfjbmap/content/2019-01/21/content_225738.htm.

formulas.⁶¹ Despite the new weapons, equipment, and technologies entering the PLA and the most massive structural reforms since the 1950s, if anything, these general assessments have become more acute during Xi's tenure, particularly concerning the state of leadership at the operational level. The totality of these criticisms implies a persistent lack of confidence in PLA capabilities and a failure of the PLA's educational and training systems to prepare commanders and staff officers for future war. Therefore, the senior Chinese military leadership demonstrates little or no appetite to immerse the PLA into the cauldron of actual combat, preferring to achieve China's national objectives through deterrence and actions short of war conducted by a combination of civilian, government, paramilitary, and military forces.

Based on their own timeline, the PLA leadership would prefer to continue experimentation and systems trouble-shooting until 2035 when modernization is scheduled to be completed. It will then use the following decade to perfect its skills to become a world-class military. However, as predicted by the action-reaction cycle inherent in the PLA's active defense guideline, should deterrence fail and the PLA is compelled to fight, its leadership will respond with the capabilities at hand, combining the old with the new, high-technology with low-technology, and integrating military and civilian assets, to defend China's sovereignty, territorial claims, and national interests.

In or around the year 2020, Xi likely will announce "success" or "substantial completion" of the recent reforms and force reduction. Nonetheless, in the decade that follows more changes will be necessary as the PLA discovers unforeseen problems in the new organizational structure and as new technologies move from the drawing board and testing into the force. For example, the Army may find that its new group armies, combined arms brigades, and combined arms battalions have been assigned too many organic units, resulting in a span of control problem for their headquarters. In response, these units may quietly adjust their structures, as occurred throughout the first decade of this century after the PLA completed 500,000 and 200,000-man reductions. At the same time, as advanced weapons and technologies are added to the force, doctrine and fighting methods will have to be adapted to take advantage of these new capabilities, requiring further experimentation on the training field.⁶²

The shortcomings in today's PLA commanders and staffs represent multiple systemic failures to execute Jiang Zemin's guidance from two decades ago that "we must train qualified personnel first, for we would rather let qualified personnel wait for equipment than equipment wait for qualified personnel" (宁肯让人才等装备,也不能让装备等人才).⁶³ Xi Jinping's "Five Incapables" highlight this specific problem and target it in the long-term through changes in recruitment policies, officer and NCO education, and unit training, with the near-term objective of raising overall combat readiness. As the commandant of the Air Force Command Academy stressed, it will be necessary for other PLA universities, academies, and institutes to update their curriculum as soon as possible and not simply focus on reorganizing the administrative structure of the military education system.

61 Conclusion based on the manner in which many formulations are attributed directly to the CMC chairman or are prefaced by words like Xi "has incisively pointed out."

62 Traditionally the PLA describes the interaction between technology and doctrine as "technology determines tactics" (技术决定战术), but is trying to increase the role of doctrine on developing technologies.

63 "Studying Jiang Zemin's 'On Science and Technology,'" *Yangcheng Wanbao*, February 13, 2001.

The PLA training regimen is likely to undergo additional reforms in the annual training cycle and how new soldiers are trained. Even with recruitment concentrating on attracting more college students and graduates to join the force voluntarily, the current method by which two-year conscripts and volunteers are trained and enter units limits the level of readiness and combat capabilities manpower-heavy units, like the infantry, artillery, airborne, and marines, can attain in a single training cycle. Many small unit commanders probably can relate to the experiences in the 1993 movie “Groundhog Day.”

Currently, though the services conduct some amount of joint and large-scale combined arms training, based on analysis of media (especially television) reporting, most training is focused on developing individual skills (in headquarters and units) and small unit (up to battalion-level) proficiency training. Foreign attention to this low-level training has been distracted by the PLA’s participation in numerous international and internal military skills competitions and training with foreign militaries in recent years, which, despite the hoopla, also emphasize individual and small unit tasks.⁶⁴ As the building blocks of larger operations, small units must be technically and tactically competent before the new joint and service headquarters can plan, execute, synchronize, and sustain larger, extended, more complex joint and combined arms operations. In this period through 2020, the PLA’s focus on building individual and small unit skills is both necessary and rational, reflecting its long-term, deliberate approach to modernization. This is applicable particularly to both reorganized units and recently created units, like the Air Force’s H-6K regiments.

There is no doubt that the PLA of 2019 has made tremendous *absolute* progress in its own capabilities and readiness from two decades ago. However, when Chinese leaders state there is a gap of “at least two to three decades” between their capabilities and those of advanced militaries, they over-simplify the actual situation. *Relatively speaking*, in certain areas, such as some categories of ballistic and cruise missiles, air defense, electronic warfare, and cyber capabilities, the PLA ranks among the world’s leaders. However, in many other battlefield functions, the PLA trails advanced militaries by one to multiple decades of experience. These include battalion-level combined arms, close air support, air assault (helicopter), and large-scale joint operations; aircraft carrier, long-range sea-based air defense, and advanced anti-submarine warfare operations; stealth, armed unmanned aerial vehicle, long-distance over-water air, and large-scale dissimilar aircraft operations. In all (or nearly all) of these functions and technologies, the PLA is in the experimental stage of developing the organizational structure, doctrine, and training to integrate these capabilities into systems-of-systems operations. Barring the party’s leadership decision that an imminent threat to China’s national interest requires a major military response, and given the PLA’s publicly announced timeline for modernization, completing the various operational experiments underway is intended to be a multi-decade, generational process.

Recommendations: Though the PLA’s self-assessments of its own shortcomings are subjective in nature, they need to be incorporated into objective foreign analyses of China’s military capabilities

⁶⁴ The most significant exception to this trend was “Vostok-2018,” in which approximately 3,200 Chinese personnel (about half the manpower of a single combined arms brigade) were dispatched to Russia. This joint PLA contingent was comprised of elements of three brigades from two group armies and six fighter-bombers from the Air Force. Most PLA exercises with foreign militaries involve about a dozen to a few hundred personnel.

and intentions.⁶⁵ Doing so necessitates examining both the PLA's absolute progress in capabilities over the years and its relative progress when measured against the ever-changing capabilities of China's potential enemies. If the PLA's own evaluations of its capabilities are balanced against the impact of new weapons entering the force, the timeframe estimated for the when the PLA is to become a peer competitor with the United States military may change. Based on publicly-available Chinese assessments, it is extremely difficult to support the U.S. National Defense Strategy's assertion that China is conducting a "a military modernization program that seeks *Indo-Pacific* regional hegemony *in the near-term*."⁶⁶ (Emphasis added) If that perceived intention is incorrect, it is possible the United States government has not accurately judged some of China's other regional and global intentions.⁶⁷

Finally, given the long-term strategy for PLA modernization, the United States and its friends in Asia should undertake comprehensive, inter-agency decision-making analyses, potentially including international consultation, before implementing policies or actions that cause the Chinese leadership to increase the pace of military modernization or justify its use lethal military force. Without actual combat experience proving (or disproving) the effectiveness of the PLA's new weapons systems and force structure, some degree of uncertainty in the senior Chinese leadership's collective mind likely will exist for many years and may serve as a brake to moving from "assertiveness" to overt military aggression.

⁶⁵ Both Roger Cliff's *China's Military Power: Assessing Current and Future Capabilities* and RAND's Michael Chase, *et al*, *China's Incomplete Military Transformation* should be commended for including the subjective factors of doctrine, equipment, personnel, and training into their analysis.

⁶⁶ "Summary of the 2018 National Defense Strategy of The United States of America,"

<https://dod.defense.gov/Portals/1/Documents/pubs/2018-National-Defense-Strategy-Summary.pdf>.

⁶⁷ Paul Heer, "Rethinking U.S. Primacy in East Asia," National Interest, January 8, 2019,

<https://nationalinterest.org/blog/skeptics/rethinking-us-primacy-east-asia-40972>, states the National Security Strategy and National Defense Strategy currently mischaracterize China's strategic intentions in the region.

Table 1. Summary of Problems Identified by General Assessments

	Lack of Warfighting Capabilities	Problems with Combat Leadership	Questions the PLA's Political Reliability
Two Incompatibles	X		
Two Inabilities	X	X	
Two Big Gaps	X		
Three Whethers	X	X	X
Five Incapables		X	

Two Incompatibles: The PLA's level of modernization 1) does not meet the requirements of winning local war under informatized conditions and 2) its military capability does not meet the requirements of carrying out its historic missions at the new stage of the new century.

Two Inabilities: The PLA's ability 1) to fight a modern war is not sufficient and 2) the ability of cadres (officers) at all levels to command modern war is insufficient.

Two Big Gaps: There are big gaps between the PLA's military modernization level and 1) the requirements for national security and 2) compared to the level of the world's advanced militaries.

Three Whethers: 1) Whether our armed forces can constantly maintain the party's absolute leadership, 2) whether they can fight victoriously when needed by the party and the people, and 3) whether commanders at all levels are competent to lead forces and command in war.

Five Incapables: Some commanders cannot 1) judge the situation, 2) understand the intention of higher authorities, 3) make operational decisions, 4) deploy troops, and 5) deal with unexpected situations.

Chart 1. Number of Articles in which Individual Self-Assessments Mentioned in *PLA Daily*

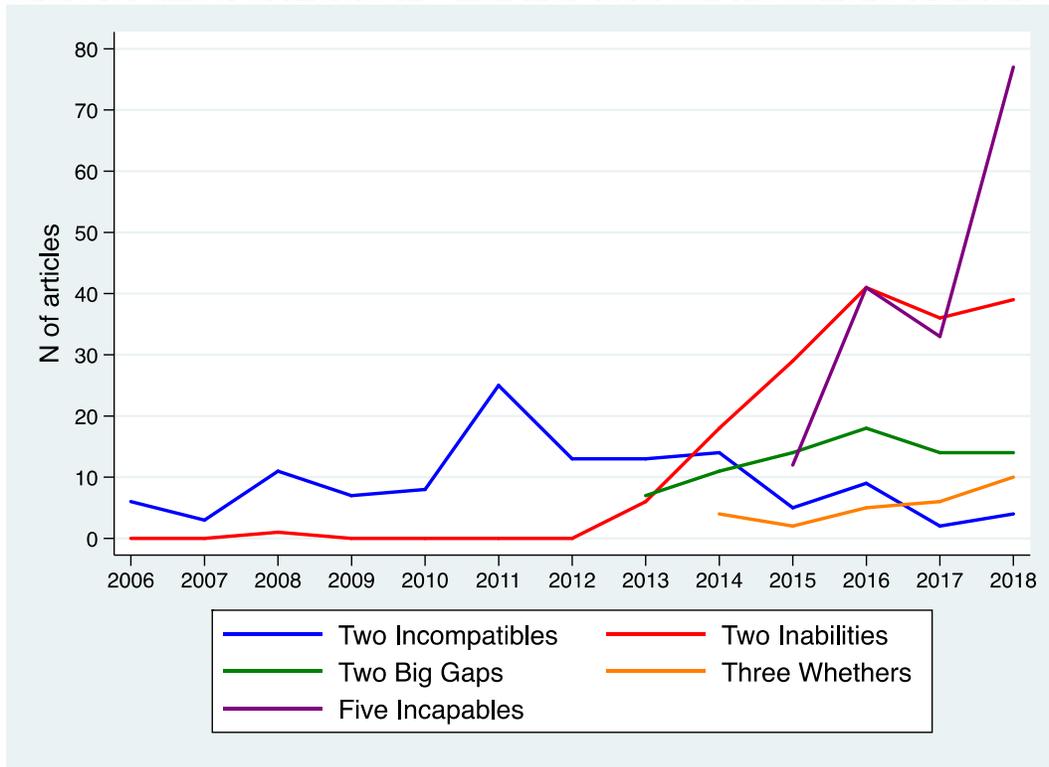
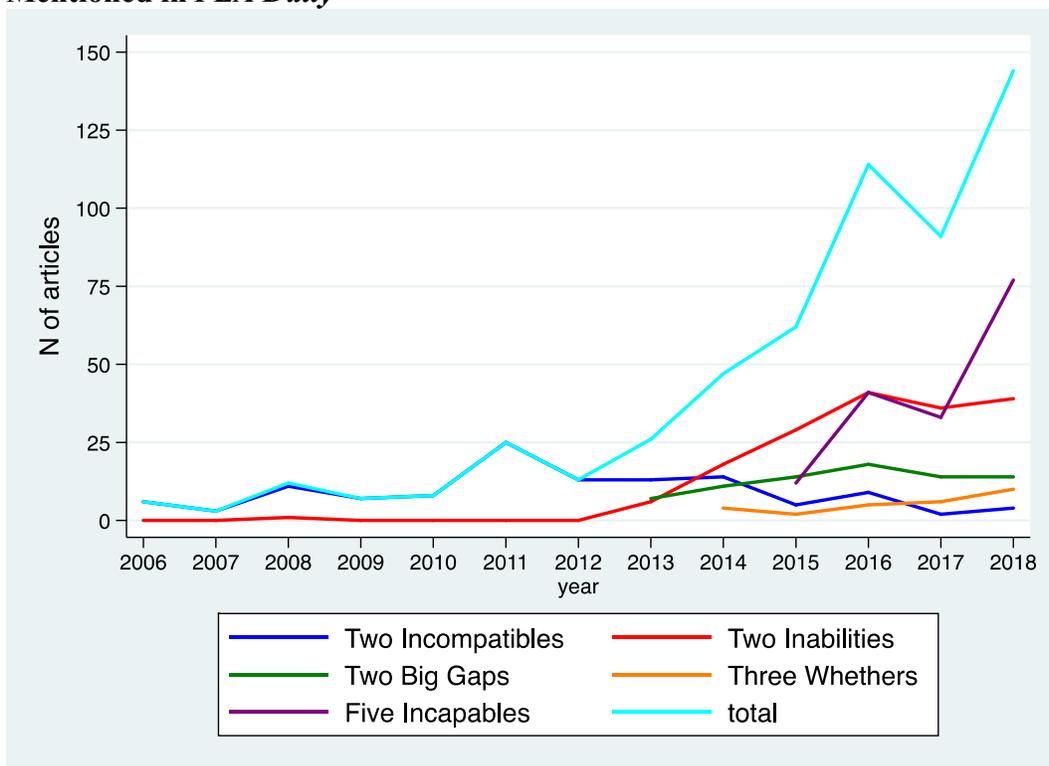


Chart 2. Total Added to Number of Articles in which Individual Self-Assessments Mentioned in *PLA Daily*



Dr. Alastair Iain Johnston conducted this research and prepared the graphics above.

OPENING STATEMENT OF RUSH DOSHI, BROOKINGS-YALE POSTDOCTORAL FELLOW

SENATOR GOODWIN: Thank you. Doctor.

DR. DOSHI: Senator Talent, Senator Goodwin, honorable commissioners, thank you very much for the invitation to participate in today's hearing. As requested, I'll be focusing on the challenges to Beijing's economic statecraft.

These issues warrant special attention because it's China's economic influence that's risen the farthest and fastest of its various instruments, the statecraft, and that now appears in virtually every corner of the globe.

I'll be focusing my remarks on three main economic areas today. First is trade, second is currency and payments, and the third is especially the Belt and Road Initiative, BRI.

Our argument today is that in all three of these areas China is running into what I call the superpower learning curve.

By that, I mean it's finding it harder to basically convert its economic influence into political power than it had hoped.

This is pretty understandable. After all, China is transitioning from a regionally focused great power to a globally focused superpower, and this learning curve is made steeper by Beijing's inexperience as well as its illiberal and opaque political system; but I'd like to stress today that Beijing is adaptable and we should not underestimate its ability to climb that superpower learning curve to still greater regional and global influence.

Before I discuss China's behavior, I'd like to pause and talk a little bit about three channels through which economic power is converted into political power.

The first is a bilateral channel. This one involves the state manipulating an unequal economic relationship with another state, and China's economic coercion through trade is a good example of this.

The second is a structural channel. This involves manipulating the very framework within which economic activity takes place.

For example, cutting off access to an RMB-denominated financial system one day could be a Chinese implication.

And third, there's a domestic-political channel. This involves targeted bribes or concessions to change a country's political leanings with the aspects of this already in BRI.

So, China is using all three of these channels in its economic statecraft, but to varying degrees of success.

So, I'll start first with trade. China spent roughly a decade trying to convert trade flows into political power, but again it's encountering that learning curve.

In the bilateral channel, we're seeing that China uses trade sanctions with Japan, Norway, Taiwan, the Philippines, Mongolia, South Korea and others, and that's tended to be effective when the issue is one China cares a lot about and others care very little about. Take Tibet, Xinjiang or Taiwan as examples.

But when other states have fundamental interests or values at stake, trade coercion doesn't work as well.

In the structural channel, we've seen China celebrate the demise of the Trans-Pacific Partnership and try to push through its own version of RCEP, but Australia, India, Japan, they've undermined some of China's objectives here and Japan even successfully resurrected TPP.

