

HEARING ON U.S.-CHINA RELATIONS IN 2019: A YEAR IN REVIEW

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

ONE HUNDRED SIXTEENTH CONGRESS
FIRST SESSION

WEDNESDAY, SEPTEMBER 4, 2019

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UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW
COMMISSION

WASHINGTON: 2019

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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 No. 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.

September 13, 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 September 4, 2019 public hearing on "U.S.-China Relations in 2019: A Year in Review." 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: Victor Shih, Ho Miu Lam Chair in China and Pacific Relations, Associate Professor, UC San Diego School of Global Policy and Strategy; Andrew Polk, Co-Founder, Trivium China; Elizabeth Economy, C.V. Starr Senior Fellow and Director for Asia Studies, Council on Foreign Relations; Oriana Skylar Mastro, Resident Scholar, American Enterprise Institute; Assistant Professor of Security Studies, Edmund A. Walsh School of Foreign Service, Georgetown University; Andrew Krepinevich Jr., Senior Fellow, Hudson Institute; Adjunct Senior Fellow, Center for a New American Security; President and COO, Solarium LLC; Michael Green, Senior Vice President for Asia and Japan Chair, Center for Strategic and International Studies; Director, Asian Studies, Edmund A. Walsh School of Foreign Service, Georgetown University; Bonnie Glaser, Senior Adviser for Asia and Director, China Power Project, Center for Strategic and International Studies; Syaru Shirley Lin, Lecturer, Politics, University of Virginia; Adjunct Associate Professor, Global Political Economy, Chinese University of Hong Kong; and Victoria Tin-bor Hui, Associate Professor, University of Notre Dame Department of Political Science. The hearing reviewed key developments in the U.S.-China relationship in 2019. Panel 1 evaluated developments in China's political economy and the impact of U.S.-China trade frictions on the Chinese economy. Panel 2 assessed the implications of Chinese military activities and modernization in 2019 for the United States and U.S. allies and partners. Panel 3 reviewed the implications of economic, political, and security developments between China and Taiwan for regional security, and explore the escalating situation in Hong Kong.

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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U.S.-CHINA RELATIONS IN 2019: A YEAR IN REVIEW

WEDNESDAY, SEPTEMBER 4, 2019

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, DC

The Commission met in Room 419 of Dirksen Senate Office Building, Washington, DC at 9:30 a.m., Vice Chairman Robin Cleveland and Commissioner Jeffrey Fiedler (Hearing Co-Chairs) presiding.

OPENING STATEMENT OF COMMISSIONER FIEDLER HEARING CO-CHAIR

COMMISSIONER FIEDLER: Good morning and welcome to the last hearing of the U.S.-China Economic and Security Review Commission's 2019 annual report cycle. Thank you all for joining us today.

Our hearing today will review and assess key developments in the economic and security dimensions of the U.S.-China relationship in 2019. And examine China's relations with Taiwan and Hong Kong.

The Commission began its hearings this year, which marks the 40th anniversary of the establishment of U.S.-China diplomatic relations, by examining 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 has been one of extreme volatility in the relationship between the U.S. and China. Change and unpredictability have been so significant since we began our hearings this year that Commissioners thought it would be valuable to revisit and explore some key topics in the economic and security realms.

There is an increasing amount of commentary in foreign policy, in the foreign policy community, conjecturing about the likelihood that the relationship between the U.S. and China is undergoing permanent change.

This commentary further characterizes China as a rival, having upgraded it from a competitor. The word enemy is less frequently used but is not absent.

The previous assumptions underlying U.S. policy, such as the current international order benefits China, and capitalism brings with it democracy, have been shattered and abandoned, even by those who fervently advocated them. It seems to me these false assumptions have yet to be replaced by more realistic ones.

Our goal today is to catch up on the facts about important developments and hopefully gain some insights about how to craft and navigate what would clearly be a new and different relationship between the United States and China. I look forward to today's expert witnesses and thank them for coming.

In addition, I would like to thank the Senate Foreign Relations Committee for securing this room for us today. I'll now turn the floor over to my colleague, and Co-Chair for this

hearing, Vice Chairman Robin Cleveland. Thank you.

PREPARED STATEMENT OF COMMISSIONER FIEDLER HEARING CO-CHAIR

Good morning, and welcome to the last hearing of the U.S.-China Economic and Security Review Commission's 2019 Annual Report cycle. Thank you all for joining us today. Our hearing today will review and assess key developments in the economic and security dimensions of the U.S.-China relationship in 2019, and examine China's relations with Taiwan and Hong Kong.

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I look forward to hearing today's expert witnesses, and thank them for being here to share their expertise with us. In addition, I would like to thank the Senate Foreign Relations 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, Vice Chairman Robin Cleveland.

OPENING STATEMENT OF VICE CHAIRMAN CLEVELAND HEARING CO-CHAIR

VICE CHAIRMAN CLEVELAND: And good morning. My statement is a little longer than Commissioner Fiedler's in part because it's about Hong Kong and I have very strong views.

When the Hong Kong Special Administrative Region was established in law under the principle of "one country, two systems," Beijing authorities explicitly guaranteed a high degree of political, economic, legal and financial autonomy. The Basic Law, which has governed Hong Kong since 1997, unequivocally protected freedom of movement, conscience, communications, and privacy; indeed, the term "inviolable" was applied to assurances that no citizen would be subject to unlawful arrest, detention or imprisonment. Perhaps most importantly, Beijing pledged Hong Kong citizens would enjoy universal suffrage in the selection of their political leadership. Hong Kong's citizens trusted that democratic elections would be the ultimate guardian of their human and political rights.

Beijing has reversed, denied, and delayed each of its legal commitments bringing millions of Hong Kong's citizens into the streets. In the past few months, over 1,100 people have been arrested for exercising their legal rights. Now, Beijing and its appointed leaders are falsely blaming and attacking the victims of its surveillance and strangulation policy. Chief Executive Carrie Lam acknowledges her government decisions have created havoc, yet claims she is not free to resign, further demonstrating Beijing's controlling role. While I am pleased that she has acknowledged that the extradition bill should be and will be withdrawn, four key demands remain unaddressed. There needs to be an independent police investigation, not one run by the police; there needs to be the removal of the designation of riot for people who are legally protesting; universal suffrage; and then freeing the detainees. This morning she recognized the time had come to withdraw the bill which provoked so much concern, which is very much appreciated, however, the facts on the ground remain challenging. I want to clearly state my support for the demonstrators' remaining compelling concerns: accelerating the Basic Law's commitment to universal suffrage; an independent investigation into police actions; release of all political detainees; and relief from any charges of "rioting" which carry serious and disproportionate penalties for citizens exercising their rights and freedom of speech.

When Congress passed the Hong Kong Policy Act, it memorialized China's obligations with every hope Hong Kong would establish a model that would encourage political and economic liberalization on the mainland. Under the Act, Hong Kong enjoys special standing with trade, investment, economic and political benefits which redound to Beijing's advantage. Hong Kong is a critical financial and trade gateway providing Beijing access to investors in mainland bonds, lending to mainland businesses, and serving as the largest off-shore clearing center for the RMB as well as channeling foreign direct investment in and out of China. Hong Kong has become the destination of choice for IPOs, surpassing New York, raising \$36 billion in 2018. Over 1,000 mainland companies with market capitalization of \$2.6 trillion are listed on the Hong Kong Exchange. They choose HK because there is no rule of law on the mainland to protect their interests. Because of a long history of good governance, ease of doing business and sound judicial institutions, nearly 4,000 companies have regional headquarters in Hong Kong, including 1,400 U.S. enterprises. Beijing's actions not only threaten the freedom, safety and well-being of Hong Kong's citizens; the autonomy and viability of Hong Kong's active and important role in global banking, finance and investment is in peril.

As tension escalates, the Congress and Administration will face a difficult challenge in

assessing the threshold for revoking Hong Kong's special status. I am hopeful today's witnesses will help define the conditions which might warrant changes in U.S. policy and what options are available to support the protection of Hong Kong's autonomy and civil liberties. For example, the Basic Law gives citizens the right to institute legal proceedings against the Chief Executive if freedoms are violated. Is there legal or technical assistance we should make available to support such an effort?

Perhaps none have watched the recent developments in Hong Kong with as much concern as the people of Taiwan. The concept of "one country, two systems" was originally intended to serve as a framework for a future unification agreement between Taiwan and the Chinese mainland. Unsurprisingly, politicians from both Taiwan's major parties as well as the vast majority of Taiwan's citizens have rejected this formula for unification. In fact, most people in Taiwan today view themselves as "Taiwanese" rather than "Chinese," and younger generations are growing more concerned about what unification with the increasingly authoritarian mainland would bring.

The Taiwan Relations Act, passed with overwhelming bipartisan support 40 years ago, provided the legal foundation for strong ties with Taiwan. The Act established "Any effort to determine the future of Taiwan by other than peaceful means," including through coercion, would constitute a threat to regional security and be a matter of "grave concern" to the United States. Over the past four decades, these provisions along with U.S. arms sales, have contributed to peace and stability in the Taiwan Strait and in the broader Indo-Pacific region.

This year, we have seen China carry out a series of provocative military maneuvers in the airspace and waters near Taiwan, which potentially threaten this stability. In March, warplanes of China's People's Liberation Army crossed the median line in the Taiwan Strait for the first time in 20 years. In July, China conducted simultaneous military exercises in multiple locations near Taiwan for the first time since the 1995-1996 Taiwan Strait Crisis. A new Chinese white paper issued this year reiterated Beijing's refusal to renounce its right to use force to resolve its disputes with Taipei and indicated that Chinese naval operations and flights encircling Taiwan would become an official tool of national policy. Beijing has also tried to interfere with Taiwan's upcoming 2020 presidential elections by swaying media coverage in a pro-China direction and pressuring Taiwan's business community to support its preferred candidates.

In the economic sphere, Beijing leverages the fact that Taiwan remains deeply dependent on the Mainland for its economic prosperity. Taiwan's leaders seek to diversify the island's economy and expand its international links but are constrained by China's success at bullying other countries into avoiding such partnerships. China has also weaponized cross-Strait tourism flows in an attempt to damage Taiwan's economy.

We are at a critical crossroads with our friends and allies, especially in East Asia, with difficult choices ahead. To be clear, this is not a choice between the United States and China. Rather, we must join friends and allies to support nations which respect civil liberties, human rights and the rules of free, fair trading systems or we default to authoritarian political systems with self-serving, imperial economic ambitions.

I would like to take this opportunity to highlight the Commission's work monitoring U.S.-China affairs to inform Congress. In November we will publish our Annual Report, which provides a comprehensive assessment of the state of the U.S.-China relationship as well as policy recommendations for Congress.

And with that, I will turn to introducing the fabulous first panel, who I hope are not shell shocked by the comments. Carolyn, would you like to say anything on Hong Kong?

CHAIRMAN BARTHOLOMEW: No.

PREPARED STATEMENT OF VICE CHAIRMAN CLEVELAND HEARING CO-CHAIR

When the Hong Kong Special Administrative Region was established in law under the principle of “one country, two systems,” Beijing authorities explicitly guaranteed a high degree of political, economic, legal and financial autonomy. The Basic Law, which has governed Hong Kong since 1997, unequivocally protected freedom of movement, conscience, communications, and privacy; indeed, the term “inviolable” was applied to assurances that no citizen would be subject to unlawful arrest, detention or imprisonment. Perhaps most importantly, Beijing pledged Hong Kong citizens would enjoy universal suffrage in the selection of their political leadership. Hong Kong’s citizens trusted that democratic elections would be the ultimate guardian of their human and political rights.

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PANEL I INTRODUCTION BY VICE CHAIRMAN CLEVELAND

VICE CHAIRMAN CLEVELAND: Okay. We'll start with Dr. Victor Shih, who is the Ho Miu Lam Chair in China and Pacific Relations and associate professor of political science at the University of California San Diego School of Global Policy and Strategy.

A scholar of China's political economy, Dr. Shih has published widely on the politics of Chinese banking policies, fiscal policies and exchange rates.

Next we will hear from Mr. Andrew Polk, who is the co-founder of Trivium China, a China focused macroeconomic research and business advisory firm.

Mr. Polk was previously the director of China Research at Medley Global Advisors and a resident China economist at the Conference Board's China Center, where he co-authored the report, the Long, Soft Fall in Chinese Growth.

Finally we will hear from Dr. Elizabeth Economy, a frequent witness and always terrific, who is the C.V. Starr senior fellow and director for Asia studies at the Council on Foreign Relations.

Dr. Economy is an acclaimed author and expert on Chinese domestic and foreign policy, who mostly recently published the excellent book, the Third Revolution: Xi Jinping and the New Chinese State.

I ask all our witnesses to keep your remarks to seven minutes. And, Dr. Shih, we'll start with you.