There's an important lesson here. When China's economic efforts are multilateralized, it

gives others a chance to veto or revise them.

Now, with respect to currency, there's a famous line that great powers have great currencies.

And China certainly wants a great currency and a structural power over RMB-denominated transactions that comes with it, but Beijing is afraid that necessary reforms for that goal by capital account convertibility will undermine the Party's rule. And with that, the RMB is currently stuck at 100 percent of global transaction.

So, Beijing is running once again into the learning curve, and it's learning that its political system and its financial objectives are, to an extent, at odds.

Even so, Beijing is climbing the curve. It can't make the RMB go global, but it can make it go regional and it can make it indispensable to Asian trade.

It's already the number one currency for all transactions involving China and its neighbors, which gives Beijing structural financial leverage over them and Beijing is enhancing that leverage.

It's building its own alternative to SWIFT messaging system, which is an enormous deal, and it's going to let it bypass the dollar system in the long run and cut off states from the budding RMB system giving it more financial power.

And finally, I'd like to talk a little bit about the Belt and Road Initiative. BRI really does it all.

It give Beijing domestic political leverage through bribes; it provides bilateral leverage by creating dependence on Chinese financing and infrastructure maintenance; and it provides structural leverage as well over the very infrastructure behind economic activity like ports and telecommunications, but hereto China is encountering a superpower learning curve.

There's been a backlash to the Belt and Road. Countries believe that China comes in with bribes, it gets politicians to sign up for overpriced projects with very few benefits, that it brings in Chinese contractors rather than hiring local labor. And when countries can't pay, it takes over the assets as in the case of Sri Lanka.

In the last few years, we've seen nine Asian countries halt BRI projects, including China's close friend Pakistan.

Democracies, in my view, seem to have particular BRI antibodies with politicians in Sri Lanka, the Maldives and Malaysia sweeping into power calling for review of costly BRI projects. And outside the Indo-Pacific other countries are raising concerns as well.

Some commentators now are claiming that BRI is dying, and I think that's entirely overstated. Yes, some projects are being canceled. Many are moving forward.

Indonesia and Thailand may have halted high-speed rail projects, but then both of them resumed high-speed rail projects.

Nepal may have canceled two investments in dams, but then a pro-Chinese government came to power and restored one project and planned for a vastly more consequential rail line connecting the two countries.

In Sri Lanka, the very country that had its politics upturned by backlash of the Belt and Road and handed China a 99-year lease on its port, still went back this year for a \$1 billion loan for highway construction. So, BRI has some endurance and, on top of that, Beijing is adapting.

President Xi Jinping announced BRI's next phase last year. Beijing is talking about scaling back, slowing down, and focusing on high-quality, small-scale investments that benefit people directly.

Xi has strengthened Party and state supervision of BRI with a new agency formed last

year to reign in egregious practices, and China is already renegotiating projects and reducing interest rates.

Ultimately since BRI, Xi's signature initiative, and since it's written into the Community Party charter, we should assume it's here to stay even if some of these reforms don't go through.

So, in my remaining time, I'll turn briefly to recommendations. On trade, the United States should engage regional trade processes to ensure its rules win out over Beijing's.

On finance, it should take care not to overuse its financial sanctions and drive allies and adversaries together in bypassing the dollar system.

And as for BRI, my view is that the United States should continue to offer select alternative financing often with allies and push institutions like the World Bank to assist. The Build Act is, of course, a step in the right direction.

Selective financing will help, but we cannot compete dollar for dollar, loan for loan against China. So, what else can we do?

In my view, the most efficient solution is to stress transparency and accountability and to empower recipient states.

There are a number of ways to do this. Here are just a few examples. And, by the way, we're already seeing that this is the most effective check on China's abusive practices.

I think we should, number one, try to multilateralize BRI so that states can check Beijing -- other states.

Number two, we should consider co-investing with China because that would make it harder for China to get away with corruption and arm twisting.

Number three, we should provide training to assist countries in assessing Chinese financing.

And finally, we should expose corruption whenever we see it as we did in Malaysia.

So, I'll end with that. Thank you again for the opportunity and I very much look forward to your questions.

**PREPARED STATEMENT OF RUSH DOSHI, BROOKINGS-YALE POSTDOCTORAL
FELLOW**

Testimony before the U.S.-China Economic and Security Review Commission

“What Keeps Xi Up at Night: Beijing’s Internal and External Challenges”

For the Panel Entitled “Backlash from Abroad: The Limits of Beijing’s Power to Shape its External Environment”

**The Superpower Learning Curve:
Challenges to Chinese Economic Statecraft**

February 7, 2019

Dr. Rush Doshi
Brookings-Yale Post-Doctoral Research Fellow
Brookings Institution and the Paul Tsai China Center

Key Points

- **The Learning Curve:** China is encountering challenges in converting economic influence into political power across efforts as varied as trade, currency and payments, and infrastructure investment. As it transitions from a regionally-focused great power to a globally-focused superpower, Beijing is running into a learning curve that is made steeper by its inexperience as well as its illiberal and opaque political system. Even so, China is an adaptable actor and many obstacles are not insurmountable.
- **Trade Relations:** China is more actively using trade as an instrument of bilateral coercion, but it is learning this only works well on issues of high importance to Beijing and low importance to others. Beijing's efforts to multilateralize its trade preferences (e.g., through the Regional Comprehensive Economic Partnership, or RCEP) are running into objections because a multilateral structure offers veto opportunities for other states.
- **Currency and Payments:** China's RMB internationalization efforts at the global level are complicated by its fear that necessary reforms like capital account convertibility will introduce instability. Despite this considerable obstacle, Beijing is nevertheless learning how to increase the RMB's centrality to Asian trade and is devising an alternative to SWIFT's messaging system – efforts that together will give it financial power regionally and opportunities to bypass U.S. sanctions globally.
- **The Belt and Road Initiative (BRI):** BRI is facing a backlash in Asia and around the world as concerns over political corruption, economic indebtedness, and security vulnerabilities mount. Even so, many states are continuing to participate in BRI, and Beijing is in the midst of adapting the initiative. Xi has declared a new BRI phase that would include greater centralization, higher quality and smaller-scale investments, direct benefits to the local populace, and renegotiated terms along with co-investment.
- **Lengthening China's Learning Curve:** Washington should not underestimate Beijing's ability to adapt and eventually climb the superpower learning curve to greater influence. Instead, emphasizing transparency in China's investments and accountability for recipient leaders can undermine Beijing's use of corruption. Strengthening multilateral bodies and offering a friendly voice in Chinese-led forums can help states distance themselves from Beijing. Finally, providing economic alternatives both on financing and trade makes Chinese economic coercion less harmful and its beneficence less attractive.
- **Recommendations:** A series of recommendations that operate in accordance with the preceding logic are provided at the end of this testimony. They include pushing to multilateralize BRI and increase its transparency; bringing existing institutions into Asian infrastructure investment; strengthening Asian multilateral bodies as alternatives to Chinese-led order; providing select infrastructure financing with allies and partners; providing training to assist partners in assessing Chinese financing; joining select Chinese-led multilateral processes to influence their development; and elevating the maintenance of financial power as a national security priority.

Introduction

Senator Talent, Senator Goodwin, and Honorable Commissioners, thank you for the invitation to participate in today's hearing and to testify today on the People's Republic of China's internal and external challenges. As requested, I will be focusing my remarks on the limits of Beijing's power to shape its external environment, with particular attention to Beijing's attempts to convert its economic influence into political power. These economic questions are of particular importance given that it is China's economic influence that has risen farthest and fastest of its various instruments of statecraft and that now appears in every corner of the world. Today I will argue that China is indeed facing obstacles in converting this newfound economic might into political influence. But I will also stress that these obstacles, while at times considerable, are not insurmountable – and that Beijing is gradually overcoming them.

Superpower Learning Curve

The core argument I hope to make today is that Beijing is encountering what I would call the “superpower learning curve.” It is in the midst of a transition from a regionally-focused great power to a globally-focused superpower, but this transition has not been smooth. It has involved missteps and setbacks. Like other great powers before it – including the United States – Beijing is learning that economic influence does not easily convert into political influence, that the exercise of power sometimes encounters friction, and that the domestic politics of distant countries are often unpredictable and intractable.

An important question before us then is just how fast Beijing will climb this “superpower learning curve.” Does Beijing's lack of experience and its illiberal and opaque political system make it harder for Beijing to act as effectively globally as the United States does? Today, I'll try to share my thinking on this question by focusing on Beijing's efforts in three broad economic areas. I'll briefly discuss China's (1) regional trade initiatives and (2) currency and payments initiatives before spending the bulk of my time on its (3) international infrastructure investment.¹

Economic Statecraft

Before I get to those categories, let me pause to talk about how economic power converts into political influence. There a number of ways, but I tend to group them into three categories.²

- (1) Bilateral: This involves an economic relationship between two states that is unequal, which gives one state the opportunity to coerce the other state through the manipulation of those unequal ties. China's economic coercion through trade constitutes an example.

¹ This testimony is informed in part by my recent work. See Rush Doshi, “China's Role in Reshaping the International Financial Architecture: Blunting U.S. Power and Building Regional Order,” in *Strategic Asia 2019: China's Expanding Strategic Ambitions*, ed. Ashely Tellis, Alison Szalwinski, and Michael Wills, (Washington, DC: NBR, 2019), 278-308.

² This approach is adapted from Susan Strange's two-dimensional approach to economic power. See Susan Strange, *States and Markets*, 2nd ed. (New York: Pinter Publishers, 1994), 24–29.

- (2) Structural: This involves manipulating the framework within which economic activity takes place. Cutting off access to the dollar-based financial system is an example, and China's control over a RMB-based financial system may constitute one in the future.
- (3) Domestic-Political: This involves manipulating the internal politics of another country through bribes to political figures, concessions to political coalitions, and purchases of domestic media. China's infrastructure investments are an example of this approach.

China is wielding all of these instruments to gain political advantage, but to varying degrees of success.

Trade Ties

Over the last decade, China has sought to turn its trade relations to political advantage by converting trade flows into bilateral leverage and by setting rules on regional trade to acquire structural leverage. In these efforts, it has run into the *superpower learning curve* – its bilateral trade coercion works only in some cases and its multilateral efforts are stalled by neighbors.

Prominent examples of China's *bilateral* coercion include unilateral trade sanctions against Japan over the East China Sea, Norway over the Nobel Prize, Taiwan over its elections, the Philippines over the South China Sea, Mongolia over a Dalai Lama visit, and South Korea over Terminal High Altitude Area Defense. These efforts have accompanied a change in China's domestic discourse on the appropriateness of economic coercion.³ There is some anecdotal evidence that these examples have led others to think twice before adopting positions at odds with Beijing on Taiwan, Xinjiang, or Tibet – though when fundamental interests and values are at stake for target states, China's coercion has limited effect.

China has also sought to achieve *structural* leverage by multilateralizing aspects of its trade agenda in ways that favor its system over rivals. But here, multilateralization has posed a limit on China's ability to influence its external environment. For example, China has long seen the Regional Comprehensive Economic Partnership (RCEP)—a multilateral economic agreement that would cover sixteen countries, nearly half of the world's population, and roughly one-third of its GDP—as an important vehicle for regional leadership. In a 2014 statement by the Ministry of Commerce, China made clear that “the smooth establishment of the RCEP is of great importance to China's fighting for the initiative [in] the new round [over the] reconstruction of international economic and trade rules.”⁴ After the United States' withdrawal from the Trans-Pacific Partnership (TPP), China's Foreign Ministry initially elevated these efforts. The head of the ministry's Department of International Economic Affairs declared, “If China has taken up a leadership role, it is because the front runners have stepped back, leaving that place to China. If China is required to play that leadership role then China will assume its responsibilities.”⁵

³ James Reilly, “China's Unilateral Sanctions,” *Washington Quarterly* 35, no. 4 (2012): 121–33.

⁴ “Give Play of China's Important Role and Accelerate RCEP Negotiations,” Ministry of Commerce of the People's Republic of China, September 1, 2014, <http://english.mofcom.gov.cn/article/newsrelease/significantnews/201409/20140900720384.shtml>.

⁵ “Diplomat Says China Would Assume World Leadership if Needed,” Reuters, January 23, 2017, <https://www.reuters.com/article/us-china-usa-politics-idUSKBN1570ZZ>.

These lofty leadership ambitions, however, encountered obstacles from regional states—especially Australia, India, and Japan. China’s desire to enshrine its preferences on issues relating to cross-border data flows and intellectual property face Japanese and Australian opposition; meanwhile, India is extremely reluctant to extend to China the same low tariffs it offers ASEAN given the enormous Sino-Indian goods deficit, especially in manufactures. Under Japanese instigation, Asian states even managed to resurrect the TPP as RCEP floundered. At least for now, RCEP remains an example both of Chinese order-building ambitions and of Asian resistance, as well as a keen demonstration of how China’s agenda can stall when it is multilateralized.

Currency and Payments

Great powers have great currencies, and with them, *structural* power – that is, the power to affect the framework in which considerable economic activity takes place, especially economic activity denominated in their currency. But in these efforts, China has once again run into the *superpower learning curve* as its domestic economic practices curb its international financial ambitions.

For the last decade, China has sought to internationalize its currency, the renminbi (RMB). Chinese leaders have long been concerned about their dependence on the dollar, which brings with it vulnerability to U.S. financial sanctions, and that is a major strategic driver of its pursuit of RMB internationalization.

But this decade-long initiative has exposed the limits of China’s ability to shape its external environment. To promote its currency, China needs to adopt a high degree of capital account convertibility so market participants know its value and can confidently move into and out of RMB as needed. China has proved unwilling to adopt convertibility because it would remove some of the control the Party has over China’s domestic financial sector and could introduce volatility that might jeopardize social stability – and with it, the Party’s rule. China’s efforts to promote the RMB without convertibility came to a halt during the 2015 stock market crash, which saw new restrictions to prevent capital outflows. These restrictions reduced the credibility of any future promises of partial convertibility and introduced a belief that the RMB would continue to lose value. Data from SWIFT suggests that the renminbi still only accounts for between 1% and 2% of all international payments.⁶

In short, the Party’s authoritarian system and intolerance for instability have limited its ability to shape its external financial environment.

Although the learning curve for establishing a global currency is steep, it is relatively flatter if China wants the RMB to become a dominant regional currency. In short, China can still acquire financial power – especially at the regional level – even without a truly convertible currency, and indeed it has already taken a few steps in that direction.

First, China has tried to promote the RMB at the regional level through bilateral swaps, the Belt and Road Initiative, agreements with foreign central banks, and the usage of Hong Kong as an RMB hub – all measures short of full convertibility. By 2015, the renminbi constituted

⁶ Huileng Tan, “China’s Currency Is Still Nowhere Near Overtaking the Dollar for Global Payments,” CNBC, February 2, 2018, <https://www.cnbc.com/2018/02/02/china-currency-yuan-the-rmb-isnt-near-overtaking-the-us-dollar.html>.

more than 30% of all transactions between China and its Asian neighbors – up from only 7% three years earlier – which made it the main currency in regional trade with China, outstripping the dollar, the yen, and the euro.⁷ As this percentage continues to grow, Asian states that wish to do business with China will increasingly need to settle in RMB. At least within Asia, China could wield some of the financial instruments that Washington wields today, laying the foundation for an enduring sphere of influence layered under the U.S. global financial order.

Second, China enhanced its financial power by investing in an alternative to SWIFT, the Society for World Interbank Financial Telecommunication. Founded in 1973, SWIFT is a standard-setting and messaging institution with a network that makes cross-border financial payments possible, thereby constituting the substructure of global finance. China realizes that U.S. influence over SWIFT constitutes structural power, and that to be cut off from SWIFT is to be cut off from the ability to easily make payments in dollars. As a result, the People’s Bank of China began investing in an alternative messaging system for RMB in 2013. This system, known as the China International Payment System (CIPS), not only insulates China from financial pressure but also increases its autonomy, giving the country control over all information that passes through its network, the power to help others bypass sanctions, and the ability to one day cut others off from the RMB-denominated system. Moreover, the ambition for CIPS exceeds that for SWIFT: CIPS will not only be a messaging service like SWIFT but will also provide clearance and settlement—that is, full integration of the payment process. For now, Beijing is still learning how to set up such a messaging system, and CIPS is not a meaningful alternative to SWIFT, but this is more a technical challenge than a political one.

The Belt and Road Initiative

By now, most of us are well familiar with Beijing’s Belt and Road Initiative. This program was originally announced by President Xi Jinping in 2013 and seeks to connect more than 60 countries from Eurasia and Africa together through rail lines, pipelines, highways, ports, and other infrastructure. Here too, China has encountered the *superpower learning curve* as investments originally intended to induce good will and dependence on China have instead in many cases brought about backlash and complaints.

BRI is a unique initiative because it creates leverage in each of the three aforementioned categories. It provides China *bilateral leverage* over others through creating a dependence on Chinese finance, on Chinese maintenance, and on Chinese trade flows that emerge from the connectivity. It provides China *structural leverage* too – giving Beijing control over ports that constitute chokepoints in maritime trade as well as opportunities to cultivate exclusive connectivity through standards for rail lines or telecommunications. And it gives Beijing *domestic-political leverage* through the opportunity to offer targeted bribes.

Backlash to the Belt and Road

The Belt and Road initially began with great fanfare, but it is now encountering obstacles. Japan, India, and the United States were initial skeptics. But suspicions have filtered outward

⁷ James Kynge, “Renminbi Tops Currency Usage Table for China’s Trade with Asia,” Financial Times, May 27, 2015, <https://www.ft.com/content/1e44915c-048d-11e5-adaf-00144feabdco>.

to a wide range of Indo-Pacific countries. Some of these concerns are political – countries are upset with Chinese bribery and political interference, and they believe some projects benefit politicians and not the public. Some of these concerns are security-related – countries fear that Chinese investments have strategic motivations and might create vulnerabilities or strategic dependence on China. And some of these concerns are economic – countries doubt they can pay back the loans or are frustrated about procurement requirements that advantage Chinese companies and labor.

As a result of these political, security, and economic concerns, a number of countries have pushed back on deals with Beijing.

Concerns about Chinese infrastructure are not entirely new. Before BRI even existed, and as early as 2011, Myanmar froze China's work on a \$3.6 billion dam and considered pausing work on two Chinese-funded energy pipelines. Its reasons then mirror some of the arguments other countries employ now.⁸ Indeed, since 2015, Indonesia, Thailand, Bangladesh, Nepal, Sri Lanka, the Maldives, Myanmar, and even Pakistan have halted or raised concerns about projects – often because of changes in government, nationalism, concerns over sovereignty, and distrust of China. For example, politicians in Sri Lanka, the Maldives, and Malaysia swept into power calling for a review of BRI projects and produced evidence that their predecessors had been paid to pursue deals that were not in their country's best interests. Outside the Indo-Pacific, countries as varied as Mexico, Kenya, Sierra Leone, Uganda, and others have similarly raised concerns – suggesting that as Beijing goes global, so too do its BRI challenges.

The Resilience and Revision of the Belt and Road

BRI's obstacles shouldn't be overstated.⁹ China is seeking to turn the tide, and it retains a number of advantages. China has resources, technical know-how, no real governance requirements for loans, and few real competitors in financing. In many cases, Beijing has either adjusted its terms or benefited from political changes in the recipient country.

A review of Beijing's setbacks reveals that, even before the recent policy shifts detailed below, BRI was overcoming the pushback it had engendered. For example:

- Indonesia and Thailand may have halted high-speed rail projects with China in 2015, but both countries ultimately went forward – with Beijing adjusting financial terms.
- Bangladesh may have switched from China to Japan in 2016 for its first deep-water port, but China is involved in a second port project and additional infrastructure investments – again, after adjusting terms.¹⁰

⁸ Shi Jiangtao, "Why Does China Care So Much About Stalled Dam Project in Myanmar?," *South China Morning Post*, August 25, 2016, <https://www.scmp.com/news/china/diplomacy-defence/article/2008816/why-does-china-care-so-much-about-stalled-dam-project>.

⁹ See Nadege Rolland's excellent essay on the resilience of the BRI in "Reports of Belt and Road's Death Are Greatly Exaggerated," *Foreign Affairs*, January 29, 2019, <https://www.foreignaffairs.com/articles/china/2019-01-29/reports-belt-and-roads-death-are-greatly-exaggerated>

¹⁰ Sudha Ramachandran, "China's Sinking Port Plans in Bangladesh," *China Brief* 16, no. 10 (June 21, 2016), <https://jamestown.org/program/chinas-sinking-port-plans-in-bangladesh/>; Sudha Ramachandran, "The Belt and Road Initiative Still Afloat in South Asia," *China Brief* 19, no. 1 (January 5, 2019), <https://jamestown.org/program/the-belt-and-road-initiative-still-afloat-in-south-asia/>.

- Nepal may have canceled two hydroelectric dam projects with China in the last two years, but the return of a pro-China government and access to Chinese ports changed the situation – one project has been restored and plans for a vastly more consequential rail line connecting Nepal to China are underway.¹¹
- Myanmar may have canceled a dam project with China, but it completed two pipeline projects as well as a slimmed down port project.¹²
- Sri Lanka may have given China a ninety-nine-year lease on its Hambantota port after proving unable to meet \$1.4 billion in payments, but still went back to China for a \$1 billion loan for highway construction this year.¹³
- A new government in the Maldives has asked to renegotiate BRI projects and considered halting some, but nonetheless promised to remain part of the initiative.¹⁴
- Malaysia may have canceled three pipeline projects and threatened to cancel a \$20 billion rail project, but China proposed cutting the rail project's price in half, leading to credible speculation that Malaysia may revive the project.¹⁵
- Pakistan may have canceled a \$14 billion dam project, and a new government may be skeptical of BRI costs, but even so Pakistan is leaning towards lengthening the timeframe of the China–Pakistan Economic Corridor (CPEC) rather than outright cancelling \$50 billion in CPEC projects.¹⁶

In short, what we are seeing is that BRI is slowing down and scaling back in some areas, but that recipient countries in many cases are reluctant to outright cancel projects and often still willing to pursue or continue alternative investments.

¹¹ Gopal Sharma, "Nepal Says to Scrap Hydropower Deal with Chinese Firm," *Reuters*, May 29, 2018, <https://www.reuters.com/article/china-nepal-hydropower/nepal-says-to-scrap-hydropower-deal-with-chinese-firm-idUSL3N1To4IQ>; Gopal Sharma, "Nepal Restores \$2.5 Billion Hydropower Plant Contract to Chinese Firm," *Reuters*, September 23, 2018, <https://www.reuters.com/article/us-china-nepal-hydropower/nepal-restores-2-5-billion-hydropower-plant-contract-to-chinese-firm-idUSKCN1M3oCZ>; Gopal Sharma, "Nepal Says China to Allow Access to Ports, Ending Indian Monopoly on Transit," *Reuters*, September 7, 2018, <https://www.reuters.com/article/us-china-nepal-ports/nepal-says-china-to-allow-access-to-ports-ending-indian-monopoly-on-transit-idUSKCN1LN1KJ>.

¹² Sudha Ramachandran, "China-Myanmar Economic Corridor Ambitions Meet Hard Reality," *China Brief* 18, no. 15 (September 19, 2018), <https://jamestown.org/program/china-myanmar-economic-corridor-ambitions-meet-hard-reality/>; Shi Jiangtao, "Why Does China Care So Much About Stalled Dam Project in Myanmar?"

¹³ "Despite Huge Debt, Sri Lanka Seeks \$1 Billion from China to Finance Highway Project," *Associated Press*, February 2, 2019, <https://www.apnews.com/302560e5679a4ae0b4a2e3bb137a5f5b>.

¹⁴ Dipanjan Roy Chaudhury, "President-Elect Ibu Solih May Look at Halting BRI Projects in Maldives," *The Economic Times*, October 19, 2018, <https://economictimes.indiatimes.com/news/international/world-news/president-elect-ibu-solih-may-look-at-halting-bri-projects-in-maldives/articleshow/66278481.cms>; Simon Mundy, "Maldives Seeks to Renegotiate with China Over Belt and Road Debt," *Financial Times*, January 31, 2019, <https://www.ft.com/content/fcab0410-2461-11e9-8ce6-5db4543da632>.

¹⁵ Anuradha Raghu, "Malaysia Still in Talks With China Over \$20 Billion Rail: Star," *Bloomberg*, February 1, 2019, <https://www.bloomberg.com/news/articles/2019-02-02/malaysia-still-in-talks-with-china-over-20-billion-rail-star>; "China Offered to Nearly Halve Cost of Malaysia's US\$20 Billion Rail Project," *Channel NewsAsia*, January 31, 2019, <https://www.channelnewsasia.com/news/asia/china-cccc-ecrl-malaysia-rail-project-negotiate-cost-20-billion-11189898>.

¹⁶ Liu Zhen, "Pakistan Pulls Plug on Dam Deal over China's 'Too Strict' Conditions in Latest Blow to Belt and Road Plans," *South China Morning Post*, November 16, 2017, <https://www.scmp.com/news/china/diplomacy-defence/article/2120261/pakistan-pulls-plug-dam-deal-over-chinas-too-strict>; Jamil Anderlini, Henny Sender, and Farhan Bokhari, "Pakistan Rethinks Its Role in Xi's Belt and Road Plan," *Financial Times*, September 9, 2018, <https://www.ft.com/content/d4a3e7f8-b282-11e8-99ca-68cf89602132>.

Even though BRI is facing undeniable headwinds, China's leadership has remained committed to it and sought to adapt. President Xi Jinping has defended the effort in several high-profile addresses – but his language suggests an understanding of the challenges the initiative faces.

A review of these speeches and of Beijing's recent policy shifts suggests a number of adjustments to BRI are in progress. Indeed, as Beijing climbs the superpower learning curve, it seems likely that its next phase will include: (1) continued elevation of BRI as a signature and global Chinese initiative; (2) a new phase focused on “high-quality” investments; (3) an emphasis on smaller projects that are easier to publicize and have direct local benefits; (4) strengthened Party and state supervision, including of Chinese entities involved in environmental scandals or corruption; (5) a continued pushback against claims that BRI is strategic; and (6) efforts to renegotiate projects, reduce interest rates, and multilateralize investment with other partners. There are good reasons to be skeptical that Beijing will be able to accomplish all of these adjustments, but if it is able to accomplish some of them, it could sustain the initiative well into the future.

Virtually all of these revisions to BRI made an appearance in a landmark address by President Xi that marked the fifth anniversary of the program. That August 2018 address indicated what is coming next for BRI and implicitly addressed some of its major obstacles:

- First, the speech revealed BRI will remain a central focus of Chinese foreign policy and its global ambitions. Xi declared that BRI is “China's program for improving the global economic governance system...and building a community of common destiny,” priorities that have been emphasized in repeated addresses, including his Party Congress addresses. Moreover, Xi's “community of common destiny” now appears in China's constitution, and BRI appears in the Party charter, suggesting China is unlikely to turn back from them despite the headwinds.¹⁷ In his speech, Xi further stressed that BRI is not just part of China's regional ambitions, but also its global ones, and is part of China's approach to what he described as a period of fundamental global power transition. His precise words were that “the world today is undergoing a period of great development, great change, and great adjustment” and that China “must have a strategic vision, establish a global vision, have a sense of the unexpected, and have a sense of history, and we must work hard to seize the opportunity of this big change that has not appeared in one hundred years.”¹⁸ In other words, Xi identified BRI as essential to China's rejuvenation and global rise.
- Second, the speech revealed that BRI needed to change and promised to usher in a new “high-quality” phase in the initiative. “After five years of laying the foundation and the beams,” Xi stated, “we must not rest on our laurels but go further.” In what appears to be a tacit acknowledgment of its difficulties, Xi declared, “On the basis of maintaining a healthy and salutary development momentum, we will promote the

¹⁷ http://www.xinhuanet.com/politics/2018-08/27/c_1123336562.htm

¹⁸ “Xi Jinping: Promoting Belt and Road Cooperation to Deeply Benefit the People [习近平：推动共建‘一带一路’走深走实造福人民],” *Xinhua* [新华网], August 27, 2018, http://www.xinhuanet.com/politics/2018-08/27/c_1123336562.htm.

transformation of BRI to high-quality development” which was a "basic requirement of the next phase."¹⁹

- Third, the speech stated that BRI should involve smaller projects that are easier to publicize, with the implicit suggestion that some of its setbacks have been products of its scale and communication. Invoking a metaphor from Chinese calligraphy, Xi argued that China had focused on “broad brushstrokes” but now needed to focus on the “fine brushstrokes.”²⁰ Xi stated that China must "make every effort to promote positive progress on the project" with special attention to the ways investments "benefit the local people." More people-to-people projects in “education, science and technology, culture, sports, tourism, health, and archaeology” would be launched.
- Fourth, Xi reserved a significant portion of his speech to emphasize the importance of centralizing stewardship of the initiative. He declared that "it is necessary to strengthen the Party's leadership over the work of building BRI," perhaps to reduce the risk of problematic investments that could damage China's reputation, and that the Party Leading Small Group with authority over BRI would need to “strengthen supervision and inspection” in addition to setting appropriate guidances ²¹ Importantly, these remarks came after Beijing had already moved to centralize BRI at the state level by shifting it from under the joint jurisdiction of China's Ministry of Finance and Commerce (MOFCOM) and the Foreign Ministry (MFA), into the purview of a singular new agency – the China International Development Cooperation Agency (CIDCA).²² In his remarks, Xi also made clear that Chinese corporations are “brand ambassadors” for BRI, and that as such, it would be important to standardize their practices to ensure they are environmentally friendly, socially responsible, and legally compliant – perhaps in response to criticisms that BRI damages the environment, provides insufficient local benefits, and often involves bribery.
- Finally, in response to criticism about BRI's strategic implications, Xi stressed that it had none. “BRI is an initiative for economic cooperation,” he argued “instead of a geopolitical alliance or military league, and it is an open and inclusive process rather than an exclusive bloc or ‘China club.’ It does not differentiate countries by ideology nor play the zero-sum game.”²³ It is doubtful these words will be reassuring, but a notable indication of China's worries about the initiative's image that they were spoken at all.

¹⁹ “Xi Jinping: Promoting Belt and Road Cooperation to Deeply Benefit the People [习近平：推动共建‘一带一路’走深走实造福人民].”

²⁰ See Nadege Rolland, "Reports of Belt and Road's Death Are Greatly Exaggerated," Foreign Affairs, January 29, 2019, <https://www.foreignaffairs.com/articles/china/2019-01-29/reports-belt-and-roads-death-are-greatly-exaggerated>; see also “Xi Jinping: Promoting Belt and Road Cooperation to Deeply Benefit the People [习近平：推动共建‘一带一路’走深走实造福人民].”

²¹ “Xi Jinping: Promoting Belt and Road Cooperation to Deeply Benefit the People [习近平：推动共建‘一带一路’走深走实造福人民].”

²² Jacob Mardell, "Foreign Aid With Chinese Characteristics," The Diplomat, August 7, 2018,, <https://thediplomat.com/2018/08/foreign-aid-with-chinese-characteristics/>; http://www.xinhuanet.com/2018-03/13/c_1122532507.htm ; http://www.xinhuanet.com/english/2018-04/18/c_137120544.htm

²³ “Xi Jinping: Promoting Belt and Road Cooperation to Deeply Benefit the People [习近平：推动共建‘一带一路’走深走实造福人民].”

Recommendations

China's attempts to build its global influence through efforts in trade, currency and payments, and infrastructure investment are clearly facing challenges. But Washington should not underestimate Beijing's ability to adapt and eventually climb the *superpower learning curve* to greater regional and global influence. The United States is uniquely positioned to complicate China's ability to develop *bilateral*, *structural*, and *domestic-political* leverage over other countries. Below I lay out in detail avenues through which Washington can respond effectively to China's global economic efforts.

First, with respect to trade, the United States should engage multilateral trade institutions to ensure its rules and high standards are reflected in negotiations. Second, with respect to financial power, the United States should take care not to overuse its financial advantages or risk driving allies and adversaries together in eroding it. Third, with respect to coping with BRI, investments in transparency, accountability, multilateralism, and financial alternatives are key instruments in limiting BRI's most egregious practices. Transparency and accountability complicate China's ability to push exploitative financing terms through political corruption and ensure that projects are the best interests of recipient countries. Multilateralism and financial alternatives give states a voice in responding to China and options outside of Chinese financing.

- **Focus on Multilateralizing BRI to Increase Transparency:** Multilateralization can limit Beijing's ability to dictate terms to other states. Promoting the multilateralization of BRI and engaging co-investment on BRI projects can give other states a voice, can bring transparency, and can complicate Beijing's political-arm-twisting at a lower cost than providing alternative financing for every Chinese project. At the same time, better infrastructure helps Asian states become manufacturing powers in their own right and makes possible the relocation of supply chains from China to other developing countries.
- **Bring Existing Institutions into Asian Infrastructure Investment:** Washington should strongly push existing development institutions, especially the World Bank, to play a higher-profile role in Asian infrastructure investment.
- **Strengthen Asian Multilateral Bodies:** Efforts to strengthen regional multilateral bodies, including various Association of Southeast Asian Nation (ASEAN) forums and the East Asia Summit, reduce the likelihood that Chinese-led alternatives become focal and give Asian states a larger role in the future of their region.
- **Provide Select Alternative Financing With Allies and Partners:** The BUILD Act passed last year was a step in the right direction, but the United States cannot and should not fund every project Beijing chooses to support or it could find itself in its own scandal similar to China's investment in Hambantota. Where projects are high-quality, the United States should partner with other regional states to support them.
- **Provide Training to Assist Partners in Assessing Chinese Financing:** In Asia but especially outside of it, many states have little experience dealing with Chinese loans and investments. The United States should advance efforts to train personnel in

foreign governments on how to navigate some of these engagements, avoid common pitfalls, and understand some of the security implications at stake.