OPENING STATEMENT OF VICTOR SHIH, HO MIU LAM CHAIR IN CHINA AND PACIFIC RELATIONS, ASSOCIATE PROFESSOR, UC SAN DIEGO SCHOOL OF GLOBAL POLICY AND STRATEGY

DR. SHIH: Great. So, thank you, Commissioner Cleveland and Commissioner Fiedler, for inviting me here.

So, I'm going to talk first about the economic impact of the trade conflict in China. And then I'm going to talk about continuing state intervention in China's economy, and then finally I have some thoughts on policy recommendations.

So, first of all, the trade conflict that China has engaged with the U.S. has had an impact on China's economy across the broad spectrum, according to the latest data, which would come from July of this year.

It has lowered the growth of China's exports overall to close to zero, and has depressed its export to the United States to negative in absolute terms. So this is pretty striking considering that China has grown its export to the U.S. pretty much non-stop since the 1980s.

Investors, more importantly, I think investors slowed their investment in trade-intensive sectors, especially in the behemoth electrical machinery sector, which includes anything from washing machines to IT equipment.

And investment in that sector saw a decline by close to ten percent year to date. From January to July. Relative to January to July of last year.

Finally, the latest data shows that Chinese firms now are facing drastically lower pricing power than was the case before. In both consumer durables and in the IT equipment sectors, we have seen negative growth in wholesale prices.

And this is seen in the latest report on PPI, the producer manager index, price index, compared to a year ago.

Meanwhile, of course, the debt level of Chinese companies continue to rise pretty rapidly, which means that many firms are now trapped in a scissors between declining per unit revenue and high debt. And all the interest payments that you have to pay when you have high debt.

So, I would say the impact to trade war on Chinese economy is worsening over time. And so that, this provides some incentives at least for the Chinese government to come to the negotiations table.

In terms of additional headwinds of course, local governments in China continue to be highly indebted, which means the banking sector has to provide a lot of credit so that they can roll over all of this, most of which is sort of bad debt, and then I can get into that in Q&A.

Despite these economic challenges however, the increasingly draconian repression of dissent and the extensive internal party purges that Xi Jinping has carried out, means that most of the signs we've seen suggest a continual tight reign of Xi Jinping within the Chinese Communist party.

There is some slight changes recent, very, very recently, with him sort of seemingly backing down on, at least a little bit, on the issue of Hong Kong. But by and large, all the signs still suggest that he is pretty strictly in control.

Okay, so, in terms of continual intervention in the economy, there are no signs that the Chinese government is withdrawing from the economy. If anything, they're intensifying their intervention in the economy.

The three major channels that I've seen is through bankruptcy, through overseas investment, and through lending. Domestic lending.

Bankruptcies, a lot of Chinese firms are in trouble, as I indicated before, but the Chinese government are basically telling banks to keep lending to them so that they don't go bankrupt.

A lot of Chinese households and companies would like to invest overseas, but the Chinese government has ordered many of these companies to liquidate their assets and bring the money back to China because the Foreign Exchange Reserve have been drained in recent years.

Banks in China would like to lend more money to the real estate sector, but the Chinese government has forbade them from doing that and instead are channeling lending to industrial policies. So, industrial policies looms very large still.

Finally, I think China has weaponized its currency as we have seen. The Renminbi has weakened passed seven to \$1.00 in recent weeks.

Overall in the past couple of months, Renminbi has weakened by four percent, vis-a-vis the dollar, which is one of the largest moves that we've seen in recent years.

But this actually, not only is it a problem for China, of course China, the problem there is that investors in China may lose confidence in the Renminbi and move money out of China drastically which will wipe out its foreign exchange reserve.

But this is potentially a problem for the United States because U.S. banks, U.S. financial institutions have exposures to China to the tune of hundreds of billions of dollars, directly and indirectly.

Banks in the United States have loaned close to \$100 billion to Chinese institutions. Institutions in the U.S. have bought, I don't know the exact number but I would guess \$50 to \$100 billion in debt issued by Chinese corporations. And if their currency were to devalue very drastically, then the stature of a lot of these loans become unclear.

Chinese companies whose cash flows are denominated in Renminbi, some of them may be forced into defaulting on their obligations. So, I think a thorough edit of the direct and indirect exposures of major U.S. institutions to the Renminbi I think would be a very timely thing. Just to make sure that if the Renminbi were to crash suddenly that major U.S. institutions would not get into trouble.

Finally, to combat Chinese industrial policies and technology theft, the U.S. will need to increase multilateral efforts to increase transparency on China's financial subsidies to the technology sector.

As I indicated previously, it's still very substantial. Here, perhaps, the IMF can help.

And then finally, it should coordinate with close allies to police technology acquisitions by authoritarian countries and to set best practices for internet and cyber security with our allies. Thank you very much and I welcome any questions.

**PREPARED STATEMENT OF VICTOR SHIH, HO MIU LAM CHAIR IN CHINA AND
PACIFIC RELATIONS, ASSOCIATE PROFESSOR, UC SAN DIEGO SCHOOL OF
GLOBAL POLICY AND STRATEGY**

Victor Shih

Ho Miu Lam Chair Associate Professor at the School of Global Policy and Strategy, UC San Diego

Testimony before the U.S.-China Economic and Security Review Commission

“U.S.-China Relations in 2019: A Year in Review”

September 4, 2019

Summary:

- The trade conflict has impacted China’s economy across a broad spectrum. It has lowered the growth of China’s exports to close to zero and has depressed its exports to the U.S. in absolute terms.
- Investors have also slowed their investment in trade-intensive sectors, especially in the behemoth electrical machinery sector, which saw investment decline by close to 10%.
- Chinese firms also are facing drastically lower pricing power. Both consumer durables and IT equipment are seeing negative growth in wholesale prices, compared to a year ago. Meanwhile, the debt level of Chinese corporations continues to rise rapidly, which means many firms are trapped between declining per unit revenue and high debt.
- The Chinese economy is also seeing additional headwinds from its high level of local debt, estimated by Chinese economists to be 66% of GDP. In an attempt to slow the growth of debt, infrastructure investment growth has fallen to the single digits. This situation is unlikely to reverse.
- Still, due to increasingly draconian repression of dissent and extensive purges within the ruling Chinese Communist Party in the past six years, Xi Jinping remains the undisputed leader of China. It would take a truly massive economic shock to threaten his power.
- Further slow-down in the economy and continued protests in Hong Kong likely will give rise to internal debates in the upper echelon of the CCP. This will force Xi to choose distinctive actions in these highly contentious debates.
- In recent years, China has increased the level and breadth of state intervention in its economy. Bankruptcy, overseas investment, and lending are now placed under much stricter state control than had been the case five years ago. This trend is unlikely to reverse in the near future as China grapples with mounting debt and the trade war.
- China has weaponized its currency by weakening it vis-a-vis the dollar. A by-product of devaluation is that it will increase the credit risk of Chinese debtors, who have cash flows and collateral mainly denominated in RMB but have borrowed close to 3 trillion dollars from foreign lenders and counterparties. The U.S. needs to require banks, as well as large pension and mutual funds, to carry out thorough audits of their exposure to RMB denominated assets and guarantees so as to reduce exposures to devaluation risks.
- To combat Chinese industrial policies and technology theft, the U.S. will need to increase multi-lateral efforts to increase transparency on China’s financial subsidies to technology sectors. It also should coordinate with close allies to police technology acquisition by authoritarian countries. However, complete economic decoupling is neither necessary nor desirable, even in the context of heightened competition between the two countries.

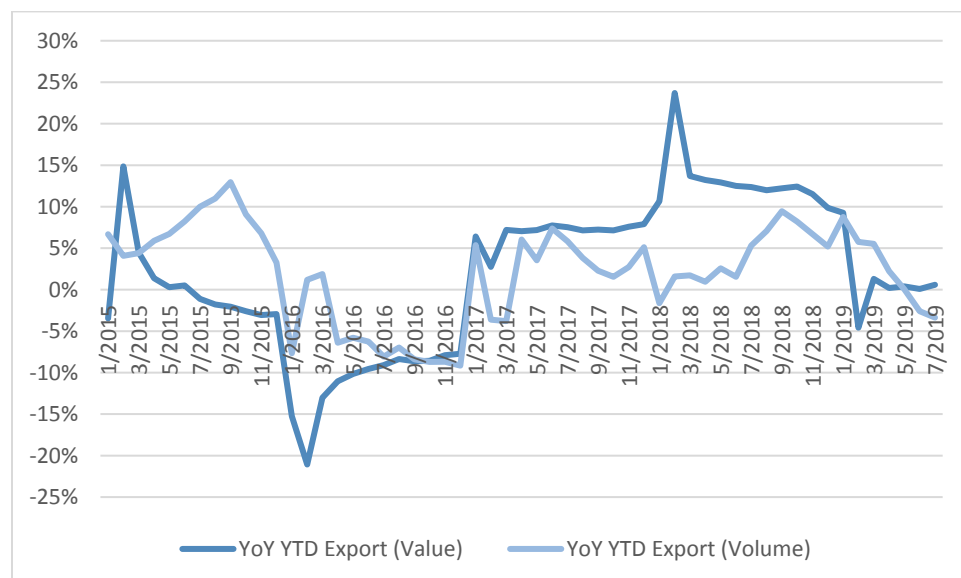
Impact of U.S.-China trade frictions on the Chinese economy in 2019

The trade friction with the U.S. has impacted China's exports, investment in export-intensive sectors, and the pricing power of export-oriented industries. First, going into 2019, one sees a visible slow-down in the growth of Chinese exports overall, and especially to the U.S., which is still China's largest single export market. **Figure 1 shows that China's overall export growth has fallen to zero in value and to negative territory in volume (Euromoney Institutional Investor PLC 2018).** Figure 2 also shows that **Chinese exports to the U.S. have largely been in negative territory in 2019. Chinese exports to Asia picked up somewhat into mid-year, probably reflecting some Chinese exports which are being trans-shipped to the U.S. via other Asian countries.**

The much more significant impact of the trade frictions on China's economy has been in the dramatic decline in investment growth in major export sectors such as electrical machinery and IT components. Investment in the production of electrical machinery looks like it is heading toward a -10% decline in investment by the end of this year. This represents a potential loss of \$20-30 billion in capital formation in China's economy in the machinery sector alone. Interestingly, **Figure 3 shows that although investment in computer and IT equipment had headed toward negative territory at the beginning of the year, it has rebounded, but still at a lower level than in 2017 and 2018. The rebound was likely due to state intervention to prevent investment in that sector from collapsing.** The continuation of the trade conflict will further depress investment in these trade intensive sectors and drive technology related investment to other countries.

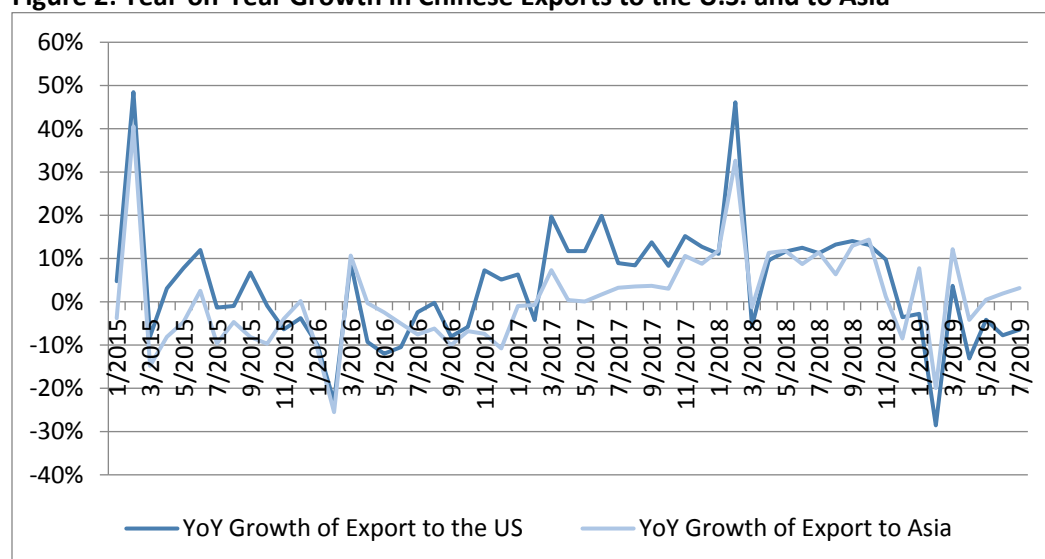
Finally, the trade frictions are likely having a negative impact on the pricing power of Chinese firms, especially in export intensive industries such as consumer durables and in IT equipment. **Figure 4 reports that producer managers are seeing negative price growth for the wholesale prices of consumer durables and computers and IT equipment.** The weak pricing power is consistent with a drop-off in exports in export intensive industries. The negative price growth also suggests that some export firms may be lowering wholesale prices in order to counteract the impact of the tariffs. This produces a negative feedback loop for Chinese firms because as their pricing power weakens, they still need to pay interest on outstanding debt and also increase wages due to high consumer inflation driven by high food prices. This will potentially force many firms in export industries to go bankrupt, especially if prices were to decline further as they did in 2014.

Figure 1: Year-on-Year, Year-to-Date Change in Chinese Exports in Value (USD) and Exports in Volume (mt)



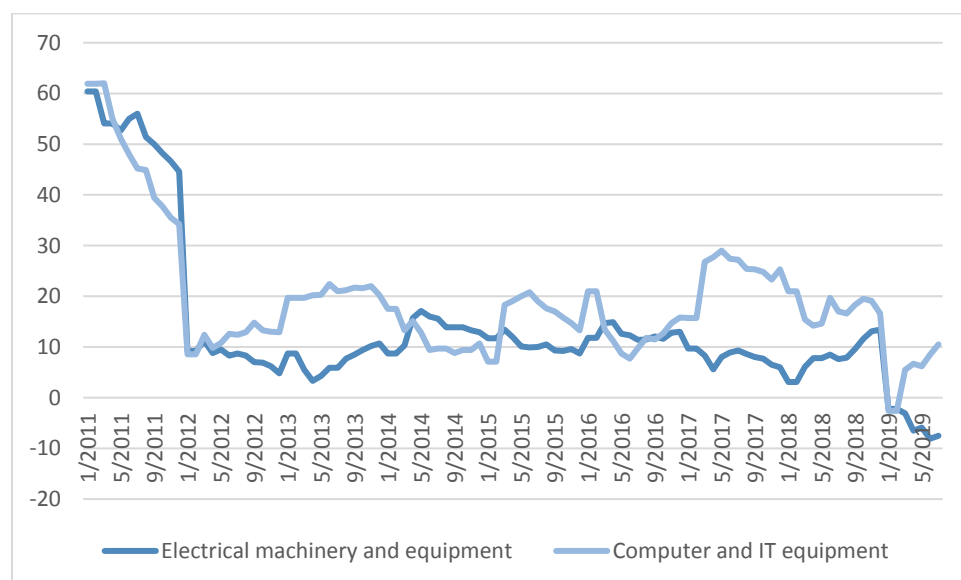
Source: Euromoney Institutional Investor PLC.

Figure 2: Year-on-Year Growth in Chinese Exports to the U.S. and to Asia



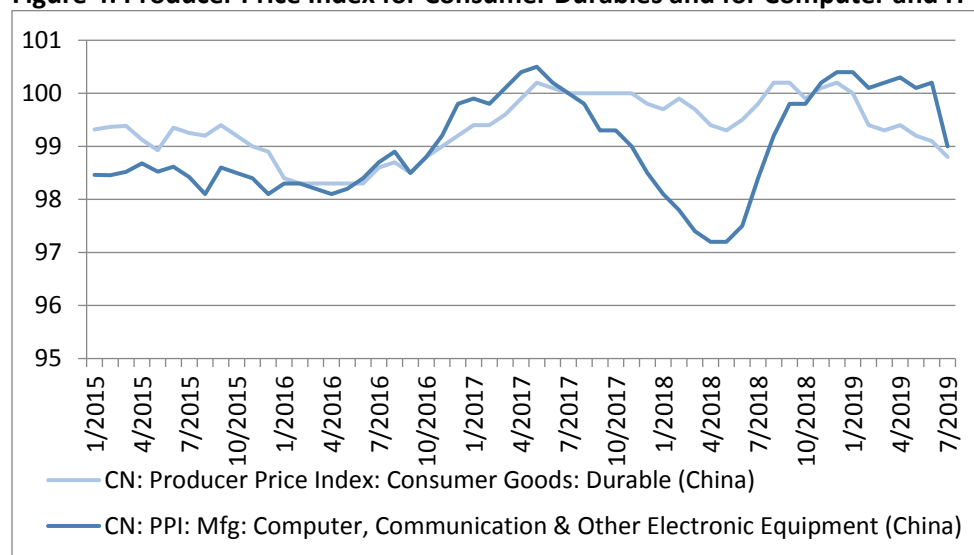
Source: Euromoney Institutional Investor PLC.

Figure 3: Year-on-Year, Year-to-Date Increase in Investment in Electrical Machinery/Equipment and Computer/ IT Equipment



Source: Euromoney Institutional Investor PLC.

Figure 4: Producer Price Index for Consumer Durables and for Computer and IT Equipment

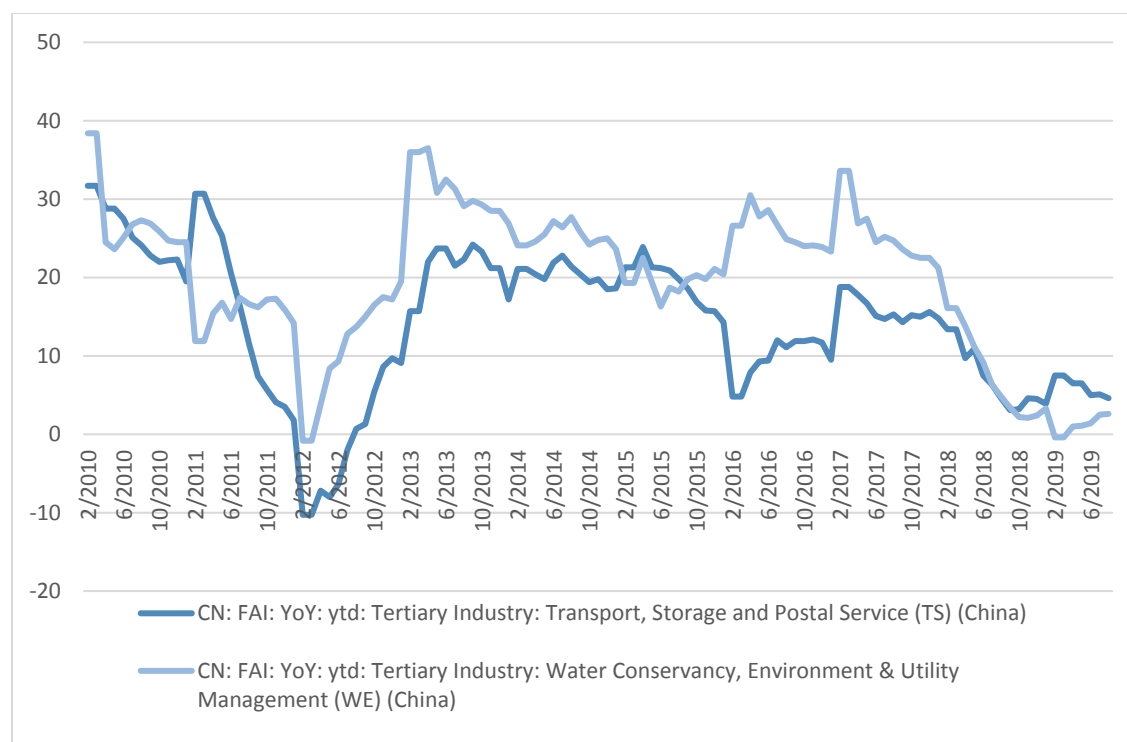


Source: Euromoney Institutional Investor PLC.

China's high debt level, especially among local governments, also has led to a slow-down in investment, which has created economic headwinds for China's economy. Essentially, due to excessively high local debt, estimated to be around 66% of nominal GDP in 2015, the Chinese government began a campaign to slow the pace of leveraging (Bai et al. 2016). **Figure 5 shows that the increase in infrastructure investment has slowed to the low single-digits by mid-2019 from the 20-30% range.** This constitutes a

major blow to China's growth engine. On top of that, the trade war has slowed exports and investment in export intensive industries.

Figure 5: Year-on-Year, Year-to-Date Growth in Investment in Transportation Infrastructure and Water/Environmental Infrastructure



Source: Euromoney Institutional Investor PLC.

Impact of economic challenges on CCP rule and economic policymaking

For now, CCP rule seems robust due to the party's extensive control over the media, education institutions, the economy, and ultimately the police and the army. The past few years have seen even more draconian policies imposed on civil society, the private sector, and ethnic minorities, including the incarceration of over one million Uyghurs in re-education camps and continual crackdown on rights advocates. Also, the party now is under the relatively unified control of Xi Jinping after six years of internal party purges. However, the trade war with the U.S. and especially the protests in Hong Kong may have provided opportunities for internal debates and disagreement within the upper echelon of the CCP to emerge. As economic losses mount in China, divergent camps will emerge urging Xi to pursue different levels of economic stimulus. For now, it seems the camp urging a moderate degree of stimulus has won the debate, but further slow-down will intensify pressure for a larger stimulus. On the issue of Hong Kong, debates doubtless have emerged on whether to pursue a hardline course of action there or not. Again, so far, the moderates seem to have Xi's ears.

Both high domestic debt and trade frictions with the U.S. have led to *increasing state intervention in the Chinese economy*. In order to prevent a financial crisis, increase credit growth, and pursue

industrial policies, *China must increase the degree of state intervention because the market now acts against the desires of the party in many instances.* The Chinese government is increasingly afraid of a debt crisis, so instead of allowing the market to force thousands of firms to go bankrupt, the government, especially the China Banking and Insurance Regulatory Commission and the People's Bank of China, have directly taken over major companies thought to be in danger of defaulting on creditors. Anbang Group, which went on a buying spree in the U.S., was placed under CBIRC receivership last year. CBIRC officials currently chair hundreds if not thousands of credit committees overseeing the restructuring of debt for thousands of Chinese companies, including local government financing vehicles. Creditors have been forced to extend credit to many major debtors in order to prevent bankruptcies. Local governments in China have expended billions to bail out companies which borrowed too much using company shares as collateral. After the bailout, however, local governments have become de facto owners of hundreds of previously private companies.

China continues to prevent Chinese firms and citizens from reallocating their investment toward overseas assets. Again, here the market would like to invest much more overseas to hedge against political risks and devaluation risks, as shown in the massive capital flight China saw in 2015. However, the draw-down of the foreign exchange reserve would undermine the continual rule of the CCP, so the party cannot tolerate it. Consequentially, capital control has become much more draconian for firms and for individuals. Although Chinese citizens can legally still convert 50,000 USD from RMB to the dollar per year, they now have to fill out an extensive form stating the purpose of their conversion. Most would find it difficult to convert more than 20,000 USD for tourism and overseas purchases.

Finally, China continues to pursue very aggressive industrial policies by giving banks political incentives to lend to firms in sectors prioritized by the Chinese government and by lending to sectoral guidance funds (Zenglein and Holzmann 2019). Here again, the government is working against the market. Banks and investment funds would like to provide more capital to the real estate sector, which remains the most profitable one overall. However, the government does not want all the money it prints to go into real estate, so it has ordered banks to limit the share of new credit going to real estate and increase credit for high technology sectors.

Implications of RMB devaluation for the United States

With the RMB falling to decade-lows vis-a-vis the dollar in recent weeks, the Chinese government seems to have weaponized its currency in the conflict with the U.S. However, this weaponization has its limits and will be costly for China's other strategic plans. First, because Chinese debtors owe international creditors close to 3 trillion USD in debt, devaluation means they would need greater RMB cash flows to meet their repayments. Lower dollar interest rates have made this an easier process, but if devaluation were to exceed 5%, which seems likely, these debtors may run into repayment difficulties. The faster devaluation occurs, the more debtors will seek to convert their RMB into dollars in an attempt to limit their losses, which would cause a rapid drainage in China's foreign exchange reserve. If devaluation were to continue, the Chinese government may not allow Chinese debtors to obtain dollars, forcing them to default on their international creditors, perhaps with a special focus on U.S. banks.

According to the Bank for International Settlements, U.S. banks have claims over roughly 180 billion dollars in mainland China and Hong Kong liabilities (BIS 2019). U.S.-based pension and mutual funds own additional billions in bonds issued by Chinese entities, whose cash flows are dominated by RMB. The true exposures may be substantially higher due to extensive Chinese borrowing from overseas locations and cross guarantees. U.S. financial authorities should urge the global banking community,

but especially U.S. banks and large-scale pension and mutual funds, to conduct a thorough audit of their exposure to assets and guarantees with ultimately risks denominated in RMB. For example, even if a loan to a Chinese real estate company is backed by a major state-owned enterprise (SOE), that SOE's underlying cash flows are denominated in RMB, so devaluation means that the guarantee from that SOE should be worth less today than yesterday. If a pension fund was over-weight in the stocks of Chinese companies, whose cash flows are denominated in RMB, further devaluation will severely undermine the dollar value of the portfolio. Where necessary, U.S. banks and major funds should reduce their exposure to assets and guarantees whose underlying cash flows are denominated in RMB.