- **Join Chinese-Led Multilateral Processes to Influence Their Development:** By joining Chinese economic initiatives like the Asia Infrastructure and Investment Bank (AIIB), Washington gains an opportunity to influence or even stall them as needed at a relatively low legitimacy cost. If Congress proves unable to authorize funding for a U.S. contribution to AIIB, the United States could join in an advisory or observer role.
- **Elevate the Maintenance of Financial Power as a National Security Priority:** The dollar's status as the reserve currency is the backbone of U.S. global leadership, and it makes it easier for the United States to finance deficit spending, monitor cross-border financial transactions, and implement financial sanctions. To maintain that status, the United States should avoid the overuse of financial sanctions, especially if their use drives allies and adversaries to unite in efforts to bypass the dollar system.

OPENING STATEMENT OF LINDSEY FORD, DIRECTOR OF POLITICAL- SECURITY AFFAIRS, ASIA SOCIETY POLICY INSTITUTE

SENATOR GOODWIN: Thank you, Doctor.

Ms. Ford.

MS. FORD: Thank you very much. I'd like to thank Senator Talent, Senator Goodwin and all of the honorable commissioners for the opportunity to come speak with you today. It's a pleasure to be here along with other esteemed experts, including my fellow panelists for today's discussion.

I've been asked to address today how other Indo-Pacific nations are responding to China's expanding power and how the relative strength or weakness of China's regional partnerships will influence its ability to achieve its strategic ambitions.

So, I'd like to start with five key points here. First, Beijing sees America's regional alliances as a unique source of strength for the United States as well as a direct impediment to China's rise.

Establishing a new network of regional partnerships, one that will provide a more favorable external environment for Beijing, is therefore a central element of China's foreign policy.

China's vision for this new Asian security concept differs from the current regional security order in important ways.

First, it's an Asia-only network, one that would give Beijing greater influence and leverage in aligning other partners with its priorities and preferred rules of the road.

And second, it's one that has no place for treaty alliances, which China's leaders have critiqued is not conducive to maintaining common security.

Thus, an important aspect of China's vision is not only to strengthen its own ties with regional partners, but also to weaken the strength and influence of the U.S. alliance system in the region.

Second, to a large extent, China has succeeded in its goal of building a stronger partnership network in the region.

It's now signed partnership agreements with all of its immediate neighbors with the exception of Japan, though the substance of these relationships varies significantly.

The foundation of most of these partnerships is economic, which has given China tremendous influence and a greater ability to shape geopolitical developments in the region.

However, Beijing is actively diversifying its engagement toolkit with a new defense cooperation, joint training exercises, arms sales and cultural diplomacy emerging as a more prominent aspect of its relationship building in recent years.

Third, most regional partners are responding to China's rise in a calibrated way, one that both hedges and balances against its growing influence, but is also quite pragmatic about the need for continued cooperation with Beijing.

This reality is unlikely to change in the near term; however, Beijing's more openly assertive foreign policy under Xi Jinping has altered the equation somewhat.

While countries are continuing to see cooperation, three developments in particular have created a somewhat more pessimistic assessment among many countries in the region about the costs and benefits of partnership with Beijing.

These include China's aggressive behavior in the South China Sea, concerns about unequal terms and conditions of the Belt and Road Initiative projects, and China's efforts to

leverage its influence and elite ties, particularly in democracies in the region, to sway domestic policy debates.

To balance, partners are pursuing a strategy of diversification. Although this also involves enhancing ties with the United States, one of the most significant developments that we've seen in recent years is an increased trend toward intraregional cooperation between Indo-Pacific nations.

There has been a notable uptick in what we would call minilateral engagement that often involves neither Washington nor Beijing and this is an important development.

It's a trend that's being driven, to a large degree, by middle powers such as Japan, Australia and India in particular.

In many ways, it's a decidedly positive development. It reflects an increasing desire on the part of many regional players to play a larger role in sharing the burden for regional security, protecting their own sovereignty and preserving a rules-based approach in the region; however, it is also a trend that reflects a degree of concern about U.S. leadership and reliability, one that ought to serve as a warning sign for U.S. policymakers.

This brings me to my final point. Both China and the United States are facing challenges and hurdles right now with regional partners.

Beijing may be an increasingly close partner for many countries, but there are clear signs that most countries remain unconvinced about its benign intent and worry about what potential leadership by Beijing in the region would mean.

China's lack of stronger, more enduring regional relationships could make it challenging in the future for it to more effectively achieve its geostrategic ambitions, including maintaining long overseas deployments as it expands its global military role; however, the United States cannot afford to underestimate the crisis of confidence it's currently facing with many regional allies and partners as well.

Far more worrisome than China's expanding influence is the notable decline in regional trust in U.S. leadership and commitment.

Regional partners are eager for U.S. engagement, but there are growing signs of concern that Washington will not step up to the plate and that partners will need to forge ahead on their own to fill the void.

This erosion of confidence and trust in U.S. leadership, partnership and reliability is the greatest challenge the United States faces right now and ought to be its most important priority as it thinks about how to compete for influence in the region.

To begin addressing this task, I would offer the following recommendations: First, the United States needs to provide increased reassurance of its sustained commitment in the Indo-Pacific region.

Partners are looking for more than rhetorical assurances that America remains a Pacific power.

While both the Obama and Trump administrations have taken important steps to expand U.S. engagement in the region, the promise of a rebalance remains unfulfilled especially in terms of the budgetary resources the United States ought to be putting toward the Indo-Pacific region.

We'll need to move far more assertively to demonstrate a tangible commitment toward leadership, and, on this front, I would suggest two things.

First, an important step would be to fully fund the recently passed Asia Reassurance Initiative for the entire five-year period.

Asian partners have noted similar initiatives in other regions such as Europe, and they

question why U.S. resources do not match its rhetoric yet when it comes to the Indo-Pacific.

Another important step would be to crust a thorough Department of Defense review of opportunities and requirements for U.S. force posture in the Indo-Pacific region.

U.S.-forward presence provides the most obvious, the most tangible and enduring symbol of our commitment to regional partners, and there are numerous signs that this presence is under strain, for example, in the Philippines and in South Korea, as well as opportunities to better enhance this presence in a way that would increase the credibility of America's security guarantees.

Second, the United States needs to enhance both the strategic and operational effectiveness of its security alliances.

At the strategic level, it needs to send the message that America remains fully committed to, as well as aligned with, its allies.

More than this, it ought to push back on the narrative that these relationships are a containment mechanism, and emphasize the tremendous public goods that this network provides for countries that include China.

At the operational level, the United States and its allies need to make operating as a coalition a much more normal, much more routine way of doing business economically and militarily.

And finally, the United States needs to improve the ability of U.S. allies and partners to maintain their sovereignty, including preserving their economic independence and providing for their own self-defense.

For many partners, the most important priority is to have the space and capacity to make their own choices.

I'll end there. Thank you very much, and I look forward to your questions.

**PREPARED STATEMENT OF LINDSEY FORD, DIRECTOR OF POLITICAL-
SECURITY AFFAIRS, ASIA SOCIETY POLICY INSTITUTE**

“What Keeps Xi Up at Night: Beijing’s Internal and External Challenges”

Testimony before the U.S.-China Economic and Security Review Commission
Lindsey W. Ford, Director for Political Security Affairs, Asia Society Policy Institute – February 7, 2019

First, thank you to Senator Talent, Senator Goodwin, and the honorable Commissioners for the opportunity to come speak to you today. The topic of today’s hearing is a particularly important one. Widespread attention to China’s growing power has created a public narrative that often conveys a sense of inevitability and irreversibility around China’s rise. This narrative ignores constraints, both internal and external, that China will face as it continues to work toward its goal of “national rejuvenation”. China is undoubtedly expanding its already significant economic and military power, and in this sense presents a formidable challenge to U.S. leadership. However, Chinese leaders remain acutely aware of the potential for either internal weaknesses or external turbulence to generate instability that could upset China’s current trajectory.

The specific topic I have been asked to discuss today is the response of other Indo-Pacific nations to China’s expanding power, and how China’s regional partnership network will influence its ability to achieve its geostrategic ambitions. In the testimony that follows, I will outline: 1) China’s vision for a new Asian security architecture; 2) how China is operationalizing this vision; 3) regional strategies to respond to China’s growing influence; and, 4) practical implications for both the United States and China. I conclude with a series of recommendations for the U.S. Congress to strengthen and revitalize U.S. security alliances and partnerships.

I. The Indo-Pacific Order and China’s Community of Common Destiny

The resilience of the post-World War II alliance system has been a unique source of strength for the United States. In the Asia-Pacific region, U.S. security alliances form the basis of a broader regional order that has enabled over seventy years of unprecedented economic growth and relative stability. This order, which includes a web of alliances and partnerships, regional institutions, and supporting rules and norms, has not only benefited countries across the Indo-Pacific region—including China—it has also benefited the United States. This is why consecutive U.S. administrations have acknowledged that U.S. prosperity is “inextricably linked” to peace and security in the Indo-Pacific region.

Chinese leaders and scholars have long recognized the significance of the U.S. alliance system and critiqued it as a de facto containment mechanism aimed at preventing China’s rise.¹ In the view of many Chinese experts, this alliance network creates an inherent asymmetry designed to enable the United States to “more effectively maintain its dominant position” and create “a hard constraint on China’s continued development”.² It is therefore unsurprising that Xi Jinping has identified creating a more “favorable external environment” and a “new type of international

¹ John Hemmings, “The myth of Chinese containment,” *The Interpreter*, March 9, 2018, <https://www.lowyinstitute.org/the-interpreter/myth-chinese-containment>.

² Zhou Fangyin, “Meiguo de yatai tongmeng tixi yu zhongguo de yingdui” [United States’ Asia-Pacific Alliance System and China’s Response], *Shijie jingji yu zhengzhi* [World Economics and Politics], 2013, http://www.sias.org.cn/gqnrMH/info_54.aspx?itemid=738.

relations” as a priority for China’s foreign policy.³ Chinese leaders have made clear they see the present moment as one of strategic opportunity, a period in which both domestic and international conditions are right for China to expand its “comprehensive national power” and seize President Xi’s “China dream of national rejuvenation”.⁴ To achieve this dream, China is actively focused on restructuring the Indo-Pacific regional order and the security relationships within it.

Through a series of speeches and publications, China’s leaders have outlined in recent years Xi’s vision for a “new Asian security concept”, which aligns with his call for China to establish “a community of common destiny for mankind”.⁵ This approach is meant to contrast with what they describe as a more competitive, zero-sum approach enshrined by the U.S. alliance system.⁶

Chinese leaders describe this new Asian security concept as one based on broad principles: common, comprehensive, cooperative, and sustainable security cooperation.⁷ However, this vision is direct on two critical points. First, China’s concept envisions a diluted role for the United States and an enhanced role for China. As Xi outlined in his 2014 speech to the Conference on Interaction and Confidence Building Measures in Asia (CICA), “it is for the people of Asia to run the affairs of Asia, solve the problems of Asia and uphold the security of Asia”.⁸ He later elaborated on this point at the 2016 CICA meeting, arguing that a new Asian architecture should better reflect “Asian needs”.⁹ Second, this new Asian order has no place for treaty alliances, which Xi’s 2014 CICA speech directly critiques as “not conducive to maintaining common security”.¹⁰ Presumably, this would include the U.S. alliance system.

³ Xi Jinping, “Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era,” Remarks delivered at the 19th National Congress of the Communist Party of China, October 18, 2017,

http://www.chinadaily.com.cn/china/19thcpcnationalcongress/2017-11/04/content_34115212.htm.

⁴ U.S. Department of Defense, “Assessment on U.S. Defense Implications of China’s Expanding Global Access,” (December 2018), <https://media.defense.gov/2019/Jan/14/2002079292/-1/-1/1/EXPANDING-GLOBAL-ACCESS-REPORT-FINAL.PDF>.

⁵ Xi Jinping, “New Asian Security Concept For New Progress in Security Cooperation,” Remarks delivered at the Fourth Summit of the Conference on Interaction and Confidence Building Measures in Asia, May 21, 2014, https://www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1159951.shtml; and “Xi urges breaking new ground in major country diplomacy with Chinese characteristics,” *Xinhua*, June 24, 2018, http://www.xinhuanet.com/english/2018-06/24/c_137276269.htm.

⁶ Michael D. Swaine, “Chinese Views and Commentary on Periphery Diplomacy,” *China Leadership Monitor no. 44* (Hoover Institution, July 28, 2014), <https://www.hoover.org/sites/default/files/research/docs/clm44ms.pdf>.

⁷ Ibid.

⁸ Xi Jinping, “New Asian Security Concept For New Progress in Security Cooperation.”

⁹ Ministry of Foreign Affairs of the People’s Republic of China, “Xi Jinping Attends Opening Ceremony of the 5th Meeting of the CICA Ministers of Foreign Affairs and Delivers Important Speech, Stressing to Jointly Create a Better Future of Peace and Prosperity for Asia Through Dialogue and Consensus,” April 28, 2016, https://webcache.googleusercontent.com/search?q=cache:nlQ5OH48hi0J:https://www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1360245.shtml+&cd=1&hl=en&ct=clnk&gl=us.

¹⁰ Ibid, Xi Jinping, “New Asian Security Concept For New Progress in Security Cooperation.”

Xi's vision of an "Asian community of common future" instead calls for China to develop a "global partnership network", one that will make "Asian countries good partners that trust one another and cooperate on an equal footing".¹¹

Although Xi describes a partnership network based on the principle of "equality", his speeches also notably differentiate between China's relationships with "major powers" and those with smaller states around its periphery. With "major powers", China seems to acknowledge a degree of inevitable friction and differing views, arguing that "major countries should treat the strategic intentions of others in an objective and rational manner, reject the Cold War mentality, [and] respect others' legitimate interests and concerns".¹² In building relationships with smaller neighbors, however, China's "neighborhood diplomacy" focuses more directly on aligning these states with Beijing's worldview. In his 2013 speech at the Work Conference on Peripheral Diplomacy, Xi Jinping emphasized the need to enhance "political good will" and economic ties, "increase China's cultural influence", and "socialize the region to accept China's view of its 'core interests'".¹³

Operationalizing China's Regional Network

China now touts the establishment of 84 "strategic partnerships" with countries across the world.¹⁴ The strategic significance and practical implementation of these agreements varies significantly, but the trend is clear: China is moving rapidly to operationalize Xi's call for a network of partnerships.

In the Indo-Pacific region, China has signed partnership agreements with all of its immediate neighbors, with the exception of Japan, and has more recently expanded its ties in South Asia and the Pacific in particular. In November 2018, China established comprehensive strategic partnerships with eight Pacific Island nations, including Fiji, Vanuatu, Samoa, and the Federated States of Micronesia.¹⁵

Broadly speaking, China aims to achieve four goals through these partnerships: 1) expanding its international strategic and political influence; 2) supporting access to resources and promoting domestic economic growth; 3) advancing its security interests and military access through deeper defense ties; and 4) enhancing the legitimacy of China's "core interests" and preferred values.

¹¹ Ibid, Xi Jinping, "New Asian Security Concept For New Progress in Security Cooperation."

¹² Ministry of Foreign Affairs of the People's Republic of China, "China's Policies on Asia-Pacific Security Cooperation," January 11, 2017, https://web.archive.org/web/20171219010150/https://www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1429771.shtml.

¹³ Timothy Heath, "Diplomacy Work Forum: Xi Steps Up Efforts to Shape a China-Centered Regional Order Jamestown Article," *China Brief* v. 13 no. 22 (Jamestown Foundation, November 7, 2013), <https://jamestown.org/program/diplomacy-work-forum-xi-steps-up-efforts-to-shape-a-china-centered-regional-order/>.

¹⁴ "Quanmian zhanlv huoban guanxi" [Comprehensive Strategic Partnership], baike.baidu.com, last edited December 4, 2018, accessed January 25, 2019, <https://baike.baidu.com/item/%E5%85%A8%E9%9D%A2%E6%88%98%E7%95%A5%E4%BC%99%E4%BC%B4%E5%85%B3%E7%B3%BB/9229535>.

¹⁵ "China, Pacific island countries lift ties to comprehensive strategic partnership," *Xinhua*, November 17, 2018, http://www.xinhuanet.com/english/2018-11/17/c_137612239.htm.