Recommendations

China's industrial policy and technology theft are issues that concern many market economies. Instead of pressuring China unilaterally, the U.S. should work with close allies and partners in developing economies to derive a set of incentives for countries to join the U.S. in pressuring China to reduce the level of state subsidies for specific industries and to coordinate on the prevention of technology theft. Some potential measures include:

- Work with the IMF to increase transparency of China's financial subsidies to industries through its banking system. The IMF already has a mandate to audit the Chinese financial system on an annual basis.
- Work with close allies to coordinate policies on investment from authoritarian countries, including China.
- Coordinate with close allies and partners to develop a set of criteria for "best practices" for information and cyber-security. Companies meeting these criteria, as confirmed by a multilateral body, can qualify to win contracts for critical infrastructure and security related projects.

At the same time, a complete decoupling with the Chinese economy would be extremely costly to the U.S. economy. For most goods traded between the two countries, complete decoupling is neither desirable nor necessary. U.S. farmers produce a surplus of output which China desperately needs. At the same time, manufacturing capacity in many light industrial sectors has left the U.S. and will never return, so trading with China at least would allow U.S. consumers to take advantage of low-cost consumer goods. For critical sectors such as information technology, bio-technology, and precision machineries and robotics, the U.S. needs to invest in more basic research and create incentives for firms to also invest in research. It also will need to set up protocols to prevent technology theft and acquisition by hostile authoritarian governments.

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OPENING STATEMENT OF ANDREW POLK, CO-FOUNDER, TRIVIUM CHINA

VICE CHAIRMAN CLEVELAND: Mr. Polk.

MR. POLK: Thank you very much, to the Commission, for having me. I'm going to talk mostly about short-term economic growth, the Chinese policy response and what it tells us about what they're thinking in terms of the relationship with the U.S.

I have a little bit of a different perspective from Victor, so I think it will be good for us to see different sides of this.

China's economy is currently growing at the slowest pace since 1990 and has been decelerating rapidly since mid-2018.

Given the growing tensions in the bilateral relationship between the United States and China, it is highly important for U.S. policy makers to understand the sources of China's current economic weakness, the policy response that Chinese officials have laid out to address these challenges and the likely impact on China's stance in trade negotiations with the United States as well as the country's broader policy towards the U.S.

China's current economic slump is overwhelmingly, indeed almost entirely due to domestic economic challenges and policy choices. While trade tensions over the past year have had a significant effect on financial markets, individual companies and specific geographies, in aggregate, the direct effect on the Chinese economy has been minimal.

However, the negative effects of trade tensions are likely to grow over time. Especially given the latest broadening of tariffs that took place on September 1st.

The most important factors driving China's current cyclical slowdown are policy choices that Chinese leaders made in early 2017. In April of that year, financial regulators introduced a policy program to slow the growth of credit, seeking to contain the overly fast accumulation of debt that the country had seen from 2010 to 2016, and to de-risk the financial system, which had experienced significant balance of volatility in 2013 and 2015.

In addition, at the same time that central officials were seeking to de-risk the banking system, they also sought to harden budget constraints for local governments. Specifically, regulators increased scrutiny over local government financing vehicles, which have been conduits for off balance sheet spending in recent years.

Officials also gave cadres a lifetime responsibility for the debt profile of the jurisdictions that they oversee. The combination of significant financial tightening and regulatory tightening over local government spending are the two key drivers behind China's current growth challenges.

Notably, both of these drivers were intentional domestic policy induced measures. And even more notably, Chinese policy makers have largely kept these policies in place despite the toll on economic growth and the additional economic uncertainty that has arisen from the trade tensions with the U.S.

While there was a significant element of intentionality behind the policy mix that led to China's current slowdown, policy makers have been caught off guard by three unforeseen developments.

First, the intensity with which the financial de-risking campaign and associated economic slowdown have disproportionately affected China's private sector.

Secondly, the speed and intensity with which the global narrative has turned against China, both on political and economic fronts.

And thirdly, the longevity and intensity of U.S.-China trade tensions.

Each of these factors has worked to unnerve Chinese policy makers and has largely defined China's evolving policy stance since growth began slowing in mid-2016. However, despite the fact that the prevailing media narrative around China has focused mostly on U.S.-China tensions, financial de-risking and the broader global shift against China have arguably been more critical in shaping China's policy actions.

So far, the U.S. tariffs appear to have little direct macroeconomic impact on the pace of growth for Chinese economy. Especially in comparison to the domestic slowdown in infrastructure investment and tightening of financial conditions.

In fact, for most of 2018, given the tiered nature of tariff imposition by the United States, Chinese exports saw strong growth as U.S. importers sought to front run, as U.S. importers have to front run each new round of impending tariffs.

In 2019, that dynamic has largely gone into reverse and the value of exports to the United States has fallen, taking about two percentage points off of overall Chinese export growth. However, that slowdown has been almost entirely offset in local currency terms, thanks to the weakening exchange rate.

That is not to say that the tariffs have had no impact whatsoever, rather the immediate impact has been primarily psychological, working to undermine private sector sentiment in China at a time when it was already ailing.

Those effects on sentiment are likely to increase over time. Importantly, despite the slowing economy and uncertainty from U.S. China trade tensions, Chinese officials are taking a largely unproven approach to economic policies with support.

During previous bouts of growth deceleration, authorities have responded by quickly ramping up monetary and credit growth to boost investment, primarily in infrastructure and real estate.

In 2019 however, authorities have taken a different tack. They have focused economic support measures on attempts to improve the overall business environment and to incentivize banks to prioritize lending to small private sector businesses.

Finally, they have boosted efforts to obtain inbound capital flows via market opening in some key areas. Chinese authorities increasingly seek foreign capital inflows, both through FDI and portfolio investment, as key to improving the domestic market.

And that reality, combined with the increased pressure from the U.S. and other foreign governments, is underpinning a pragmatic market opening streak. This pragmatism of Chinese policymakers is often overlooked due to the broadly increased tensions between the U.S. and China.

However, it is important that U.S. policymakers understand that China has increasingly looked into widening market access for foreign companies, both thanks to this increased pressure from the U.S. and other governments, as well as China's own domestic needs.

In my view, the fact that Chinese policy makers are understanding this current, unproven policy approach, focused on improving the business environment and opening wider to foreign investment as opposed to the crude stimulus efforts of the past, underscores Chinese policymakers' confidence in their ability to shepherd the economy through this downturn.

Chinese officials' confidence in their economic management ability may well be misplaced. However, the fact that this confidence exists should indicate to U.S. policymakers that China's economic growth is not presently a point of leverage for pushing Chinese officials to acquiesce to U.S. demands and trade negotiations.

The domestic focus among Chinese policymakers underscores that directly influencing

CCP behavior and policy decisions toward the economy or otherwise, via U.S. policy actions, is highly difficult.

In my view, the most reliable way to adjust to China's economic rise will therefore be to invest in American competitiveness. This means prioritizing investment in the American education system. Especially in science and technology.

While such investments should always be a priority in my view, making these investments now is even more critical than in the past because of the heavy emphasis that China is placing on improving its own education system, especially in the sciences. Thank you.

PREPARED STATEMENT ANDREW POLK, CO-FOUNDER, TRIVIUM CHINA

**Testimony before the U.S.-China Economic and Security Review Commission
Hearing on “U.S.-China Relations in 2019: A Year in Review”**

Andrew Polk, Co-founder, Trivium China

September 4, 2019

Key points:

- China’s economy is undergoing a cyclical economic downturn driven almost entirely by domestic factors.
- The key drivers of the slowdown are tight financial conditions, thanks to a recent financial de-risking campaign, and weak local government investment.
- That said, China’s economy is not on the precipice of an implosion – and domestic policymakers are confident in their ability to manage the economy through a down cycle, as evidenced by their measured policy response.
- So far, US tariffs on China have had little macro impact on the Chinese economy – specific companies, industries, and geographies have been disproportionately affected, but in aggregate the effects have been minimal.
- The longer the trade war drags on, however, negative impacts through trade, sentiment, investment, and technological channels are likely to weigh on China’s medium-term growth prospects.
- China is already facing substantial medium-term growth challenges as it undergoes a momentous economic transition toward higher-quality growth – this is in addition to its short-term cyclical slowdown.
- As China’s economy matures, economic reform will become ever more important in order to unlock productivity gains that can propel economic growth.
- It is important to understand the nuance within China’s reform program – some areas, such as marketization and liberalization of the financial sector, will continue apace; more difficult changes like fiscal reforms will move along gradually; and highly difficult areas like SOE reform will remain largely stalled.
- As part of this process, Chinese policymakers will continue to both develop market forces and strengthen the state sector – the economy will remain a hybrid economy for the foreseeable future.
- Chinese authorities increasingly see foreign capital inflows – both through FDI and portfolio investment – as key to improving the domestic market; that reality is underpinning a pragmatic market opening streak.
- A unified Party apparatus will oversee these changes to the economy – in the short term, the CCP is not threatened by slowing economic growth, but in the long term, a split among the Party elite is possible, especially the longer that Xi Jinping holds on to power.

Recommendations for US policymakers, in brief:

1. US policymakers should work under the assumption that China will successfully transition to a high-quality economy. If China fails, then it won't be a genuine long-term economic challenger to the US, but if China is successful and the US is not prepared, the US will be at an economic disadvantage.
2. Rather than designing policy to change or influence CCP behavior, US policymakers must make long-term investments in America's competitiveness. This goes far beyond infrastructure spending and extends to significant investment in the education system and government-assisted research in science and technology. It could also include a robust industrial policy that leverages federal money to encourage private investment into strategic sectors.
3. US policymakers should recognize and acknowledge areas where China is making progress – both in terms of regulatory reform and market access. The financial sector is a good example where China is both opening to foreign companies and increasingly looking to roll out market mechanisms.
4. US policymakers should continue to apply significant pressure on their Chinese counterparts to further pursue market opening. Chinese officials understand that they need foreign capital and that the business community has grown impatient with China's excessive promises but slow follow-through. These dynamics, combined with sustained pressure from other foreign governments, have led to progress in market opening over the past 18 months. That pressure should continue to be applied, albeit in a consistent, strategic manner – with a clear endgame and alongside US allies.
5. Perhaps most concretely, the US Congress should invest time and energy in defining exactly which sectors and business activities *do not* fall under the rubric of America's economic national security; ever expanding definitions of this concept on both sides of the Pacific risk completely undermining the US-China economic relationship; if clear rules around national security can be agreed between the US and China, this could provide the backbone of a new operational framework under which the US and China can continue to do business, while decoupling in areas of clear strategic importance

A domestic slowdown – not an implosion

According to China's official statistics, the country is currently growing at the slowest pace since 1990.¹

Given the growing tensions in the bilateral relationship between the United States and China, it is highly important for US policymakers to understand the sources of China's current economic weakness, the policy response that Chinese officials have laid out to address these challenges, and the likely impact on

¹ While China's GDP statistics are widely considered to be unreliable, even they show historically low growth

China's stance in trade negotiations with the United States – as well as the country's broader policy toward the US.

China's current economic slump is overwhelmingly – indeed, almost entirely – due to domestic economic challenges and policy choices. While trade tensions over the past year have had a significant effect on financial markets, individual companies, and specific geographies, in aggregate the direct effect on the Chinese economy has been minimal.

However, as I discuss below, the negative effects of trade tensions are likely to grow over time – especially given the latest broadening of tariffs, set to take place on September 1, 2019.

A policy-induced slowdown

The most important factors driving China's current cyclical slowdown are policy choices that Chinese leaders made in early 2017. In April of that year, financial regulators introduced a policy program to slow the growth of credit – seeking to contain the overly fast accumulation of debt that the country had seen from 2010 to 2016 and to de-risk the financial system, which had experienced significant bouts of volatility in 2013 and 2015.²

Beginning in early 2017, financial authorities tightened oversight of banks, insurance companies, and other types of financial institutions. Officials also reduced liquidity in the banking system, which raised the cost of leverage and wholesale financing for banks. These moves were combined with a number of inspection tours by central regulators to examine individual institutions and ensure that the local offices of various regulatory bodies were increasing oversight on the ground.³

Over the course of the next 18 months, until mid-2018, authorities also handed out a record number and level of fines to institutions and individuals operating in the financial sector.⁴

These efforts led to significant reduction in the pace of credit growth in China. The growth of bank assets, for example, fell from a high of 16.5% y/y in October 2016 (a few months before the de-risking campaign started) to a low of 6.3% y/y in November 2018 – a dramatic reduction in the pace of growth for such assets (see chart 1).