The centerpiece of China’s economic cooperation with regional partners is the “Belt and Road Initiative” (BRI), its signature global infrastructure development plan. Through BRI, China is working with partners on traditional infrastructure needs—building roads, ports, dams, and bridges—but it is also leveraging BRI to build expanded cooperation on trade, transportation agreements, and a new “digital silk road”.¹⁶ The majority of China’s BRI spending is going to projects in the Indo-Pacific region—the largest recipients of Chinese funds are currently Pakistan, Bangladesh, Malaysia, and Indonesia¹⁷—and most of China’s neighbors have endorsed some form of cooperation under the BRI rubric.¹⁸

Although many of China’s neighbors have accepted BRI investments, there have nonetheless been signs of growing pushback and discontent about the terms and conditions of these agreements. Lack of transparency, unsustainable debt levels, and poor environmental standards have sparked backlashes in several countries, moving leaders in countries like Malaysia, Nepal, and even Pakistan, to cancel or revisit the terms of various BRI projects. In spite of these challenges, China’s economic ties to its Indo-Pacific neighbors remain robust—China is the largest two-way trading partner for the majority of Indo-Pacific countries, including ASEAN,¹⁹ Australia, India, and Japan.²⁰ These economic relations are the foundation of China’s regional influence and engagement.

China has also moved in recent years to enhance the military and defense aspects of its regional partnerships. The most prominent aspect of China’s defense ties has been its arms sales to regional neighbors, especially those countries who may not be able to purchase, or could have difficulties affording, U.S. weapons systems. Between 2012 and 2016, Chinese arms sales totaled \$20 billion dollars, with nearly half of these sales (eight billion) going to partners in the Indo-Pacific region. Pakistan, Bangladesh, and Myanmar have been the three largest importers of Chinese arms in recent years.²¹ Notably, China has also stepped up defense sales and technology cooperation with two U.S. allies—Thailand and the Philippines.

In addition to arms sales, the PLA has significantly increased the pace and scope of its international military exchanges and joint exercises in recent years. This includes an increased pace of high-level defense exchanges, as well as professional military education and Chinese language training for foreign officers through PLAAF and PLAN Command Schools. According to a new report by the U.S. Department of Defense, from 2008-2017, China participated in 62

¹⁶ Jonathan E. Hillman, “How Big Is China’s Belt and Road?” (Center for Strategic and International Studies, April 3, 2018), <https://www.csis.org/analysis/how-big-chinas-belt-and-road>.

¹⁷ Cecilia Joy-Perez and Dereck Scissors, “The Chinese State Funds Belt and Road but Does Not Have Trillions to Spare,” (American Enterprise Institute, March 2018), <https://www.aei.org/wp-content/uploads/2018/03/BRI.pdf>.

¹⁸ Daniel M. Kliman and Abigail Grace, “Power Play: Addressing China’s Belt and Road Strategy,” (Center for a New American Security, September 2018), <https://s3.amazonaws.com/files.cnas.org/documents/CNASReport-Power-Play-Addressing-Chinas-Belt-and-Road-Strategy.pdf?mtime=20180920093003>.

¹⁹ ASEAN, “Top ten ASEAN trade partner countries/regions, 2015,” November 2016, https://asean.org/wp-content/uploads/2016/11/Table20_as-of-6-dec-2016.pdf.

²⁰ World Integrated Trade Solution, “Top Exporters and Importers 2016,” <https://wits.worldbank.org/CountryProfile/en/Country/WLD/Year/2016/TradeFlow/EXPIMP>.

²¹ Ibid, U.S. Department of Defense, “Assessment on U.S. Defense Implications of China’s Expanding Global Access.”

bilateral military exercises and 42 multilateral exercises with partners across the Indo-Pacific.²² Russia and Pakistan are by far the most frequent partners for these exercises, but China now conducts regular training engagements with countries across the region, including Australia, Singapore, Thailand, and Indonesia. China also recently inaugurated a new multilateral maritime exercise with ASEAN, which was held in 2018 for the first time.²³ Most interestingly, China has reportedly begun to explore military access arrangements with foreign partners, to help secure the logistical access it will need to sustain longer overseas deployments. Recent reports suggest China has explored access arrangements with both Cambodia and Vanuatu.²⁴

Finally, China is actively seeking to expand its “soft power” and influence with its neighbors, in support of Xi Jinping’s exhortation to “tell China’s story well”.²⁵ Beijing’s cultural diplomacy supports its broader strategic aims by encouraging greater alignment with China’s preferred policy positions, as well as aiming to lessen regional threat perceptions among its neighbors.

In the past several years, China has increased its cultural diplomacy on multiple fronts, including new Chinese-language media outlets across the region; establishing Confucius Institutes; expanding youth, political party, and business exchanges; and creating new sister city initiatives with foreign partners. For example, since 2004, China has opened 89 Confucius Institutes and 159 Confucius Classrooms in East Asia and the Pacific. It has also more than doubled its sister city arrangements with East Asian partners since 2000, up from 400 to 950. China also hosts nearly half a million foreign students in China, over 40% of whom hail from other Indo-Pacific nations.²⁶ Many of these initiatives have been well-received, but much like China’s BRI projects, there are also concerns that elements of China’s cultural diplomacy appear to have a sharper edge. In particular, Indo-Pacific democracies such as Australia and New Zealand have raised concerns that China has leveraged ties to elite policy, expert, and business communities to exert political pressure and shape domestic policy debates.

II. Regional Responses: Shifting Perceptions of Chinese Partnerships

How are regional partners responding to China’s growing influence? It is difficult to answer this question in a comprehensive way, given the significant differences in individual nations’ relationships with Beijing. On the one hand, close U.S. allies, such as Australia and Japan, have enhanced coordination with the United States and other like-minded democracies. Other countries, such as Cambodia and Pakistan, have more whole-heartedly embraced strategic ties to Beijing. The response of most nations, however, lies somewhere in between.

²² Ibid.

²³ Lim Min Zhang, “China, Asean kick off inaugural maritimes field training exercise in Zhanjiang, Guandong,” *Straits Times*, October 22, 2018, <https://www.straitstimes.com/asia/east-asia/china-asean-kick-off-inaugural-maritime-field-training-exercise-in-zhanjiang>.

²⁴ Ibid, U.S. Department of Defense, “Assessment on U.S. Defense Implications of China’s Expanding Global Access.”

²⁵ Justyna Szczudlik, “‘Tell China’s Stories Well’: Implications for the Western Narrative,” Policy Paper no. 9 (169) (Polish Institute of International Affairs, September 2018), <http://www.pism.pl/Publications/PISM-Policy-Paper-no-169>.

²⁶ Samantha Custer et al, “Ties that Bind: Quantifying China’s public diplomacy and its ‘good neighbor’ effect,” (Williamsburg: AidData at William & Mary, June 2018), 12, <https://www.aiddata.org/publications/ties-that-bind>.

Given China's substantial economic and military power, engagement with Beijing is not really a choice, but a fact of life for countries in the Indo-Pacific region. Regional partners are both pragmatic about this reality, as well as clear-eyed about the potential challenges associated with China's regional influence. To the extent that it is possible to decipher a common strategic approach, most countries are broadly focused on three goals: sovereignty, balance, and stability.

First, countries desire the strategic space to make independent economic and foreign policy decisions, free from coercion or influence. As Australia states in its most recent Foreign Policy White paper, the aim is to be "sovereign, not reliant".²⁷ To maintain this strategic space, countries are seeking greater diversity in their economic and security ties, even as they continue to maintain cooperative relations with Beijing. In particular, most regional partners are eager for deeper U.S. engagement in the Indo-Pacific, to provide a counterweight against Beijing's growing power. And finally, countries are seeking stability. Many regional partners remain wary of China's rapidly expanding military presence and capabilities, including the potential for Chinese activities to destabilize areas such as the East or South China Seas. On the other hand, although most partners welcome American pushback against Chinese actions that encroach on their freedom of action, they are also leery of the impact that major power competition could have in the region.

China remains a vital economic partner for most of its Indo-Pacific neighbors, a reality which creates a more complex and at times muted approach toward strategic balancing than might be expected. However, Beijing's more openly assertive foreign policy behavior under Xi Jinping has also fueled cynicism about China's strategic intentions. While countries continue to seek pragmatic cooperation with Beijing, there are signs that some regional partners are increasingly skeptical and pessimistic about the costs and benefits of this partnership. For example, in a recent survey of Southeast Asian policymakers and experts, only 9% of respondents assessed that China was a "benign and benevolent power" in the region.²⁸ In particular, some countries have begun to more openly voice questions about China's commitment to 'equality' and 'win-win' outcomes. Three developments in particular have increased perceptions that China is wielding its economic and political influence to achieve outcomes that advantage Beijing at the expense of its neighbors.

China's Activities in the South and East China Sea: China's aggressive pursuit of its territorial claims in the South China Sea has played a significant role in reshaping regional and global perceptions about Beijing's foreign policy behavior and its treatment of regional partners.

In particular, China's rapid 2013-2015 land reclamation campaign, followed by its deployment of wide-ranging new military capabilities to the South China Sea, called into question its commitment to resolving disputes without the use of force or coercion. Beyond Chinese land reclamation, China's use of maritime militias to exert sovereignty over disputed maritime areas, its efforts to prevent neighbors from exploiting resources and fishing within their own exclusive

²⁷ Department of Foreign Affairs and Trade, "Foreign Policy White Paper 2017," (Canberra: Australian Government, November 2017), iii, <https://www.fpwhitepaper.gov.au/>.

²⁸ Tang Siew Mun et al., "State of Southeast Asia: 2019," *ASEAN Focus*, January 11, 2019, https://www.iseas.edu.sg/images/pdf/ASEANFocus%20January%202019_FINAL.pdf.

economic zones, as well as its refusal to recognize the 2016 ruling issued by the Hague's Permanent Court of Arbitration, all raised serious concerns in the international community about China's commitment to the rule of law, freedom of navigation, and the principles of sovereignty and non-interference.

The most notable regional impact of China's behavior has been on its relationships with neighbors in Southeast Asia. Beijing's activities in the South China Sea have been the single largest source of friction with its ASEAN neighbors. China's standoff with the Philippines in 2012 at Scarborough Shoal, and then with Vietnam in 2014 over China's deployment of an oil rig in disputed waters, not only soured government-to-government relations, they also did serious damage to public opinion toward Beijing. China's aggressive pursuit of its South China Sea claims has also been a significant factor in accelerating Southeast Asian military modernization, including Indonesia's military buildup around the Natuna Islands, as well as incentivizing new maritime cooperation between ASEAN claimant states and partners, including the United States, Japan, and India.

Belt and Road Initiative: The impact of China's Belt and Road Initiative (BRI) on its smaller Indo-Pacific neighbors has become a subject of great debate. Although most countries initially welcomed the initiative, the absence of clear standards and lack of economic sustainability surrounding many of the projects has sparked political pushback and grassroots protests in a number of Indo-Pacific countries. China's insistence on using primarily Chinese companies and materials for these projects has generated frustration in smaller nations, such as Thailand, Cambodia, and Malaysia, where workers complain that Chinese development has come at their expense.²⁹ In other countries, such as Laos and Indonesia, concerns about the potential environmental impact of Chinese hydropower and railway projects have also sparked objections.³⁰

Perhaps the most significant worry emerging around China's BRI investments, however, is that China may be promoting highly risky loan arrangements that are saddling smaller nations with unsustainable levels of debt. The turning point in this debate seemed to be the revelation that Sri Lanka found itself so deeply indebted to Beijing that it offered up a 99-year lease to the port of Hambantota and the surrounding land.³¹ Increasingly, public perceptions that Chinese deals are crippling smaller neighbors and impinging on their sovereignty has become a political liability for China in various places, including Malaysia, Bangladesh, and the Maldives, where domestic opposition has led political leaders to step back from closer cooperation with Beijing.

²⁹ Wichit Chaitrong, "China's loan terms rejected," *The Nation*, August 14, 2017, <http://www.nationmultimedia.com/detail/national/30323682>; Tom O'Connell, "China's ambitious plans meet resistance in Southeast Asia," *Southeast Asia Globe*, September 11, 2018, <http://sea-globe.com/chinas-belt-and-road-initiative-meets-resistance-in-southeast/>.

³⁰ Basten Gokkon, "Environmentalists Are Raising Concerns Over China's Belt and Road Initiative," *Pacific Standard*, July 18, 2018, <https://psmag.com/environment/environmental-concerns-over-chinese-infrastructure-projects>.

³¹ Maria Abi-Habib, "How China Got Sri Lanka to Cough Up a Port," *New York Times*, June 25, 2018, <https://www.nytimes.com/2018/06/25/world/asia/china-sri-lanka-port.html>.

Domestic Interference and Influence: Finally, a more recent point of concern for some countries has been China’s efforts to cultivate influence with specific elite leaders and constituencies. In some cases, such as in Sri Lanka and Malaysia, reports suggest that China enabled corrupt political leaders in order to secure its preferred infrastructure deals.³² With both the construction of the Hambantota Port and Malaysia’s agreements for new railway and pipeline projects, Chinese funding appears to have flowed not just to development, but also into the direct coffers of political leaders.³³

In other cases, countries have expressed concerns that China leveraged close ties to specific political leaders to secure unbalanced economic deals. For example, the newly elected government in the Maldives expressed deep concerns about the Free Trade Agreement former President Abdullah Yameen signed during a visit to Beijing in December 2017. Describing the agreement as a “one-way treaty” with no economic logic for the Maldives, the new Solih government has vowed to review the deal.³⁴

There has also been a heated debate within some democracies—Australia and New Zealand, in particular—about Chinese efforts to leverage financial ties to business and political elites. In both instances, the conversation was partially precipitated by revelations of policymakers with personal or financial linkages to the Chinese Communist Party (CCP). Australia’s domestic intelligence agency, ASIO, warned the two major parties in 2015 that Chinese donations “might come with strings attached”.³⁵ The following year, a high-profile scandal emerged over Australian Senator Sam Dastyari’s financial ties to Chinese donors and support for Chinese talking points on the South China Sea.³⁶ In late 2016, responding to rising concerns about potential foreign influence, the Turnbull administration commissioned a classified report on foreign interference into Australia’s domestic politics, which was reported to have identified Chinese influence as a key threat to Australia’s political independence.³⁷ This resulted in the passage of new legislation to ban foreign political donations and force disclosures on foreign lobbying practices.³⁸

³² Tom Wright and Bradley Hope, “China Offered to Bail Out Troubled Malaysian Fund in Return for Deals,” *Wall Street Journal*, January 7, 2018, <https://www.wsj.com/articles/how-china-flexes-its-political-muscle-to-expand-power-overseas-11546890449>; Ibid, Maria Abi-Habib, “How China Got Sri Lanka to Cough Up a Port.”

³³ Ibid, Tom Wright and Bradley Hope.

³⁴ Sanjeev Miglani and Mohamed Junayd, “Maldives set to pull out of China free trade deal, says senior lawmaker,” *Reuters*, November 19, 2018, <https://www.reuters.com/article/us-maldives-politics-china-exclusive/exclusive-maldives-set-to-pull-out-of-china-free-trade-deal-says-senior-lawmaker-idUSKCN1NO0ZC?il=0>.

³⁵ John Garnaut, “Australia’s China reset,” *The Monthly*, August 2018, <https://www.themonthly.com.au/issue/2018/august/1533045600/john-garnaut/australia-s-china-reset>.

³⁶ Stephanie Peatling and Fergus Hunter, “China scandal: Embattled Labor senator Sam Dastyari resigns from Parliament,” *Sydney Morning Herald*, December 12, 2018, <https://www.smh.com.au/politics/federal/china-scandal-embattled-labor-senator-sam-dastyari-resigns-from-parliament-20171211-h02ddn.html>.

³⁷ Tara Francis Chan, “A secret government report uncovered China’s attempts to influence all levels of politics in Australia,” *Business Insider*, May 29, 2018, https://www.businessinsider.com.au/secret-australian-government-report-uncovered-china-influence-campaign-2018-5?r=US&IR=T&_ga=2.124305930.1665568208.1548881313-1754222265.1494863903.

³⁸ Electoral Legislation Amendment (Electoral Funding and Disclosure Reform) Act 2018 (Cth), https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=s1117; Foreign

Regional Responses: Diversification and Balancing

In response to these concerns, many Indo-Pacific partners are taking steps to expand their strategic space and maintain balance in the region. Although there is some evidence of military balancing underway in the Indo-Pacific, this trend is highly uneven across the region, reflecting vastly different threat perceptions and security priorities among regional partners. Traditional military balancing, for most countries, is an infeasible strategy to respond to China's rise. Instead, the most prevalent strategic response is one of diversification. Partners are seeking to enhance ties to the United States, both economically and militarily, while also building a more diverse network of intra-regional partnerships.

Engagement with the United States

Over the past several years, there has been an increased demand signal from Indo-Pacific allies and partners for the United States to strengthen its role as a regional security guarantor. In response, the United States and its partners have taken numerous steps to bolster security cooperation and increase U.S. forward presence in the region. This includes notable new agreements enabling rotational deployments of Littoral Combat Ships in Singapore, U.S. Marines in Australia, and access to air and naval facilities in the Philippines. U.S. partners are also seeking enhanced training and assistance from the United States, in order to shore up their own self-defense capabilities, especially in the maritime domain. This has led to new defense cooperation with partners such as Vietnam and the Philippines, as well as the establishment of a new U.S.-ASEAN maritime security exercise, which will be held for the first time in 2019.