This deceleration coincided in 2017 and 2018 with the first outright contraction in interbank assets since 2010 (which was the year that China's banking system first started to see explosive growth, as authorities employed the banks to stimulate the economy in reaction to the Global Financial Crisis).⁵

² See relevant regulatory documents from the China Banking and Insurance Regulatory Commission here: <http://www.cbirc.gov.cn/cn/list/9102/910201/20.html>

³ 21st Century Business Herald, 银监会彻底封堵监管套利路径 强调防范“处置风险的风险”, January 16, 2018. http://epaper.21jingji.com/html/2018-01/16/content_78690.htm

⁴ 21st Century Business Herald, 银监会拆解“影子银行”等风险：明确2018年重点整治八大领域, January 9, 2018. http://epaper.21jingji.com/html/2018-01/09/content_78229.htm

⁵ Geoff Dyer, Financial Times, *China authorises 'massive' stimulus package*, November 10, 2008. <https://www.ft.com/content/6e89710e-ae91-11dd-b621-000077b07658>

The extreme tightening over the interbank market was particularly important, as it is a key funding source for banking and non-banking financial institutions. In particular, large SOE banks use the interbank market to provide financing to small- and medium-sized banks and other financial institutions. Lack of oversight of the interbank market over the previous decade had allowed it to foster significant leverage, malfeasance, and speculative investments by financial institutions in China. And given that interbank markets often play a starring role in financial crises – including the Global Financial Crisis⁶ – de-risking this space was one of the financial de-risking campaign’s top initial priorities.

This sustained tightening of credit conditions – while successful in its initial efforts to de-risk the banking system and broader financial system – ultimately had a significant downward impact on nominal growth of the economy beginning in mid-2018, just as the first 301 tariffs went into place in July 2018 (see chart 2).

In addition, at the same time that central officials were seeking to de-risk the banking system, they also sought to harden budget constraints for local governments. Specifically, regulators increased scrutiny over local government financing vehicles (LFGVs), which have been conduits for off-balance-sheet government spending in recent years.⁷ Officials also gave cadres lifetime responsibility for the debt profile of the jurisdictions that they oversee.⁸

These two efforts led to a gradual deceleration in local government investment throughout 2017, followed by an additional dramatic reduction beginning in March 2018 (see chart 3) – just as the negative impact from financial tightening was also kicking in. Local government spending levels have still not recovered, despite a significant increase in local governments’ ability to obtain bond financing throughout 2019.

The combination of significant financial tightening and regulatory tightening over local government spending are the two key drivers behind China’s current growth challenges. Notably, both of these drivers were intentional, domestic-policy-induced measures. And even more notably, as I discuss in depth below, Chinese policymakers have largely kept these policies in place despite the toll on economic growth and the additional economic uncertainty that has arisen from trade tensions with the United States.

Trade tensions are so far having little direct impact on China’s economy

While there was a significant element of intentionality behind the policy mix that led to China’s current slowdown, policymakers have been caught off guard by three unforeseen developments:

⁶ Gara Afonso, Anna Kovner, Antoinette Schoar, *What happened to US interbank lending in the financial crisis?*, CEPR Policy Portal, April 26, 2010. <https://voxeu.org/article/what-happened-us-interbank-lending-financial-crisis>

⁷ Bloomberg News, *China’s New Crackdown on Regional Debt May Curb Bond Sales*, April 12, 2018. <https://www.bloomberg.com/news/articles/2018-04-11/china-s-new-crackdown-on-regional-debt-may-curb-bond-offerings>

⁸ Xinhua, 习近平：深化金融改革 促进经济和金融良性循环健康发展, July 15, 2017. http://www.xinhuanet.com//politics/2017-07/15/c_1121324747.htm

1. The intensity with which the financial de-risking campaign, and associated economic slowdown, have disproportionately affected China's private sector
2. The speed and intensity with which the global narrative has turned against China – on both political and economic fronts
3. The longevity and intensity of US-China trade tensions

Each of these factors has worked to unnerve Chinese policymakers, and has largely defined China's evolving policy stance since growth began slowing in mid-2018, as I discuss below. However, despite the fact that the prevailing media narrative around China has focused most intensely on the third factor, factors 1 and 2 above have arguably been more critical in shaping China's policy actions.

Chinese authorities are clearly not thrilled with the fact that their economy is growing at the slowest pace in three decades at the same time that they are locked in tense trade negotiations with their largest trading partner.

However, so far the US tariffs appear to have had little *direct* macroeconomic impact on the pace of growth for China's economy – especially in comparison to the highly significant impacts that the domestic slowdown in infrastructure investment and tightening of financial conditions have had.

In fact, for most of 2018, given the tiered nature of tariff imposition by the United States, Chinese exports saw strong growth as US importers sought to front run each new round of impending tariffs (see chart 4).

In 2019, that dynamic has largely gone into reverse, and the value of USD-denominated exports to the United States has fallen. Moreover, we estimate that this reduction has taken about 2 percentage points off of overall USD-denominated Chinese export growth. However, that slowdown has been almost entirely offset in local currency terms, thanks to the weakening exchange rate.

Given that the immediate and direct aggregate impacts from US tariffs have been minimal so far, it is no surprise that near-term economic dynamics have thus far not been a key factor in Chinese leadership's approach to the trade negotiations.

However, that is not to say that the tariffs have had no impact whatsoever. Rather, the immediate impact has primarily been psychological – working to undermine private sector sentiment in China, at a time when it was already ailing (thanks to the highly negative impact of financial tightening on private sector businesses).

The effects on sentiment are likely to increase over time. In addition, bilateral tensions in other, more powerful channels including investment and technological competition will further affect China's economy in the medium term. I discuss each of these channels below.

Trade

The most obvious and direct way that trade tensions should affect China's economy is through weaker export growth to the United States. But while these impacts may be significant for specific companies,

from a macro standpoint, the overall impact on China's export position has been minimal so far – and as such, the direct impact on the economy to-date has similarly been quite small.

In US-dollar terms, Chinese exports to the United States contracted by -8% y/y in the first half of 2018, according to Chinese customs data, or -12% y/y according to US data. This compares to Chinese export growth to all other countries of 2.6% y/y in the first half of 2019.

Typically, China's exports to the United States grow at a rate that is very closely in line with overall Chinese exports to other countries, so absent current trade tensions, we could reasonably expect that Chinese exports to the United States would have grown by about 2-3% in H1 this year. We estimate that this 10-14 percentage point negative swing in export growth to the United States reduced overall Chinese export growth by about 2 percentage points – coming in at just 0.6% y/y growth in H1 2019.

All else equal, we estimate that this downward adjustment would have taken about 0.4 percentage points off of China's nominal GDP growth in H1 2019 – lowering it to 8.1% y/y from what would have otherwise been 8.5% y/y.

However, given the adjustment of the USD/CNY exchange rate over the past six months, exporters' overall earnings in local currency (CNY) are virtually unchanged from what they otherwise would have been – further limiting the direct impact to the Chinese economy, in aggregate, from weak exports to the United States.

This is thanks to the fact that a weaker Chinese exchange rate not only helps to offset the US tariffs directly, but also increases Chinese export earnings from non-US trading partners in CNY terms, especially given that much of that trade is denominated in US dollars.

That is not to say that individual companies and specific geographies within China have not felt an effect. As numerous media reports have displayed, any company or geography with significant exposure to the US market in a tariffed sector has experienced significant difficulties.

Moreover, the direct aggregate drag from US tariffs on Chinese exports is likely to start increasing soon, now that tariffs have been raised to 25% on USD 250 billion worth of Chinese exports as of May 2019 – and that another round of tariff increases are currently set to take place in September and October.

Sentiment

The impact of US-China trade tensions on private sector sentiment on the mainland is much more difficult to quantify. Anecdotal evidence suggests that trade tensions are negatively impacting confidence in both China's export sector and the global economy.

Moreover, China's Purchasing Manager's Index (PMI) – a key survey of manufacturing sentiment in China – has shown deepening contraction in its employment sub-component in recent months. The PMI has shown contraction in this area for several years, underscoring the role that ongoing domestic challenges play in the sector's woes. However, the recent intensification of the downtrend evidences an additional souring of sentiment among China's manufacturing sector thanks to US-China economic tensions.

As trade tensions grind on – and especially now that US tariffs are set to continue increasing – the psychological sense of economic malaise is likely to deepen, which should ultimately feed into weaker business investment.

Investment

A critical second-order effect of US tariffs on Chinese exports will be slower business investment due to weaker sales and slumping sentiment. These indirect effects on Chinese growth from US-China trade tensions will take time to manifest – as Chinese businesses will, over time, increasingly operate under the assumption that the trade tensions will persist indefinitely, and they may have permanently lost a key export market.

We have already highlighted the ongoing slump in local government infrastructure investment, which is a key driver of China's current cyclical economic downturn. In addition, growth in Chinese manufacturing investment has also decelerated rapidly – albeit from a high growth rate – since November 2018. This deceleration is thanks in large part to the leveling out of a strong policy-induced increase in manufacturing investment throughout most of 2018. It has likely further been exacerbated by the tightening of domestic financial conditions, especially for the private sector.

However, it is likely that growth of private business investment will continue to further decelerate thanks to prolonged trade tensions between the US and China. Were this to occur, the impact on China's overall economy would be much more significant than the direct impacts that we have so far seen from weakening exports. In my view, such a scenario would likely require a change in tack on both domestic policy and in trade negotiations by Chinese officials.

That being said, if such a scenario plays out for Chinese businesses, it is also likely that private business investment in the United States will similarly deteriorate, which may also change the calculus of US policymakers.

Technology

The channel through which heightened US-China economic tensions could prove the most disruptive over time will be in the technological sphere. Chinese officials, including General Secretary Xi Jinping, have clearly stated their desire for technological self-sufficiency and their desire for China to become a “technological superpower.”⁹

While domestic industrial policy is largely geared toward achieving those aims as quickly as possible, authorities are keenly aware that they are reliant on the United States and other countries for the purchase of core technologies – such as semiconductors – and will likely remain reliant on sales of these technologies from foreign countries for at least 5-10 more years.

If Chinese companies were to be immediately cut off from these technologies – through actions such as adding companies like Huawei and ZTE to the Entity List – it would have a significant, potentially

⁹ See Xi Jinping's Report at the 19th Party Congress

devastating, direct impact on China's economic performance and longer term ability to continue moving up the value chain.

That being said, it is unclear whether this issue is (or should be) directly tied to the US-China trading relationship, per se. It is also unclear whether the US administration will use this issue as a point of leverage in trade talks with the Chinese – or if it is seen as a separate issue of national security, independent of ongoing trade negotiations.

China's policy response

Despite the evident medium- and long-term threats to Chinese growth from the investment and technological channels outlined above, the immediate macroeconomic policy stance is primarily being dictated by the domestic economic challenges of a slumping private sector (thanks to tight financial conditions for private businesses) and weak growth in local government investment.

Because Chinese officials have rightly diagnosed these issues as the primary short-term challenges to economic growth, officials are taking a unique approach to economic policy support. During previous bouts of growth deceleration, authorities have responded by quickly ramping up monetary and credit growth, to boost investment – primarily in infrastructure and real estate.

In 2019, however, authorities have taken a different tack. They have focused economic support measures on attempts to improve the overall business environment – by cutting various administrative and bureaucratic requirements for businesses, as well as reducing various fees and reducing businesses' required contributions to social security programs. Financial officials have also sought to incentivize banks to prioritize lending to small, private sector businesses. Finally, they have boosted efforts to obtain inbound capital flows via market opening in some key areas.

Authorities have also leaned more heavily on the expansion of fiscal policy, as opposed to monetary or quasi-fiscal expansion through the banking system, which they have employed in past downturns. The goals of these policies have been to support on-balance-sheet spending by local governments – and thereby arrest the slowdown in local government infrastructure spending – while containing overall local government debt, and especially reckless off-balance-sheet spending.

This unique – at least by Chinese standards – policy response is unproven, and has so far been much less effective at reviving economic growth than past policy responses. That is partly by design, since authorities are looking to shore up the economy without giving up hard-won gains on financial de-risking, or materially worsening the country's debt load. However, the ultimate impact of these moves has not yet come to fruition. Tax and fee cuts for businesses, alongside reductions in administrative red tape, will take much longer to translate into stabilized economic growth than the investment and credit-fueled stimulus policy that China has relied on in the past.

What is remarkable about this policy approach, though, is that Chinese officials have shown themselves to be willing to take a chance on an unproven – and likely less effective – set of policy tools even in the midst of heightened uncertainty from US-China trade tensions.

In my view, this underscores Chinese policymakers' confidence in their ability to shepherd the economy through this downturn – and also highlights policymakers' focus on domestic economic dynamics, rather than external factors. Chinese officials' confidence in their economic management ability may well be misplaced. However, the fact that this confidence exists should indicate to US policymakers that China's economic growth is not presently a point of leverage for pushing Chinese officials to acquiesce to US demands.