Another noteworthy trend is the newfound strength of the U.S.-India partnership, as highlighted by the inaugural U.S.-India 2+2 Dialogue that was held this past September. India's concerns about China's growing presence in the Indian Ocean region have incentivized robust growth in bilateral defense ties between Washington and New Delhi in recent years, including agreements to jointly develop and co-produce defense equipment. Equally notable, India has shown greater openness to multilateral coordination with the United States and other allies, such as Japan and Australia. While still relatively nascent, India's openness to greater multilateral cooperation—for example, Japan's regular participation in the U.S.–India Malabar exercise—mirrors a broader trend toward integrating security ties among the United States and close partners. For example, the United States, Japan, and Australia agreed in a leaders' summit in 2014 to a suite of new trilateral defense exercises,³⁹ and just this past year the United States agreed to collaborate with Australia in developing a naval base in Papua New Guinea.⁴⁰

Influence Transparency Scheme Act 2018 (Cth),

https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r6018.

³⁹ The White House, "Australia-Japan-United States Trilateral Leaders Meeting Joint Media Release," November 15, 2014, <https://obamawhitehouse.archives.gov/the-press-office/2014/11/15/australia-japan-united-states-trilateral-leaders-meeting-joint-media-rel>.

⁴⁰ Jonathan Barret, "U.S. joins Australian plan to develop new Pacific naval base," *Reuters*, November 17, 2018, <https://www.reuters.com/article/us-apec-summit-port/u-s-joins-australian-plan-to-develop-new-pacific-naval-base-idUSKCN1NM06X>.

Beyond security cooperation, however, the more significant priority for many Indo-Pacific partners is to strengthen and restore U.S. economic leadership in the region. The U.S. withdrawal from the Trans-Pacific Partnership agreement, and the critiques of this agreement expressed throughout the 2016 presidential campaign, shook regional leaders and generated deep anxiety about continued U.S. leadership in the region. China's strong economic influence, and increasing ability to reshape and circumvent international economic rules, has only heightened calls, from U.S. allies in particular, for a stronger U.S. hand in sustaining a fair and open economic order. Over the past year, the United States and several partners have established a range of new economic initiatives, including an agreement between the United States, Australia, and Japan to facilitate private sector-driven infrastructure development in the Indo-Pacific and a new U.S.-ASEAN Smart Cities Initiative to collaborate on digital infrastructure in Southeast Asia. These and other similar efforts highlight the ongoing appeal of U.S. investment and economic leadership. On their own, however, they will do little to sustain the open trading architecture the United States helped establish.

Intra-Regional Cooperation Networks

Perhaps the most significant development of the past few years is the degree to which Indo-Pacific middle powers, including Australia, Japan, and Vietnam are driving a new wave of intra-regional networking and agreements. While this trend is partially driven by concerns about rising Chinese power, it's also important to note that it is equally driven by fear of U.S. abandonment and unreliability, a worry that has deepened in recent years. In a recent poll, nearly 70% of respondents expressed a lack of certainty in American commitment and reliability in the region.⁴¹

Japan has been a particular leader in driving intra-regional cooperation on both the security and economic side. The Abe administration's initiative to salvage the Trans-Pacific Partnership Agreement resulted in the historic signature of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership on March 8, 2018—an agreement that is projected to result in \$147 billion in global income gains, and notably includes neither China nor the United States.⁴²

Beyond economic cooperation, Japan has been one of the most energetic champions of increased engagement between Indo-Pacific democracies. Though the renewed establishment of the Quadrilateral Security Dialogue between Australia, India, Japan, and the United States has received much attention, in many ways it is the bilateral and trilateral collaboration between Australia, India, and Japan that has been much more substantive. Japan and India now hold regular leaders' level meetings and 2+2 ministerials, and have emerged as significant economic partners. India is now the largest recipient of Japanese Official Development Assistance (ODA), and Japan is India's fourth largest provider of foreign direct investment. The two countries have also agreed to collaborative research and development on military robotics and are working on an acquisition and servicing agreement (ACSA) that would grant reciprocal access to defense facilities such as Japan's base in Djibouti and India's bases on the Andaman Islands. Japan and Australia have similarly increased their bilateral economic and security cooperation, including

⁴¹ Ibid, Tang Siew Mun et al., "State of Southeast Asia: 2019," 10.

⁴² Matthew P. Goodman, "From TPP to CPTPP," (Center for Strategic and International Studies, March 8, 2018), <https://www.csis.org/analysis/tpp-cptpp>.

signing a new Japan-Australia Economic Partnership Agreement in 2014, to reduce tariffs and labor market barriers, and establishing a new acquisition and servicing agreement in 2017 to facilitate closer defense cooperation.⁴³

Australia, Japan, and India are not only increasing ties to each other, they are also each enhancing their cooperation with smaller countries in the region, especially in Southeast Asia and the Pacific. For example, the India-Vietnam relationship has been a notable new node of regional cooperation. In the past five years, their bilateral cooperation has included Vietnam hosting three Indian warships, joint coast guard exercises in India, Indian-provided training for Vietnamese submariners, as well as an Indian offer of a \$500 million defense line of credit to Vietnam. Similarly, while Australia has historically been the largest aid donor to the Pacific islands, increased Chinese infrastructure investment and loans have prompted Australia to recommit itself to the region through a new “stepping up” strategy.⁴⁴ This includes providing 21 patrol boats to island nations stretching from the South Pacific to Palau, as well as agreements to help Fiji develop a new military facility and a joint agreement with Japan and the United States to fund an undersea cable project for both Papua New Guinea and the Solomon Islands.⁴⁵

III. Implications and Recommendations for Congress

There is no doubt China has broadened the scale and scope of its partnership network across the Indo-Pacific region. China’s overwhelming economic and military power make some degree of cooperation with Beijing a fact of life for most Indo-Pacific nations. Yet unless China’s leaders can more effectively reassure partners in the region about its benign intent, China may face difficulties in establishing more meaningful partnerships outside of the economic arena. Many partners will continue to pursue a bifurcated approach that balances closer economic ties to Beijing with closer security ties to the United States. This will have practical implications on many fronts:

- The absence of reliable security alliances and partnerships could make it more difficult for China to obtain the overseas military access it needs to support an increasingly global military presence;

⁴³ Department of Defence (Australia), “Joint Statement: Eight Japan-Australia 2+2 Foreign and Defence Ministerial Consultations,” October 10, 2018, <https://www.minister.defence.gov.au/minister/cpyne/media-releases/joint-statement-eighth-japan-australia-22-foreign-and-defence>.

⁴⁴ Rajat Pandit, “With an eye on China, India to hold naval exercise with Vietnam,” *Times of India*, May 20, 2018, <https://timesofindia.indiatimes.com/india/with-an-eye-on-china-india-to-hold-naval-exercise-with-vietnam/articleshw/64241913.cms>; Press Trust of India, “Coast Guards of India, Vietnam hold joint exercise off Chennai,” *Times of India*, October 4, 2018, <https://timesofindia.indiatimes.com/india/coast-guards-of-india-vietnam-hold-joint-exercise-off-chennai/articleshw/66076682.cms>.

⁴⁵ Naval Technology, “Guardian Class Pacific Patrol Boat,” <https://www.naval-technology.com/projects/austal-pacific-patrol-boat-40/>, accessed January 30, 2019; Christopher Mudaliar, “Australia outbids China to fund Fiji military base,” *The Interpreter*, October 4, 2018, <https://www.lowyinstitute.org/the-interpreter/australia-outbids-china-fund-fiji-military-base>; Tom Westbrook, “Pacific leaders sign on to Australian internet cabling scheme, shutting out China,” *Reuters*, July 11, 2018, <https://www.reuters.com/article/us-australia-pacific-internet/pacific-leaders-sign-on-to-australian-internet-cabling-scheme-shutting-out-china-idUSKBNIK202Q>.

- Absent strong security alliances, China would be forced to bear a greater share of the burden in protecting its growing overseas commitments. This could be a particularly risky and costly prospect given instability in many parts of the Middle East and Africa;
- Growing skepticism about the terms of China’s development assistance could lead partners to seek out other options, making it more difficult for Beijing to find new partnership opportunities and export markets abroad;
- A deficit of soft power with regional partners could serve as a sort of tax on Beijing’s ambitions, forcing it to expend greater resources to bend regional norms and rules to more closely align with China’s preferences.

China may face very real limitations and challenges in consolidating its regional partnership network. However, it would be a mistake for U.S. policymakers to assume that Beijing cannot, or will not, adapt its policies to better assuage regional concerns. Although countries are not rushing to embrace China’s regional leadership, for the most part they are still seeking to find some kind of middle path between Washington and Beijing. Recent analysis suggests that there is a decided trend toward “under-balancing” in the Indo-Pacific, with nations taking the “minimum steps necessary to preserve their security and sovereignty”.⁴⁶ As a result, many partners will remain leery of more open strategic competition between the United States and China, and reluctant to be pulled in directions that force a choice between the two major powers.

More importantly, the United States cannot afford to underestimate the crisis of confidence it is currently facing with many regional allies and partners. Far more worrisome than China’s expanding influence is the notable decline in regional trust in U.S. leadership and commitment. Director of National Intelligence Dan Coats offered a dire warning about the state of the U.S. alliance system in his recent testimony to Congress, noting: “some U.S. allies and partners are seeking greater independence from Washington in response to their perceptions of changing U.S. policies on security and trade”.⁴⁷ Evidence of this concern is abundant. Experts in Australia and Japan—two of America’s closest allies—are openly debating the need for new self-defense capabilities and questioning the firmness of the U.S. security guarantee. U.S. partners are seeking out new partnerships and trade arrangements outside the region, such as the recent concluded Japan-EU trade deal. The trend lines are clear. Many U.S. partners are worried they can no longer wait on the United States to lead in shoring up the international rules, norms, and institutions it helped create, and are increasingly convinced they will need to work together to fill the void.

This erosion of confidence and trust in U.S. leadership, partnership, and reliability is the greatest challenge facing the United States in the Indo-Pacific region. Over the past seventy years, U.S. alliances and partnerships have provided strategic, financial, and operational advantages that

⁴⁶ Ibid, Jeff Smith, “China’s Rise and (Under?) Balancing in the Indo-Pacific: Putting Realist Theory to the Test.”

⁴⁷ Daniel R. Coats, “Statement for the Record to the Senate Select Committee on Intelligence,” *Worldwide Threat Assessment of the US Intelligence Community*, January 29, 2019. <https://www.dni.gov/files/ODNI/documents/2019-ATA-SFR---SSCI.pdf>.

enabled America's global leadership. America's ability to effectively compete in the Indo-Pacific region will depend on its ability to restore the strength and sustainability of these relationships. To begin addressing this task, I offer the following recommendations:

#1: Provide increased reassurance of sustained U.S. commitment to the Indo-Pacific region

- Fully fund the recently passed Asia Reassurance Initiative Act for the entire five-year authorization period.
- Request a Department of Defense review of opportunities and requirements for U.S. force posture in the Indo-Pacific region, including an assessment of the potential implications of reduced operational readiness on the Korean peninsula.

#2: Enhance the strategic and operational effectiveness of U.S. security alliances

- Encourage closer coordination between the United States and its allies/partners on reforming and strengthening the World Trade Organization and regional economic institutions such as the Asian Development Bank.
- Support the request of the Philippines' Ministry of National Defense to review the bilateral Mutual Defense Treaty and encourage support for clarification of its scope in the South China Sea.
- Increase funding levels for joint exercise programs in the Indo-Pacific, to facilitate greater readiness for U.S. and allied forces.
- Create legislation to enable closer cooperation between the United States and regional allies in the realm of defense innovation, including data-sharing initiatives, and research and development.

#3: Improve the ability of U.S. allies and partners to preserve their economic independence and self-defense

- Provide additional funding for technical and legal assistance to educate small Indo-Pacific nations about how to maintain sustainable debt levels and evaluate infrastructure projects.
- Mandate a comprehensive assessment of the most pressing infrastructure requirements and priorities in key Indo-Pacific nations that could be shared with partners such as India, Japan, and Australia.
- Explore legislation to enable greater multinational security education between the United States and Indo-Pacific allies, including establishing funding for new shared schoolhouses and integrated training centers such as those shared with NATO.

PANEL III QUESTION AND ANSWER

SENATOR GOODWIN: Thank you.

Senator Talent.

SENATOR TALENT: Thank you.

So, Colonel Blasko, your testimony -- written testimony and verbal, also, was very compelling and you say the Chinese leadership do not trust the ability of the PLA to execute, I presume, across a fairly broad range of missions.

So how might we be able to exploit that uncertainty on their part with respect to particular prospective flashpoints like Taiwan?

I mean, like, my concern is they may think, okay, the PLA has problems, but we can make the tip of the spear effective, right?

In other words, that's what we do. We've had readiness issues for years. But when we actually have a mission, you know, we make the tip of the spear effective so that we can accomplish the missions. How can we structure our aid to places like Taiwan, or our approach, to magnify their concern of operational failure?

And then, Dr. Ford, a question for you. You said that China's neighbors are concerned that their intentions are not benign, the Chinese, and I think they're absolutely right if you look at what they're doing in Southeast Asia, for example, and they have good reason for that.

So I'll ask you, is there any possibility that the Chinese leaders, in order to deal with that, might actually develop some benign intentions regarding their neighbors, or are they going to continue basically trying to create a kind of 21st century vassalage of different kinds with their country?

So, those are my two questions. And please, Doctor, if you'd like to jump in on either, go ahead.

LTC BLASKO: Thank you.

Unfortunately, your questions force me into a policy kind of role, and I'm very uncomfortable.

As an intel officer, I was trained to provide the facts and let smarter people devise policies.

However, what I would observe in that question in response, would be that perhaps by us trying to exploit PLA worries -- this is exactly the last point that I was trying to make -- we may be causing them to increase their modernization.

They'll see through what we're trying to do, and we might be forcing them to react to our means of however we decide to exploit.

So, I would highly recommend before we try to do that, to do the interagency scrub down that I know the United States government can do, and has done, and look at the potential Chinese reactions to everything that we do decide and look for off-ramps whenever possible.

I'm really sorry I just can't get into it myself.

SENATOR TALENT: That's okay. I don't want to push you too far beyond your comfort level.

LTC BLASKO: Yeah.

SENATOR TALENT: Ms. Ford.

MS. FORD: Thank you.

So, your question about China's benign intent, there was actually a recent poll that came out, I referenced this in my written testimony, of Southeast Asian elite leaders where only 9

percent of them said that they trusted that Beijing had benign intent in the region.

It's a fairly damning statistic. Although I think for most folks in Southeast Asia, it's also probably one that's not surprising.

So, would Beijing recalibrate? Yes. Absolutely. They've done it time and time again. And, to a certain degree, it's been effective.

Dr. Doshi mentioned in terms of BRI, some of the efforts that China has taken to sort of adapt what it's doing and assuage partners' concerns.

I think we've seen very similar developments in the South China Sea, where over the last decade, two decades, there's been sort of a repeated cycle up and down of tensions.

And what's happening here, is that oftentimes Beijing assesses that it may have gone too far, it may have pressed smaller nations too much and they're beginning to push back.

We saw this most recently after the land reclamation campaign that China engaged in between 2013 to 2015.

In particular, after the Philippines actually took the step of submitting a case to the Permanent Court of Arbitration, which really resulted in its favor, you saw Beijing make some serious moves to try to take a much softer approach, in particular, to enhance its ties and relationships to the Philippines so that the Philippines would no longer be the pointy tip of the spear and pushing back on Chinese sovereignty claims, as well as a move to reassure partners that it wanted to negotiate a code of conduct, that it was willing to take these steps.

So, I think there is a perpetual cycle in how you see Beijing engage partners where it pushes until it sees a point of pushback, and then it will back off a bit and figure out how to recalibrate.

SENATOR TALENT: You wouldn't say, though, that they actually change their intentions at that point, they just stop pushing as hard until the resistance goes down.

MS. FORD: It's not a change in strategy, it's a --

SENATOR TALENT: Right.

MS. FORD: -- change in tactics.

SENATOR TALENT: Okay. Thank you.

SENATOR GOODWIN: Admiral McDevitt.

COMMISSIONER MCDEVITT: I have a question for each of you.

Dennis, I enjoyed your paper very much. A couple of questions. First, one of the other things that I've seen at least looking -- doing research with regard to the PLA Navy, is that Xi Jinping seems to have his foot on the gas pedal.

He is always exhorting them that we have to go faster, we need to achieve -- become -- help China to become a maritime power and the PLA Navy has to go.

And so, my reading of that has generally been that means more stuff as opposed to overcoming training shortfalls.