Structural Challenges to China's Economy

Looking out a bit further, as the US-China economic relationship evolves in the coming years, it is also critical for US policymakers to understand that China is not *only* undergoing a cyclical economic slowdown thanks to policy-induced financial tightening from 2017, but more broadly is in the midst of a profound long-term economic transition that will likely see it settle at a growth rate of around 3-4%, somewhere around 2025¹⁰.

This transition will see the nature of economic growth in China change significantly. It is occurring as the economy matures into middle income status, and is driven by a host of factors that are pushing down rates of investment, producing a demographic drag on the economy, and hindering productivity growth.

I discuss each of the three key inputs into China's economy – and the challenges that they are facing – in the following sections of this testimony.

But the critical point for US policymakers is that China's current cyclical downturn is coming on top of a structural, long-term deceleration in economic growth. This dynamic again underscores that China's economic struggles are by-and-large domestically driven, but it also has implications for the length and severity of China's current and cyclical downturn – as well as longer term implications for China's ability to avoid the middle-income trap.

Year to year, China's economic performance should be seen in the context of cyclical movements around a decelerating trend (see chart 5). Given the developing nature of China's economy, cyclical decelerations are unlikely to result in outright recessions – i.e. actual contractions in the size of the Chinese economy – but they will produce business cycles “with Chinese characteristics.”

This means that cyclical downturns, such as the one China is now facing, will be deeper and longer-lasting than previous economic downturns have been – while the cyclical upturns will generally be shallower and shorter-lived. In general, then, while Chinese leaders may be confident in their ability to manage the economy, that does not mean that China is necessarily negotiating with US officials from a place of economic strength – but neither is it on the precipice of a devastating economic implosion.

In a best-case scenario for China, this structural economic transition will end in higher-quality, more sustainable economic growth, but at much lower growth rates than in the past. But whether Chinese

¹⁰ David Hoffman and Andrew Polk, The Conference Board, *The Long Soft Fall in Chinese Growth*, October 2014. <https://www.conference-board.org/retrievefile.cfm?filename=KBI-FY15---China-Slowdown---Final-Draftv2.pdf&type=subsite>

authorities can successfully shepherd the domestic economy through that transition is still an open question – and one that will not be answered for years to come.

This means that uncertainty around China's future economic performance will only continue to grow in the coming years.

In general, however, my recommendation to US and other western policymakers is to design policy toward China on the assumption that the country will mostly be successful in achieving its economic and business goals.

This is not because I believe in Chinese exceptionalism. However, planning for China to succeed, designing a proactive policy agenda to deal with a successful China, and not having to use it in the event of China's failure is an eventuality that the US can live with.

On the contrary, planning for China to fail, and having no contingency plan in the event that the country successfully navigates the transition to a high-value-add, wealthy economy with commensurate geopolitical clout would be a grave error.

Demographics

Perhaps the most reliable forecast for any element of China's economy is that the population will age rapidly over the next 30 years and the working age population will continue to shrink rapidly, as well. According to projections by the World Bank, China's working age population is likely to contract by over 193,000 people by 2050 – a reduction of almost 20% from its 2019 level.

The Conference Board estimates that this shrinking of the employment pool will detract 0.3 percentage points from Chinese growth, on average, each year for the next 10 years. This means that all of China's growth over the next decade will have to be generated from capital services and productivity improvements. It also means that Chinese officials will increasingly be preoccupied with addressing the needs of a large elderly society.

Taken together, these demographic dynamics only further challenge China's ability to successfully move up the economic ladder over the longer term, not least because one of China's perennial economic advantages – a large, improving, and relatively cheap labor force – will increasingly dissipate.

Investment

Capital investment has been the key driver of growth in China over the past two decades (see chart 6). In particular, infrastructure and property investment were both ramped up significantly as part of the government's stimulus package in response to the Global Financial Crisis of 2008-2009.

From 2007 to 2012, gross capital formation grew by an average of 19% annually – constituting 56% of GDP growth on average in those years. And according to independent measures, such as The Conference Board's alternative GDP series for China, capital deepening accounted for a full 90% of GDP growth over that period.

Such rates of capital growth were clearly unsustainable – having quite obviously led to well-known vulnerabilities in China’s economy including high debt levels, property bubbles, white elephant government investment projects, non-performing assets at banks, and ever-lower returns on capital.

Indeed, in recent years overall investment rates have already been pulled back – contributing just 5.5 percentage points to GDP growth on average in 2013-2018, down from 7.8 percentage points in 2007-2012, according The Conference Board (see chart 6).

But despite the fact that investment rates have come down from their peak, the pace of capital formation will continue to “naturally” decelerate in coming years. This is thanks primarily to the constraints that very low investment returns have placed on the banking system and local governments, as well as an enlarged capital base.

Productivity

Of the three fundamental supply-side inputs into any economy, productivity is by far the most important. This is because productivity improvements are the only truly sustainable form of economic expansion. People age and returns on investment naturally diminish, but economic efficiency and innovation can always advance, given the right circumstances.

Unfortunately for China, productivity improvements have been the most challenging aspect of the country’s growth story over the past five years (see chart 6). Unleashing productivity improvements – through firm-level innovations, institutional reforms, and increased domestic competition – will be absolutely essential if China is to successfully avoid the middle-income trap.

At present, China’s trend rate of productivity growth does not look promising. This weak trend has come to fruition largely because key parts of the economic reform program, such as SOE reform, have stalled in recent years – holding back productivity improvements.

Productivity and economic reform

The intensifying need to boost productivity growth in China – as capital formation slows and the population ages – will only add further urgency for policymakers to pursue economic reforms more aggressively in the coming years, in order to find new sources of economic growth.

If the recent past is any guide, Chinese policymakers will make varying degrees of progress on this front.

By now, it has become apparent to most China watchers that when Chinese officials use the word “reform,” they usually do not mean the type of liberalizing and marketizing economic reforms long envisioned by western policymakers and economists.

That being said, policy improvements and moves to create a more stable business environment are likely to move forward in various ways – some of which will be based on market principles, while others are not.

Based on my assessment of recent progress on the “reform” front, I conceptualize likely progress along three separate lines.

The low hanging fruit: In some areas, policymakers understand that increased marketization and opening to foreign players can help to improve domestic industries quickly. The clearest example of this is in the financial sector, where authorities have accelerated market opening measures over the past two years – by raising foreign equity caps, increasing the business scope for foreign players, and granting more operating licenses to foreign companies, among other actions.

In addition to market opening, authorities have also undertaken a sweeping financial de-risking campaign (discussed at the outset of this testimony), and have also worked to steadily improve the central bank’s execution of monetary policy to be more in line with the operations and oversight activities undertaken by western central banks.

The reasons that Chinese leaders are comfortable pursuing both liberalizing reform and market opening in this space are three-fold:

- Chinese financial institutions have grown so large that foreign entities simply cannot compete with them in terms of market share
- Chinese financial institutions still do not manage risk well, and competition from foreign firms is expected to help introduce greater discipline and sophistication to domestic industry
- China’s increasingly complex economy requires financial institutions to allocate resources in a more efficient way

Given these dynamics, reform and liberalization of the financial sector is likely to continue moving forward fairly rapidly – in a way that aligns with what western policymakers traditionally mean by “reform.”

Areas like this, where Chinese policymakers are pursuing reform in line with US preferences, should be acknowledged by US policymakers, as they may act as a point of departure for positive, productive dialogue on economic policy issues.

Sticky issues with steady progress: In many areas, authorities have found reform progress more difficult thanks to entrenched political incentives and/or vested interests, among other reasons. However, a relatively high level of political will to address economic inefficiencies means that progress will continue to move forward, but slowly.

On this score, fiscal reform stands out as an obvious example. In the past two years, central authorities have made concerted efforts to harden local government budget constraints, reduce off-balance-sheet spending, and contain overall local government debt (as discussed at the beginning of this testimony).

These efforts have progressed slowly in large part thanks to the structure of the fiscal system. Because local governments are responsible for 80% of fiscal expenditures but pull in just 50% of fiscal revenues, cutting off their ability to tap into off-balance-sheet financing immediately and completely would run the risk of depressing local spending to a truly detrimental degree.

Meanwhile, undertaking a fundamental remake of the fiscal system will necessarily be a protracted and gradual endeavor – as missteps on this front could have devastating economic consequences. Still, US policymakers should recognize and encourage continued progress on this front – as it should facilitate a

rebalancing of the Chinese economy toward more consumer-led growth, which would help to address existing imbalances in the US-China economic relationship.

Punting off the truly hard stuff: The third major bucket of the reform program consists of areas that are seeing little to no progress – with SOE reform perhaps the most glaring example. When it comes to SOE reform, in particular, Chinese authorities are not only moving slowly due to the complex nature of improving state-owned behemoths. They are also moving in the opposite direction that US policymakers would like to see – toward greater state and Party control and intervention, as well as SOE consolidation, which only makes such entities bigger and more aggressive.

These are the areas where US policymakers need to continue not only expressing concern to their Chinese counterparts, but also designing domestic policy that can address the incumbent advantages that Chinese SOEs face due to their connection with the Chinese state.

Geopolitical tensions, short-term downturn, and structural economic challenges converge to influence policy

China's short-term and long-term economic challenges are interacting with current geopolitical dynamics to influence domestic policy decisions – perhaps in some surprising ways.

As I mentioned in the previous section of this testimony, there are some sectors, such as finance, where Chinese policymakers see accelerated market opening as being in their own interests – both to help address domestic economic challenges and as a response to the increased and widespread frustration with Chinese trade and investment practices.

So while the prevailing narrative toward China highlights the political and ideological tightening that is occurring – the reality on the ground is more complex. In my view, the current trade tensions and the slowing economy are giving renewed impetus to regulatory reform and market opening.

The prevailing political narrative is too simplistic

It is undeniably true that China has seen a significant tightening over the information environment under the leadership of Xi Jinping, combined with a sharp ideological shift toward the Party's socialist roots. Moreover, the strength and reach of the Party has been significantly buffeted throughout all aspects of society in recent years – including the business environment.

However, the narrative of China's ideological hardening and the increased strength of the Party – while true – is too simplistic. At the same time that the Party has asserted greater influence over the business environment, policymakers are also showing their pragmatic side – enacting genuine, concrete market opening in some areas (which I have outlined throughout this testimony). This pragmatism is driven both by certain economic realities that policymakers must respond to, as well as a seemingly genuine desire to employ market solutions in economic governance where possible.

Perhaps counterintuitively, in many cases a push for market liberalization is even meant to strengthen the Party apparatus, as these moves are designed to break up vested interests. It is important, therefore, for US policymakers to understand that the on-the-ground picture is complicated – with economic liberalization happening *alongside* political tightening.

Boosting the state-led economy and markets – at the same time

A critical question that analysts and foreign policymakers often attempt to answer when it comes to China is whether the state-led portion of the economy or the private sector is winning out.

The complex reality is that both state-sector entities and market-based private sector forces are being strengthened in China at the same time. Over the past year, for example, authorities have taken great pains to ensure that China's private sector companies – particularly SMEs – gain better access to credit. In fact, this push has been the fundamental driver of economic policy since mid-2018. But even as that push has taken place, central leaders have remained committed to the stated policy of making central SOEs “bigger, stronger, and better.”

How do we reconcile these two contradictory developments?

In my view, the most straightforward way to understand these competing dynamics is to listen to how Xi Jinping characterizes his goal for market forces. During his speech at the 19th Party Congress in October 2017, Xi stated:

- “[We should] Develop an economy with more *effective* market mechanisms, dynamic micro enterprises, and sound macro regulation.” (emphasis added).

Xi's focus on “effective” market mechanisms – as opposed to “efficient” market mechanisms is telling. It underscores that Chinese policymakers are not only okay with market solutions, but they actually prefer them – at least when market forces can be relied upon to achieve desired outcomes. The goal, therefore, is not necessarily for markets to fully determine how resources should be allocated, but rather to allocate resources effectively within pre-determined parameters.

China fundamentally needs FDI and portfolio inflows

One of the fundamental dynamics pushing Chinese policymakers toward a pragmatic embrace of markets forces – despite the increasing ideological crackdown – is the need to continue seeing inbound capital flows from both FDI and portfolio investment. Policymakers were especially unnerved in the 2015-2016 time period when a combination of domestic financial volatility and a string of high-profile outbound investment deals led to strong capital outflows and significant depreciation pressure on China's currency.

In response, policymakers increased restrictions on outbound flows of capital – both through capital controls in 2016 and tighter restrictions on ODI spending in 2017, culminating in the issuance of a new outbound investment catalogue in August of that year.

Policymakers also moved to incentivize more FDI inflows via accelerated market opening in areas such as finance, autos, and oil and gas in 2018-2019. They also sought to stoke inbound portfolio flows through increased linkages with global financial markets, giving investors more channels to bring capital into the country.

These opening measures are fundamentally driven by China's need to balance its own outbound spending – through programs like the Belt and Road Initiative – with commensurate inbound flows, rather than an overarching desire to open China's market, per se. However, the ultimate effect is still the same, as Chinese policymakers have begun to understand that foreign companies and investors will not continue to bring capital into the mainland unless genuine, concrete market opening measures take place.

Economic growth and the CCP

A key pillar of CCP legitimacy over the past 40 years has been its ability to deliver sustained economic growth that has improved the lives of its citizens. However, as China's population grows richer, citizens are increasingly concerned with quality of life issues – such as quality healthcare, good education, and clean food and water. At the same time, numerous high-profile food safety scandals, as well as widespread environmental degradation threaten to undermine CCP legitimacy.

The CCP leadership is aware of the changing needs of its population, and has consequently been changing its economic development model to one that prizes “quality” over “quantity.” This shift was most clearly illustrated at the October 2017 19th Party Congress. At the Congress, the CCP made the historic decision to change the “principal contradiction” facing the party from being between “the ever-growing material and cultural needs of the people and backward social production” to being between “unbalanced and inadequate development and the people's ever-growing needs for a better life.”

It is hard to overstate the importance of this shift. For the CCP, addressing the principal contradiction is the fundamental imperative guiding all party action. It is rarely changed, and the change in 2017 was the first in nearly 40 years.

The new principal contradiction signaled clearly to all CCP officials that their focus should no longer be solely on boosting economic growth, but instead on providing more intangible benefits to the populace. This is yet another reason that US policymakers should not overread short-term economic developments as a key point of leverage in trade negotiations with the Chinese.

The CCP is here to stay...at least for the time being

The CCP has widespread support in China. Though public opinion polling data in China is difficult to come by, the limited polling that has been done – including by objective foreign institutions – has

painted a picture of strong popular support for the CCP.¹¹ This polling data is reinforced by my own anecdotal evidence, obtained by living and working in China.

CCP legitimacy has been enhanced over the past 40 years by the Party's ability to deliver consistent economic growth. But the more important source of CCP legitimacy comes from a combination of nationalism and patriotism that sees the CCP as the steward of the nation, working to restore China's historical greatness. This means that, even should China encounter serious economic difficulties, it would not necessarily undermine CCP legitimacy.

Perhaps equally important, the CCP enjoys a high degree of security due to the fact that there are no viable alternatives to CCP rule. Opposition to CCP rule is relatively little, dispersed, and unorganized.

This means that regime stability will likely remain unthreatened unless there is a split within the CCP itself. While there are debates over policy within the party, there is not, at present, any discernible faction or group that credibly opposes Xi Jinping. This may change, however, as Xi's rule progresses.

Xi's decision to change Party succession norms was not supported by many in the Party. And the longer he rules, the more that resentment will grow – particularly if it means that other cadres cannot get promoted.

The bottom line, then, is that short-term economic growth is likely to have little impact on high-level politics in China – which, again, is also why short-term growth impacts have not fundamentally played into China's stance on US-China trade negotiations.

Still, the CCP's medium- to long-term viability will always be in question, thanks to the ever-present possibility of an internal party fissure.

Recommendations

Start with the assumption that China will succeed

When designing policy governing US reaction to China, US policymakers should start from the assumption that their Chinese counterparts will be largely successful in achieving their stated policy goals. It is easy to dismiss sweeping claims from Chinese leadership – like their plan to become a global leader in artificial intelligence by 2030 or to boost connectivity throughout Asia via the Belt and Road Initiative over the next decade plus. However, China has a recent history of beating the economic odds and outperforming the expectations of naysayers.

There are two components to this strategy. First, it is imperative that US congressional leaders invest in understanding Chinese policy priorities – with respect to everything from the macroeconomy, to technological advances, to autos, to the environment. Too often, western policymakers are caught by surprise when it comes to Chinese policy ambitions. China's policymaking apparatus is very rigid – meaning policy goals rarely change quickly – and surprisingly transparent. Policymakers rarely hide their ambitions or intentions.

¹¹ Extensive discussion of polling data and regime legitimacy in China can be found in *The Dictator's Dilemma: The Chinese Communist Party's Strategy for Survival* by Bruce Dickson; Oxford University Press, 2016.

Chinese officials may not always be successful in achieving their policy aims, but they do always *attempt* to achieve them. So step one is simply to understand what Chinese policymakers are seeking to achieve. To this end, the more internal China expertise that lawmakers can build, the better. This imperative extends beyond congressional committees that are traditionally focused on foreign affairs or intelligence – as developments in China will increasingly impact global markets in everything from agriculture to technology.

Secondly, US policymakers should not only understand the range of Chinese policy goals, but they must also assume that China will largely be successful in achieving its ends. Starting from this assumption will allow policymakers to be proactive rather than reactive in designing domestic policy in relation to China. For example, understanding China's ambition to improve technology in its agricultural and biopharmaceutical sectors will have a global impact. Congress should think through the implications for American companies in these sectors, were major Chinese competitors to emerge, as is likely.

Focus on your own house

Directly influencing CCP behavior and policy decisions via US policy actions will be highly difficult, especially in the absence of a united global alliance. As such, the most reliable way to adjust to China's economic rise will be to invest in American competitiveness. This means prioritizing investment in the American education system – especially in STEM. While such investment should always be a priority in my view, making these investments now is even more critical than in the past because of the heavy emphasis that China is placing on improving its own education system, especially in the sciences. If America wants to sustain its educational and technological advantage over China, increased investment needs to occur now.

In addition to ensuring that American schools are well resourced and high achieving, Congress should also look to support joint research projects between government and private entities – to develop technologies that will power future innovation. China is providing significant government support to companies that are undertaking R&D in everything from semiconductors, to connected vehicles, to drones, and AI. There is little that the US can do to change this dynamic within China, and as such the US should also look to offer government support to such research. In contrast to China, however, the US should do so using market-based, competitive mechanisms that will ensure technological neutrality and minimize malinvestment.

Look for and acknowledge areas of progress with Chinese officials

As I outlined in my testimony above, over the past two years Chinese officials have genuinely accelerated market opening measures in some sectors. This is due primarily to an assessment among top Chinese officials that more foreign participation will help sectors such as finance, chemicals, and oil and gas to improve domestic competitiveness. However, increased pressure from the US and other foreign governments – as well as the growing frustration from the global business community – has certainly helped.

Given the tense nature of economic relations between the US and China, acknowledgement of China's progress in these areas by US policymakers should be part of the conversation, in order to keep dialogue balanced and productive.

Keep up the pressure – but calibrate it better

As I mentioned above, while it is not the only factor driving market opening in China, increased US pressure is working to a certain extent, in that market opening has been accelerated in some key sectors. Increased pressure from other foreign governments, including the EU, and global business leaders has also helped Chinese policymakers realize the extent of global frustration with some of their anti-competitive behaviors.

At present, however, America's ultimate goals in the trade negotiations are unclear. President Trump has cited his desire to lower the trade deficit, other administration officials have focused on economic decoupling, while congressional and business leaders have focused on improved market access for American companies. Congressional leaders should look to articulate what, exactly, an optimal outcome would look like, and press the administration to clarify its goals. This clarification would also likely allow US trading partners to show support for US actions, and a more unified global front would boost pressure on Chinese leaders to respond productively.

Define economic national security more concretely

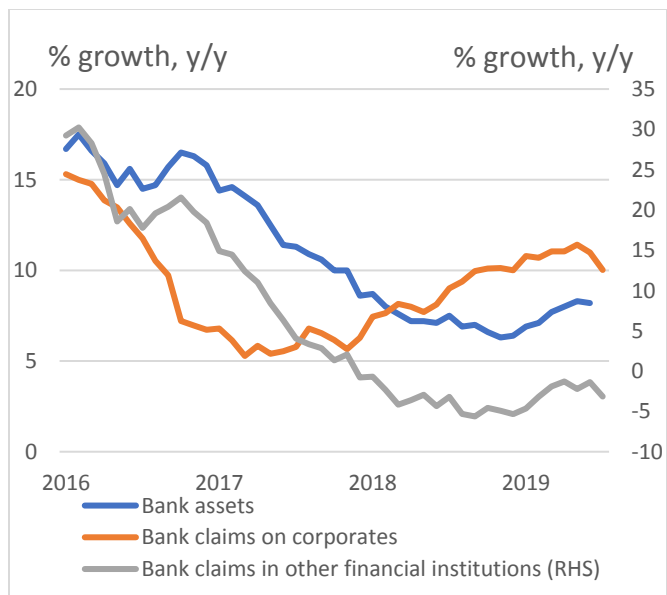
In recent years, Congress has taken a proactive role in defining the bounds of US economic national security, particularly when it comes to Chinese investment in the United States. In particular, the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) took positive steps to reform the CFIUS review process – making the process more flexible, especially with regard to Chinese investment.

These actions will help to make the national security review and inspection process more robust, especially when it comes to potentially sensitive investment by state-linked Chinese companies. That said, given that economic tensions between the US and China are likely to continue increasing, Congress should also consider laying out in detail the sectors where national security is *not* a concern.

Officials in both the US and China have outlined an enlarged concept of economic national security in recent years. And at times officials in both countries have gone so far as to indicate that essentially all parts of the economy should be viewed under the rubric of national security. If these definitions continue to expand and morph as competition between the US and China further increases, then the two countries' ability to do business of any kind with each other will be severely hampered.

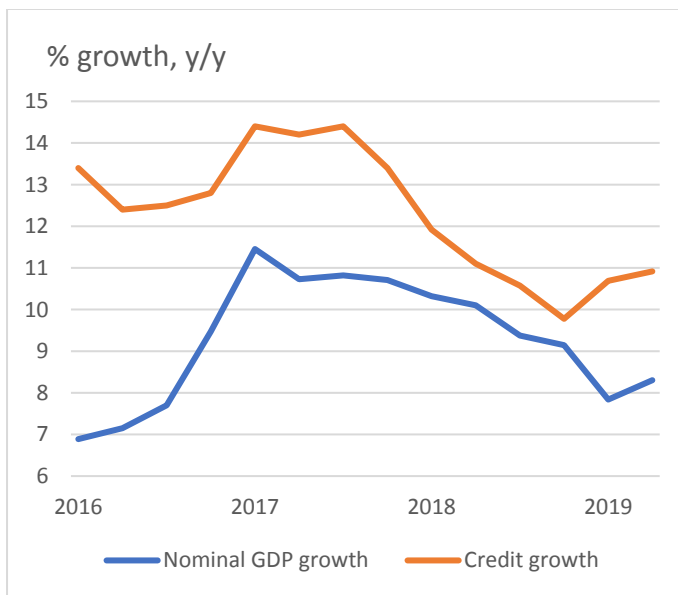
To combat this eventuality, Congress should carefully consider which sectors, industries, and businesses should not be considered as critical to the country's national security, so that private Chinese companies can have a clear roadmap as to what is possible in terms of investing in the United States. Ideally, US policymakers could eventually consult with their Chinese counterparts to agree on a mutually acceptable set of industries that should be open to cross-investment. Of course, both countries will need to retain flexibility to apply national security restrictions due to unforeseen circumstances. But greater clarity and certainty in parts of the US-China business relationship would be a positive development.