Your presentation makes me think that obviously there's an element of training there, but have you seen anything when it comes to -- the Navy and the Air Force are expanding. The Army is contracting.

When you look at these critiques of performance, are they oriented more toward the ground force or, in fact, are they oriented more toward the Air Force and Navy that are expanding and presumably are having to promote officers and put them in command jobs and responsibilities like that at a very rapid pace and, hence, their seniors are concerned about their skill sets?

So, that's the -- two things, the foot on the gas and then, if you will, how this applies to

each service.

Dr. Doshi, your presentation I found very compelling. I remember reading some years ago that China's near neighbors all need China much more than China needs them, and each one of their near neighbors knows that China has the ability to ruin their economy.

And particularly those neighbors who share a common land frontier with China also have to be aware that the PLA Army could show up on their doorstep tomorrow.

And so, the question is -- this has been points of leverage for some years. And so have you seen this? Is this increasing? Is China even more confident that it holds the whip hand with its near neighbors, the countries that live in the shadow of China with, perhaps, the exception of Japan? I'd be interested in your take on that.

And Lindsey, for your comment, you touted again in your recommendations -- or touted again in the recommendation that forward presence is very important, but as China's military power grows, they're the home team, and forward presence at the 7th Fleet or the 5th Air Force, they're the away team.

And when you start counting noses in terms of capabilities of airplanes and missiles and ships and submarines and what have you, our forces that are there, you know, forward presence posture are horribly outgunned and just in terms of things that can shoot missiles and torpedoes at you.

So, the question is, is forward presence getting to the point where it is no longer credible?

In other words, are forward presence forces seen as first responders who are going to mainly be able to hang on until reinforcements arrive because they can't deal with the overwhelming power of China?

And so, the question then is, do we need to change our posture when it comes to forward presence?

LTC BLASKO: Thank you, Admiral.

Yes -- I would say, yes, indeed, Xi Jinping is putting his foot on the gas pedal because he looked at the PLA and said, boy, Hu Jintao tells me these guys can't fight.

And I think that's probably what the senior officers on the CMC were also telling him, couldn't -- we can't be certain about going up against a modern force, a modern enemy, especially one that has the backing of Uncle Sugar.

So, he has pushed -- is pushing on the gas pedal, but not because of any date certain as of 2021 or, you know, you name it -- we like to go 2020 according to our planning cycles, but they've got their own planning cycle and I don't see any specific date for them training to actually, well, we have to have this capability by such and such date so we can invade Taiwan.

I don't -- what they're trying to do is deter Taiwan, deter all sorts of bad things from happening to them.

And in doing this, what -- the way I would characterize the PLA today is an experimental military.

I like Dr. Doshi's learning curve analogy. The PLA's on a learning curve just like China is as learning how to be a superpower.

And so, it's learning how to be an advanced military power, and I see them -- that learning going to take a long time for them to execute.

But if we or other people do things, they can push on the gas pedal even more and part of the active defense strategy is reaction to what they perceive as threats to their sovereignty or national interests.

Then, as for -- as you know, I focus more on the Army, and the Army is still roughly half

of the PLA, so there are a whole lot more articles about the Army and the problems they have in the Army.

And one of the big problems with the Army, the Marines and the Air Force airborne troops, plus a lot of the second artillery, is that they are very dependent on conscripts.

They've got more conscripts than many of the other units in the Navy and the Air Force, which have a larger percentage of NCOs.

So, in that regard, some of those units could be brought up to speed faster because they've got more experienced officers and NCOs in the units.

But again, I think in my testimony you'll find that all of the Services specifically talk about the same problems, especially the Five Incapables of the leadership at their operational units. Thank you.

DR. DOSHI: Thank you, Admiral, for those questions. I'll start with the observation on the continental question.

It's true that China's influence is often strongest on the states that it shares a land border with, and Vietnam and Myanmar know well the threat of possible PLA incursion.

Vietnam, of course, experienced it although China pretends it never happened since, in Leninist fashion, it lost the war. And Myanmar has been threatened that multiple times.

What's interesting -- and, Admiral, you know this very well, of course -- is that as China invests in power protection capabilities, those at ability to project course of power over your neighbors is expanding outward, and that's a crucial element of regional hegemony. If you can't do that, you can't be a hegemon.

And so, what we're seeing now, I think, is a military foundation for greater regional hegemony.

Now, to your second question about sort of the economic foundations of hegemony, it's an excellent point that in many ways dependence on China is not new. That's certainly been the case. That's often been trade-dependence.

What we are seeing, what is new now, is that the dependence is moving into other forms of economic activity.

By certain estimates, the United States still has a greater private stock of investment in Southeast Asia than China does, and include those SOEs. That won't remain the case indefinitely.

Furthermore, as I suggested earlier, the Belt and Road Initiative is a fundamentally new form of kind of influence. It has every target in there.

It allows China to create trade dependencies through new connectivity that's designed for Beijing.

For example, the Nepal-China railway will make Nepal far more dependent on China than it is now.

At the same time, it also provides certain opportunities for bribery, and that's a very different form of influence than simple trade flows. And in addition, I think we cannot discount the importance of financial power.

And I'll pause by saying this: That we know the United States has incredible financial power, we wield it against our adversaries routinely, but I want to imagine a world now -- I want all of us to imagine a world where China wields some aspect of that financial power regionally.

That world, in my view, is coming with the investments it's making, especially in the counter to SWIFT, and it will give it less blunt instruments than just a trade stoppage at courting the elites of other countries.

The final point I'll make very quickly, is that that regional hegemonic sphere, it's moving out as well into the Indo-Pacific, into Africa, perhaps one day into Latin America.

And so, the question we have to ask ourselves also is, can we deal with these -- can we kind of revise a method to deal with these instruments in Asia that will apply elsewhere?

And that's why I stress the focus on transparency, accountability and other forms of empowerment. Thank you.

MS. FORD: Thank you.

Let me start, first, with your last question, which is does the United States need to change its posture in the Indo-Pacific region?

Yes, is the simple answer to that question; however, I don't think that necessarily means that the -- you know, the answer to the growing lethality and threat that the United States faces from China in the military sphere is simply to pull back and rely on, you know, the ability to project power into the region. So, I think it actually needs to be both/and.

So, in terms of updating U.S. posture, the Obama administration in the force posture review that it did early on identified three principals for U.S. posture in the region.

I think that those ought to remain the targets, but I think there's a lot more we could do to achieve those goals.

And so, those three were a posture that was more geographically dispersed, operationally resilient, and politically sustainable.

I think we have a long way still to go in -- although we have taken some important steps.

A more geographically dispersed, operationally resilient posture complicates China's calculus, and that's an important step to take.

Also, having a more dispersed posture forward in the region, I think, sends an important message to U.S. allies and to China that China cannot effectively, through anti-access and area denial, push us out of the region. So you have to stay forward.

But to do that, I think you have to rely on both new capabilities and new ways of operating.

And so, here, I think it's really important not just to think about posture and the credibility of U.S. posture simply as how many boots we have on the ground, which I think is a really outdated metric, it's one that oftentimes our partners tend to look to, and I think we need to encourage them to move beyond that and emphasize both new types of capabilities that the United States can bring to bear and move forward to the Indo-Pacific region that make our military deterrence more credible, that make the value of the forces much more obvious.

And secondly, in terms of new ways of operating a more flexible --

SENATOR GOODWIN: Ms. Ford, I'm sorry to cut you off and I beg your pardon.

MS. FORD: That's all right.

SENATOR GOODWIN: Let's return to this in a moment, but see if we can get through some more --

MS. FORD: Sure. No problem.

SENATOR GOODWIN: -- commissioners' questions.

All right. Commissioner Kamphausen.

COMMISSIONER KAMPHAUSEN: Thank you all for just a terrific panel. Three quick questions. Two for you, Colonel Blasko.

The first is, you talk about Two Incompatibles, Two Inabilities, Two Big Gaps, Three Whethers, Five Incapables, and then we layer on that Xi Jinping's enjoiners delivered on multiple occasions to the PLA to fight and win wars. How do you reconcile that? Is there a

subtext or a backstory to that that would be important to understand? That's the first question.

The second is, given his personal imprint on this increased effort to train more realistically so that they can fight and win wars, is there a risk for him personally of being too closely identified with this? In other words, is he sitting alone at the -- on the CMC and he does not have allies in his uniform vice chairs of the CMC?

And for Ms. Ford, you've very effectively talked about the challenges to U.S. credibility in the region. I want to turn it a little bit.

You said there's a secular trend of intraregional balancing, the emergence of minilaterals, that is really not related -- it's a function of concern about the U.S. and worries about China, but it's not driven by either of those players.

To the extent that you can comment, to what degree is Xi himself worried about the emergence of independent intraregional balancing in the form of these minilaterals that are not necessarily driven by the U.S.?

How does that complicate his own thinking and decision-making? Thank you.

LTC BLASKO: Thank you.

Fight and Win was Xi's first slogan, literally, within months of him taking over the CMC.

I look at that as his solution to the operational readiness problem and realizing that they've got to do a whole lot more work to raise the unit's operational readiness capabilities to respond to the variety of challenges that they may face.

I see this fight and win very similar to slogans that we use in the United States military today such as to be -- in Korea, we say we're ready to fight tonight. Okay. That's the same -- to me, it's the same thing.

Back in the day when I was in Europe, it was win the first battle, train to be able to win the first battle.

I say that's basically what he's trying to get the PLA to do, to raise that operational readiness level.

Not necessarily that they can jump and wage a war of aggression, but at this point they're looking at to raise their deterrence level. That's how I read it.

Risk to Xi personally, one of the beauties of a long-term military modernization is that nobody is ever really responsible.

And if you set the date as 2035 -- anybody going to raise their hand? Is Xi going to still be around in 2035?

So, you know, when it comes -- the PLA holds a lot of folks responsible for a lot of things, but not necessarily on their rate of raising the military modernization.

If somebody really were to take responsibility, that would be a big change, in my opinion, but I don't see it, you know.

Again, this, to me, is the result of consensus building and collective leadership and that's the way I see it.

Xi certainly is a powerful figure, but when it comes to military topics, he's relying on the good judgment of the people that's around him and working to build consensus, as I see it from my open sources.

I'm willing to be corrected through -- with other new evidence.

COMMISSIONER KAMPHAUSEN: Ms. Ford.

MS. FORD: Great. Thank you.

So, on the question of to what extent is China or Xi Jinping concerned about some of this intraregional cooperation trend, I guess I would say two things.

One, I think obviously China does not like this trend. However, I think that when you look at the differences between Beijing's reaction to, let's say, for example, the renewed quadrilateral dialog and the response to, say, Australia and Japan doing more exercises together or Australia and India cooperating, there's a notable difference. And the difference there is the involvement of the United States.

And so, I think that Beijing calculates that in terms of minilateral cooperation, while it may not like it, at the same time, China can still remain the biggest player in the region and, therefore, have a degree of influence with regional partners that when suddenly it becomes minilateral cooperation with the United States involved, too, the calculus changes. And I think that's why you see a far more strident reaction.

SENATOR GOODWIN: Thank you.

Chairman Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you very much, and thank you to our witnesses.

I have questions for each of you and, at first, I thought they were really separate, but I think what they sort of are all tied together by is China's -- the progress in meeting its goals.

So, Colonel Blasko, I was really interested that you talked about this issue of problem show, but was thinking about the opposite of it because we know that, you know, when it comes to economic statistics, local governments, for example, will miraculously have statistics that meet the targets.

Is there an issue with some of these soldiers or leaders who are reporting in on progress in operational readiness that they might not have, because there is an expectation that they will be accomplishing these things? So, that's one.

Ms. Ford, I was interested that you were talking about how China sort of backs off when it gets some pushback, but actually they accomplished their goal. They have the artificial land.

And so, I guess I'm just trying -- I struggle to see that if they're pushing forward and then accomplish what they want, there is no cost to walking back.

I mean, if they were recalibrating, they would remove those artificial islands, and they aren't going to do that. So, I just would like a little bit more of your thinking on that.

And then, Dr. Doshi, on SWIFT, we have seen, over the years, that we have been surprised at the progress that China has made on things. I think weapon systems in particular.

And for a while, over the years, in this Commission, people would come and they would say, we're surprised that they have made this much progress in submarines or we're surprised -- and I said, the only thing that is surprising us is that we continue to be surprised.

So do you have any assessment of how far along they are in this alternative to SWIFT, because I'm not sure that people are paying attention to this and it could have really serious consequences?

So, Colonel Blasko, you want to start?

LTC BLASKO: Thank you.

Problem show, I think, is very interesting. I think it is the result of gaming the system.

They know what the commander is interested in, so they show the commander -- they give the commander what they want. I'm sure that's not unique to the PLA.

And so, they -- and, again, the reporting, there's quite a bit of reporting about this, but they repeat, well, we -- this unit over here, they learned -- this unit over here reported that we can't use night vision goggles, so we're going to report that, too, or things like that.

False reporting, again, I can't imagine a military, junior officers, mid-level officers

providing false reports to senior levels. Gee, I'm not surprised that happens.

Again, in the military, there's a term of art and it's cover your -- anyway, but it's -- I think there's a lot -- there's certainly a lot of that going on because the standards are being raised for them and training is hard.

And taking the shortcut -- taking the shortcut is one of the things that they talk about as a peacetime practice -- a bad peacetime practice.

They're trying to stop people from doing these things, but it's -- I'm sure it happens everywhere in the world and in militaries all over.

CHAIRMAN BARTHOLOMEW: So, is it that we really can't assess the progress they're making on operational readiness unless there's a conflict situation and we see it unrolling?

LTC BLASKO: Going to war is a good way to assess that, but as I say in the text, I'm sure they have, as we do, classified readiness reports and things like that. I certainly don't have access to them.

What I am saying is that what we need to do is take into account some of this -- some of these statements of their senior leaderships -- and, also, these are battalion commanders, company commanders, brigade commanders saying the same things.

What I would recommend is -- there's a lot of television out there showing them training. Take folks who have actually -- from -- they can be from our military, other militaries, but show them some of these films of some of this training.

And folks who have been out there and have done it can look at some of the training that's going on and say, oh, well, this is really -- well, this is really advanced or this is really rudimentary.

I think that's something that could be exploited, and that's the subjective nature of it. People who have done those kind of things look at the best evidence we've got because they're not inviting us to any of their exercises, as they did years ago, but they are showing a whole lot of exercises on television.

MS. FORD: Thank you. Two points.

One, on China achieving its goal, I think one thing that is actually important when we look at what's happening in the South China Sea, what's happening with the Belt and Road Initiative, is we have to think more broadly about what China's goal is.

I agree with you that China achieved a lot at no cost in the South China Sea. However, if the broader goal there is getting Southeast Asian claimants to give up their claims and to acknowledge China sovereignty, it hasn't happened.

And if the broader goal of BRI is really about sort of enhancing economic hegemony in the region, that also hasn't happened.

So I do think it is sometimes important to keep in mind that I don't think China has yet achieved its broad strategic goals.

However, the trend lines are not great here and I think that really we need to have different tactics on the U.S. side to address the fact that the tactics the Chinese use, I don't think we're meeting them in a very effective way.

So China is using what's often called gray zone coercion, right, and the challenge for the United States, I think, has, in particular, been we've often been too late to recognize what's happening. And at that point, you really can't impose sufficient costs.

So, I think the United States; one, has to be more proactive, identify in advance what we care about, what the red lines are.

And, second, I think we have to move much more quickly when China starts taking steps

to impose costs before it gets so late and so far down the road when there are islands. What are you going to do about it at that point?

DR. DOSHI: Thank you very much, Chairman.

I'd like to just begin by agreeing with my colleague, Ms. Ford, on the question of we should start with what China's objectives might be.

And with that in mind, when it comes to this alternative to SWIFT, I think the objective is twofold.

One is to bypass certain elements of American financial hegemony. That is the stated objective that you see in secondary Chinese literature on the subject.

It's hard to find diehard Party officials in the top institutions talking about it, but the secondary literature is quite clear.

The second objective that I see is to be able to cut off other states potentially in the future from a Chinese financial system.

The one thing I wanted to point out about SWIFT and about the Chinese system, is that they're different in fundamental ways.

SWIFT is simply a messaging system. As many of us may know, no money actually goes through SWIFT. It just allows the banks to talk to each other.

But in the case of the Chinese system, it will not only be capable of messaging, it will also be capable of clearance and settling.

If messaging is the road that gets you from Point A to Point B, clearance and settling is the product that you sell when you get to the end of that road.

What's interesting about this is we are seeing SWIFT engage with this particular trend.

In 2013 when China announced its interest in creating an alternative to SWIFT, it suggested that messaging would be a core part of it. SWIFT was concerned.

There's a lot of money that SWIFT makes off its ability to dominate interbank messaging, and of course our -- the United States and its allies gain a lot of strategic leverage from that.

SWIFT's solution was to try to embrace the Chinese and persuade them not to invest in messaging, but instead to invest in clearance and settling.

I'm not sure you're going to get a credible commitment from the Chinese on that question.

From what I understand, although we lack adequate open-source information on this, China has continued to invest in the technology and capabilities for its messaging system.

The point is at the end of the day when that messaging system is operational, what it will effectively mean is that banks can talk to each other through a language that's not necessarily one that SWIFT monitors or controls or executes. And that gives China the ability to bypass the dollar-based financial system accumulating -- rather, achieving the first objective.

As for the second objective, that's also going to happen. It doesn't necessarily need a SWIFT alternative to do that. It already has something that can sort of do that. That's called CNAPS.

I forget exactly what the acronym stands for because of the translation question, but the acronym is really about a Chinese equivalent to Fedwire.

In other words, when a company is doing business with China, they need to settle it, they do the clearance, and CNAPS takes care of that process.

So, by restricting who has the ability to access that, they can cut you off from the renminbi system.

Final point, as the renminbi becomes more popular in Asian trade, China's financial power will grow.

So, to answer your question, the progress is coming, but they can achieve the goals without being able to completely duplicate SWIFT. Thank you.

SENATOR GOODWIN: Commissioner Cleveland.

VICE CHAIRMAN CLEVELAND: Yeah. I'm not sure this hearing is what keeps Xi up at night, but rather what keeps us up at night.

(Laughter.)

VICE CHAIRMAN CLEVELAND: Thank you to all of you. It's really excellent presentations. My question is for Dr. Doshi. Two parts.

The first is, part of what BRI was about was to create export opportunities and economic opportunities for state-owned enterprises and to essentially export jobs for Chinese citizens.

So I'm interested in how you see those objectives which require big projects and large investments squaring with this declared intent to commit to smaller projects with higher quality. So that's part one.

And I'm also interested in what you see as -- I mean, Xi seems singularly invested in this.

I'm interested in what you see as political interest and/or opposition internally because we focused a lot on what -- Myanmar and the Maldives and your testimony addresses how other countries see BRI, but how do you perceive its support internally? Thank you.

DR. DOSHI: Thank you very much for those questions.

On the first question as for BRI's economic purposes to bolster China's economy, it's absolutely right that some have argued that BRI is about exporting China's surplus capacity.

One good test of that, though, would be just how much of China's surplus capacity can BRI actually absorb?

One of my colleagues at Brookings, David Dollar, has done a quick back-of-the-envelope calculation which shows that even if pretty much every BRI project was funded, it would barely absorb China's surplus steel capacity. And that's just steel.

In other words, there's a real question as to whether or not all that surplus capacity can really be exported easily.

Now, that, to me, suggests strategic motivations, but others disagree. What they say in response, is, no, BRI is about paying off individual corporations, individual SOEs.

I take issue with this view as well. I still tend to believe it's strategic. And one reason I believe that it's strategic is because BRI isn't really about BRI itself. BRI began before BRI was ever announced.

A lot of the port projects we're talking about today, a lot of the ones that are problematic, a lot of the ones that the PLA has actually said, we like that port project, those began well before Xi Jinping even took power, which suggests, again, strategic motivations.

Your question about how that's going to square with small project is an excellent question.

And in a way, it's because I don't believe that BRI, as a branding matter, actually matters. I believe it's the structure and actual projects that matter. I'm not too worried about it.

Because as long as China is investing in its major port projects, its major infrastructure initiatives, enough of those that are strategically valuable, the fact that it has to, in some cases, dial back ambitions won't be an issue that hinders strategic possibility. So that's how I think about it.

The second question about internal opposition, it's a great question and I only wish we had better insight to what exactly is going on inside the system.

As many of us know, there's some evidence that President Xi has faced some pushback

and that he may have been, you know, criticized by elders for being too assertive, perhaps, with the United States or provoking a trade war.

On the BRI question, all I can say is that a number of pro-business groups in China, private sector groups are upset about BRI and they're upset about China doubling down on SOEs.

Some of them will privately tell you that they welcome the trade war because it will push the reforms that they want.

So my argument here would be that to the extent there's opposition, maybe that's where it would come from. And many prominent leaders are saying -- it's easy to criticize foreign aid and they're making the same criticisms of Xi's BRI efforts. Thanks.

SENATOR GOODWIN: Commissioner Lewis.

COMMISSIONER LEWIS: In light of what China has done in the South China Seas with the islands that they're building and the reaction of the countries around those islands, what has the United States policy been in response to what China has been doing, and what should the United States' response be?

MS. FORD: Is that for me?

COMMISSIONER LEWIS: All three.

MS. FORD: Oh, okay. Happy to start here. Thank you. This is an important question.

My personal opinion is the United States right now is fundamentally lacking a strategy in the South China Sea.

I think that the speed and the scope of China's land reclamation campaign really caught the United States off guard.

By the time that the United States really came out in a significant way to note and criticize Chinese land reclamation, the reality is the islands were already 90 percent built.

And at that point, then, the United States started saying that, well, we would encourage, you know, China to sort of cease and desist and not pursue militarization; but at the point that they've built islands, it stretches the imagination to think that they're just going to leave them as large beaches in the middle of the South China Sea.

So, to me, the problem is the United States has sort of not identified since then what do we actually care about in the South China Sea and, therefore, what do we need to be doing?

The result is all that we're really doing at this point right now, is we're doing freedom of navigation operations.

Those operations are great, they're necessary, I think they send an important message about where the United States can operate, but they're not doing anything to change the fundamental situation in the South China Sea.

To me, the United States needs to be focusing far more on the relationships with the countries around the South China Sea, ensuring that they feel that they are free from coercion and, therefore, can maintain their own sovereignty and independence and don't have to back off their claims. That's, at the end of the day, what we ought to be preserving.

We can continue to sail, we can continue to talk about the islands if we want, but that doesn't really do anything.

Far more worrisome, I think, is the fact that you have countries like Vietnam who, for example, cannot even, you know, exploit energy in their own EEZs. And that when China prevents them from doing that, the United States really doesn't do a whole lot about it. We don't impose any costs on China when they take those actions. We ought to be.

Secondly, I think that you have actually very credible international legal ruling at this

point that if the United States is saying that we really believe in the rule of law, we ought to be doing far more to encourage Southeast Asian countries and partners around the world to uphold the force and the meaning of that ruling.

And the problem is that by the time that permanent arbitration ruling came out, the diplomatic response was pretty weak.

People nod to it now and then, but there's really not much of a cost on China for the fact that it doesn't have to adhere to that ruling at all.

So, I think the United States, if it wants to both preserve its relationships with Southeast Asian allies, bolster their own independence and make what we say about the rule of law meaningful, needs to start taking real steps in terms of imposing costs on China that freedom of navigation operations alone just simply won't do.

DR. DOSHI: Thank you very much. I'll just quickly interject with -- to build on Ms. Ford's comments and note that one way that cost and position would be most effective, is -- and this is a controversial notion -- we consider what kinds of weapons that these countries would necessarily need to better deter Chinese advances in the South China Sea.

There's been a lot of discussion over the last decade about will India/will India not sell certain anti-ship cruise missiles to Vietnam. The BrahMos especially, the world's second fastest antiship cruise missile.

I guess my view on this is that China seems to understand when we try to impose costs, and when those costs are credible, sometimes it changes policy.

A good example right now does appear to be the trade war. We're getting more concessions, in part, out of China than we ever have. And that's, in part, because of the tough line.

So, I wonder whether a similar line applied perhaps to the proliferation of certain anti-ship missiles would assist in this process. Thank you.

LTC BLASKO: I will defer to greater policy minds than I have, but I would just note we are in a spiraling security dilemma in the South China Sea.

And whatever we do, there's going to be Chinese response and pushback. And we need to consider that what we think we're doing as defensive, the Chinese will respond with what they think they're doing as defensive.

And without some sort of leadership to -- for an off-ramp, I don't see an end to that spiral, and what we're suggesting is increasing that spiral with all the countries in the region.

COMMISSIONER LEWIS: Thank you.

One follow-up question to that is, there's been very little discussion about Chinese leaders pushing back on the leader of China and, yet, you've all mentioned that there has been some discussion among the Chinese leadership pushing back a little bit.

What sources do you have when you realize that the leader's policies are not always followed or approved by everybody else, and what can we expect the impact of that would be on him?

LTC BLASKO: Speaking from the military side, the latest reforms have increased the powers of the Inspection and Discipline Committees.

And so, they're reaching down into the units looking at things not only for political loyalty and discipline, but also for training.

So just a much bigger eye on the force from the military perspective.

DR. DOSHI: Thank you. That's an excellent point.

I would just add that with respect to the evidence that we have of any kind of pushback,

the first is somewhat less credible.

Within a number of newspapers we see -- within the region we see Chinese academics and others who are dissatisfied with President Xi's rule telling us about what they've heard. So these are secondhand rumors suggesting that there's been pushback. We can only take that for what it's worth.

I'm a little bit skeptical that that pushback means very much because, in every political realm, Xi of course has centralized a good deal of authority.

And with the ability to sort of mount the anti-corruption campaign against opponents, it does seem like it would be very difficult for any opponents to collectively organize against him.

It's hard to do that when you're being monitored; it's hard to do that when you're being punished. Who would take the risk?

So, while there might be, you know, a consensus among certain older hands and certain patronage networks that he's overreached on Point A or Point B, whether they can do anything, I'm skeptical.

COMMISSIONER LEWIS: Thank you very much.

SENATOR GOODWIN: All right. Exercising the discretion of the chair, I'll ask our last round of questions here.

And to borrow a phrase, Doctor, I wonder whether the United States and our allies have our own learning curve with how to engage with a rising superpower in China.

And this really goes, Ms. Ford, to your responses to a couple of questions which is how best to engage, how to be reactive or proactive to impose costs before it's too late, and to impose costs for conduct that runs afoul of international norms or is seeking to change the international order in a way that best fits China's model and its ambitions.

Let me use a recent, perhaps, limited example to pose this question. Recently, Reuters reported that State Department reached out to our friends in Europe to discourage them from allowing the use of Huawei products in the deployment of 5G technology.

In the article, a spokesperson for a German business industry group said, I'm not sure we want to do that because it narrows the universe of potential bidders and vendors and, thereby, raising cost. And, of course, we fear if we do that, there will be Chinese retaliation. So what do we do?

And more broadly, to bring it back to the focus of this particular panel, what outreach or engagement do we need to exercise in the region to combat that skepticism, Ms. Ford, that you talked about in your written testimony, about our sustained commitment to our longtime partners there? And I'll open the question to the panel.

MS. FORD: Thank you.

It's an excellent question because I think it really is sort of the fundamental strategic question that's facing the United States right now in the Indo-Pacific region.

So do we have a learning curve? Yes, obviously we do. I think the United States is facing a far more formidable strategic competitor than we have in decades, and the reality is, is that competition is most intense in the Indo-Pacific though, as Dr. Doshi has said, it is growing, I think, in other regions as well.

So, to me, the United States and allies need to be thinking about three things that I would point out.

One is we need to be far more proactive about identifying our strategic priorities up front.

I am sometimes concerned that there seems to be a tendency to essentially chase China wherever it is headed. It creates a bit of a whack-a-mole feel to foreign policy.

And the reality is like with BRI, you're simply not going to be able to match China dollar for dollar, nor do we need to.

And far too often I think the tendency is almost kids with a soccer ball, everywhere that China pops up with a new project or a new port, everybody rushes over there.

The United States doesn't necessarily have vested strategic interest in all those places. So if we're reactive, it's a highly inefficient way of going about competing.

So one, sit down with our allies together, identify where we have priorities.

Two, think about how we can actually deconflict and better coordinate addressing those priorities because, in some cases, the United States can do it most effectively and, in other cases - for example, I would point to Australia in the Pacific, they're closer, they have more ties there, we ought to let them take the lead.

Second, the United States needs to think far more actively about how to impose nonmilitary costs.

We're, frankly, very used to turning to the military as the first and biggest tool that we have in our toolkit.

That's fine, and we absolutely should maintain our military deterrence in the Indo-Pacific, but where China is competing most effectively is not actually in the military realm. It's what it's doing on the economic side and diplomatically, and that's where I don't think we have figured out a very good toolkit to address coercion in those areas.

And third, I think that we have to get into what I would call a coalition mindset in the Indo-Pacific region that we have in places like Europe that we just haven't necessarily had for a long time.

The hub-and-spoke network that always sort of has the United States at the center, it creates a very sort of bilateral tendency.

So, the webs between those spokes, they're growing, but we're not used to turning to sort of a multilateral coalition response to something as the first way of going about doing business.

And there are challenges to this in the Indo-Pacific, you know, you brought up Huawei. This has been, in some ways, an easier thing for the United States to address in Europe than it has, at times, in the Indo-Pacific.

Japan, Australia, New Zealand are fairly aligned with the U.S. position here. India, South Korea less so. Certainly not in Southeast Asia.

So, there's a higher hurdle to how do you do things multilaterally and how do you get people on board with you in the Indo-Pacific that we haven't had elsewhere. And I think we need to sort of wrap our minds around that a little bit more.

DR. DOSHI: Thank you, Senator, for that great question.

I want to agree again with my colleague that we -- you know, we can't match China necessarily dollar for dollar or loan for loan. That kind of approach will probably bankrupt us before it bankrupts them. So, the question is how can we compete efficiently?

I think we compete on values, primarily. To me, the biggest obstacle to Belt and Road's success is the fact that it really does go against the self-interest of many of those countries.

When there's political corruption involved, when those projects are white elephants, when certain elected -- certain coalitions are gaining at the expense of other coalitions, that's a vulnerability for Belt and Road. So what do you do about that vulnerability? How do we harness it?

My view is multiple -- you know, the values that we need to emphasize are threefold. Transparency, number one; number two, accountability; and, number three, general -- general

agency, just the agency of these countries vis-a-vis the others, and we can compete on those without spending a lot of money.

Transparency is at some form of information operation, in a sense, one that's not necessarily Machiavellian or problematic, it just means people knowing what's happening in their own countries.

So, to that point, let me just note a few ideas to get a little more concrete rather than abstract.

I think that BRI, when it's unilateral, is dangerous to some countries; but when it's multilateralized, it's a lot less so.

Multilateralizing it gives people -- there's more veto points, there's more information about what's going on, there's more chances to shape it, and I give you an example of this too, actually.

The first is AIB. We know that when China tried to launch AIB, its actual first vision of it was a naked instrument of economic statecraft.

That's not quite what happened, in part, because lots of European and Asian states joined and it became harder for China to get away with that. The same thing is true for BRI. I think the more states that joined it, the better.

Second -- and specifically the more allies that join, and they don't have to participate in every project, they don't have to endorse the initiative, but if they're co-investing or they have a veto power over some of the initiative, it will shape it.

Second, I'll just note that certain values like a free press, free internet and just simply reporting our own media being able to report in a developing world makes a difference.

And, as an example, not necessarily of our journalists, but just of our own rule of law having an impact.

Again, look at Malaysia. When it became clear the extent of the corruption and possible degree of Chinese involvement, it changed things in that region.

Finally, I would just say that we should continue to help train countries in making these decisions. And this is especially true as BRI goes global.

We know, for example, that some of our colleagues in other parts of the world are not experienced dealing with the Chinese.

This is true in Latin America, this is true in parts of Africa, it's true in parts of Central and Eastern Europe.

Training these colleagues and getting them to better understand the risks and stakes involved will make it easier for us to win the long game of influence competition.

And the final point I'll make is simply that, you know, BRI is at a weak point right now. We've talked a lot about resilience; we've also talked a lot about weaknesses.

BRI is at a weak point, so this is the time for the United States to put forward not just a competing financial alternative, but a competing conceptual alternative, one that competes on values and basically is able to undermine it while it's weak. Thanks.

LTC BLASKO: And very briefly, I will agree with my colleagues that we need to expand our nonmilitary options and capabilities because China is using primarily nonmilitary means to reach its national objectives, specifically with regard to the BRI.

You can't beat something with nothing, so we've got to be able to offer something if we think that challenging the BRI is the way to go.

SENATOR GOODWIN: Thank you, Colonel, and thanks -- my thanks to the entire panel. Very interesting session. So, thank you. We'll stand adjourned.

(Whereupon, the above-entitled matter went off the record at 3:06 p.m.)

PUBLIC COMMENT FOR THE RECORD

Submitted via email by Jean Public on February 2, 2019

public comment for the meeting since i cannot attend in person

i believe china is an enemy of the usa and has an alliance with north korea so that we are in peril in the usa. i see that china is constantly trying to expand all over the world. comes here and they steal our secrets in attempt to make us weak. i am not in favor of any chinese students coming to america for education. i think they represent a real threat to america. i think we should try to have russia as an ally because china has world domination issues. they want to be no 1. they have not been fair at all ever in dealing with our country. not ever imo. This comment is for the public record. please receipt. jean public1@gmail.com