Chart 1



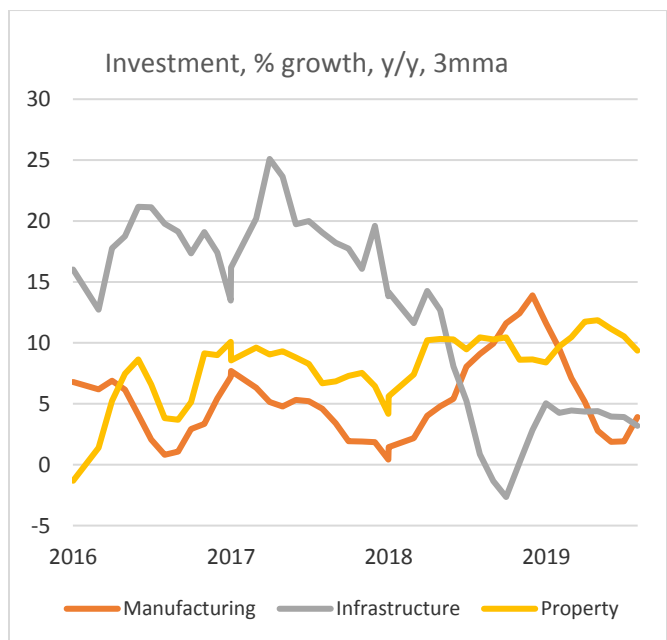
Source: PBoC, WIND Information, Trivium China

Chart 2



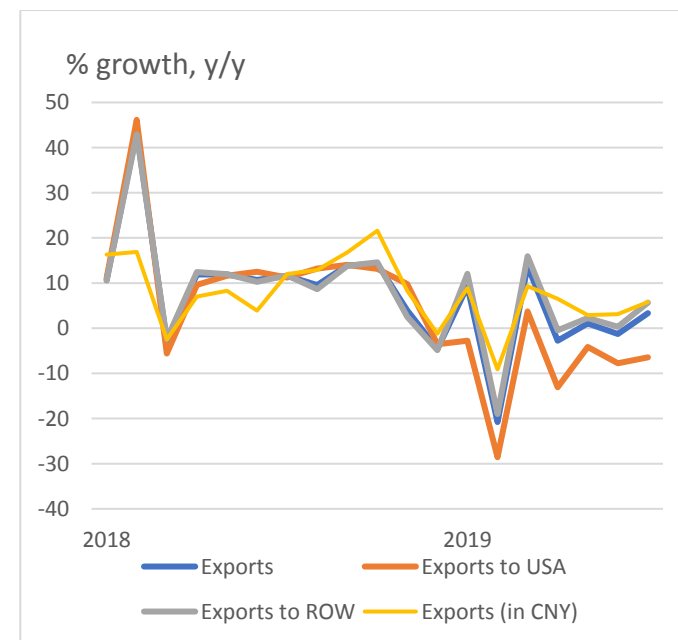
Source: PBoC, NBS, WIND Information, Trivium China

Chart 3



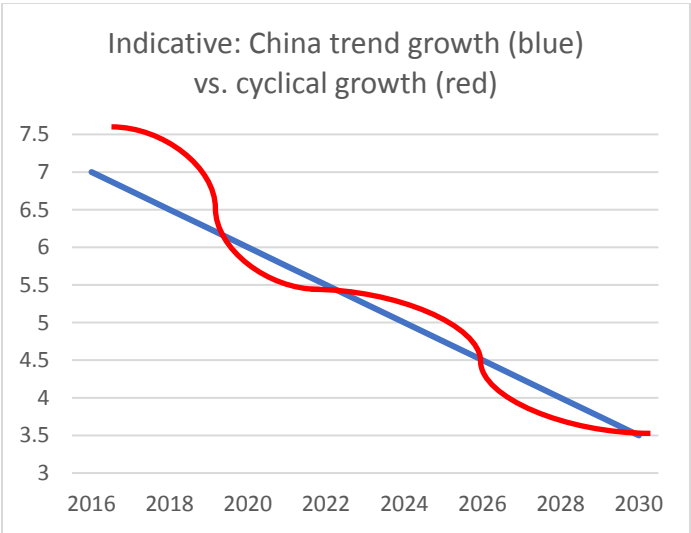
Source: NBS, WIND Information, Trivium China

Chart 4



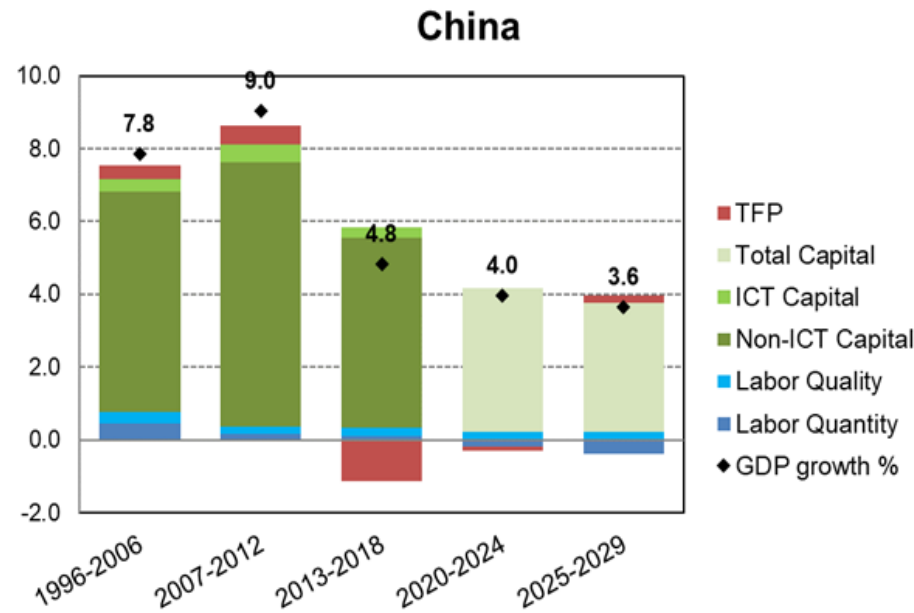
Source: Customs Bureau, WIND Information, Trivium China

Chart 5



Source: Trivium China

Chart 6



Source: The Conference Board, Global Economic Outlook, Fall 2019 update (preliminary estimates)

OPENING STATEMENT OF ELIZABETH ECONOMY, C.V. STARR SENIOR FELLOW AND DIRECTOR FOR ASIA STUDIES, COUNCIL ON FOREIGN RELATIONS

VICE CHAIRMAN CLEVELAND: Thank you, Mr. Polk. Dr. Economy.

DR. ECONOMY: Thank you very much, Vice Chair Cleveland, Commissioner Fiedler and Members of the Commission. I appreciate the opportunity to speak before you this morning on this really important issue of how the trade war is affecting China.

In the time allotted to me I'd like to focus on three or four trends that I see emerging. But let me preface my remarks by putting forth one caveat, which I think speaks to the point that Mr. Polk just made which is, it's difficult to disaggregate the effects of the trade war, right, trade frictions, from what's taking place domestically in what was already a slowing Chinese economy.

So, in my remarks please understand that what I'm talking about is an added layer of pressure that I believe comes from the trade war, not necessarily the direct impacts of the trade war on the Chinese economy.

So first, I think, as in the United States the trade war has contributed to volatility in the stock market, greater uncertainty and declining levels of consumer confidence. And I think this has manifested in a number of ways.

All provinces except Xinjiang and Jiangxi have lowered their growth targets this year. There is slowing growth, or even absolute decline, in household consumption, in areas like appliances, electronics and autos.

And there's been a very sharp contraction in venture capital deals. Both in terms of the scale, the value and the number.

For example, there is decline of 75 percent in the value of deals from the second quarter of 2018 to the second quarter of 2019. A decline of 62 percent in value from the third quarter of 2018 to 2019.

Second, the trade war I think has forced Chinese policymakers to focus more on putting out fires as opposed to what they really wanted to work on, which was structural economic reform.

If you look at the Rhodium Group's most recent report, it finds that there has only been progress in two out of ten areas of economic reform. Trade, which as Mr. Polk mentioned, the Chinese have lowered tariffs in a number of areas, and in the financial sector.

Overall however, I think the Chinese have in fact, to some extent, reverted to traditional mechanisms like encouraging local governments, again, to borrow and to develop infrastructure through issuance of special bonds, providing subsidies for consumer goods, cutting the sales tax, for example, for rural residents in half.

They have resisted. They were going to eliminate the subsidy that they were providing for purchases of new energy vehicles, they've not done that.

So, I think they're looking for many different ways to try to ensure that Chinese economic growth continues. And many of these, again, are some of these short-term measures that they have traditionally relied upon.

Third, I think the trade war undermines the ability of the Chinese leadership to tackle other socioeconomic priorities.

For example, in the environment, the minister of ecology and environment in late 2018 explicitly stated that the trade war was going to force the Chinese government to take a step back from their most ambitious targets for reducing pollution. And indeed we saw them, we saw

pollution soar between sort of December through March of this year, as they allowed heavy industry to go and took a step back from enforcement, and for more ambitious targets.

We've also seen CO2 emissions increase each of the past two years in China. And they're undergoing a very significant debate once again about climate change and how committed the Chinese leadership needs to be in the face of this slowing economy.

Demographics, economic optimism correlates very directly with birth rate. And we've seen just from 2017 to 2018, despite the fact that the Chinese have now a two-child policy, a decline in births of two million. The lowest rate since 1961.

Marriage is also, marriage rate is the lowest it's been in 11 years.

Labor issues. So, I think the reorientation of the supply chain is having some impact, estimated somewhere, the numbers that I've seen are between 1.2 and two million jobs have been lost as a direct effect of the trade war.

Li Keqiang, the Premier, has talked about employment as his number one concern. And they are now establishing a new central leading group on employment.

So, even if we're not sure of the exact impact, we do know that the concerns are significant. Right?

We can look behind the scenes to try to see what they're doing politically to address these problems, even if we don't know whether the unemployment rate is really four percent, as they say, or 20 percent, as you can find some Chinese scholars asserting.

And then last, I think the trade war, at this point in time, is now strengthening the hand of the hardliners.

I think if you look back nine months to a year, you would find a period of time when Chinese economic reformers, certainly privately but also, to some extent, publicly, would talk about President Trump and the trade war as an opportunity.

All right. An opportunity to push forward on structural economic reform, much in the same way that Zhu Rongji used the pressure from accession to the WTO to work on state owned enterprise reform back in the late 1990s.

Now, however, that type of talk is not, at least I don't hear it anymore, instead what you hear is that the United States is trying to contain China. Our own narrative has moved from one of holding China accountable, right, to a rules based order to talking about China as an existential threat.

And I think that shift in narrative has allowed the hardliners to come up with their own narrative that basically says, the United States is trying to contain China.

This isn't simply about intellectual property theft or what we're doing wrong on the lack of market access, right, this is about the fact that we are now, when I was in Beijing in July somebody said, we are now technologically superior to the United States and the United States doesn't know what to do, so this is their response.

So I think this is emboldening hardliners and giving them sort of greater strength and weakening the hand of the economic reformers. I think the fact that we don't distinguish now between national security and economic security is also problematic.

Are we talking about 5G or are we talking about subway cars I think is an issue that we have to address. And I think it also very clearly enhances Xi Jinping's efforts to decouple the two economies and push forward more aggressively on Made in China 2025.

What should we do? I think first we have to change our narrative back to one that talks about China's adherence to the rules of the game. And that is a good way to bring in our allies because they all do support what we're trying to do with China on the trade front and it allows us

to bring more pressure to bear on them.

I think second we do have to distinguish between economic and national security more clearly. And then third, I think as Mr. Polk mentioned, it's about U.S. resilience. It's about investment, immigration and education. I'll stop there.

PANEL I QUESTION AND ANSWER

VICE CHAIRMAN CLEVELAND: Thank you. Commissioner Fiedler.

COMMISSIONER FIEDLER: I want to delve into a little of the behind the scenes sort of politics and the impact of what I characterized earlier as unpredictability in the relationship and what that has meant in normal diplomatic relations going on.

I mean, with trade, the trade war has captured most of the public attention, but there are lots of other things that have to be going on behind the scenes. In others words, do we have as much access to people in positions, whether in the private sector or the government sector as we had before, how are the Chinese viewing the unpredictability of the relationship now? Liz if you would start?

DR. ECONOMY: Sure. I think in the beginning the Chinese felt as though they had President Trump pretty much figured out. They believed that by buying more goods they would address what was his primary concern and that the whole thing would go away.

I think over time they have become less certain of their ability to understand the direction in which the administration is moving. And I think at this point in time there is also a certain amount of exhaustion.

So, I think if you look at the, sort of the various stages of Chinese statements, I think they begin with, you know, there was some laughter and some jocularity.

I can tell you in the expert community around President Trump initially, I think that moved to some greater concern. And again, a desire to strike a deal and to move forward. To have a good relationship with China.

Victor, I think, sort of began to talk a little bit about some challenges that President Xi might have faced. This would be last summer.

Where it looked as though the fact that he couldn't make the U.S.-China relationship work was bringing some pressure to bear on him within the top echelon, as well as push back on the Belt and Road initiative.

I think that has now ended because the more unpredictable the United States is the more that they can't understand what it is we're really after, what is a good deal. I think the less patience they have and the more they just believe that Xi Jinping is the right person to stand up and lead China forward.

So, I think sort of going back to what I was suggesting earlier, I think there was a moment in time when economic reformers were empowered. There was a sweet spot, and I think we've moved passed that sweet spot at this point in time.

COMMISSIONER FIEDLER: Thank you. Do either of you want to comment?

MR. POLK: Yes, I mean, I would agree that the change in perspective in Beijing has been quite swift.

Just a year ago, June 2018, before the first 301 tariffs came into effect, there was still a feeling we could figure out the U.S. President. And the Chinese were just absolutely stunned by how quickly the narrative, the sentiment in Washington, D.C. on both sides of the aisle, shifted against them.

And now they very much view the relationship as one of containment. And in terms of the volatility, I think they're steeling themselves, essentially, for short-term volatility and long term competition.

Just yesterday Xi Jinping gave a speech to the central party school talking about how we have to get ready for struggle on economic fronts, on societal fronts, on political fronts. And the

political narrative in China, internally, is very dire right now. And it sort of talks about the long march and self-sufficiency and all these things.

And so, I think they view the world as having fundamentally changed in this past year, in terms of the relationship with the U.S.

COMMISSIONER FIEDLER: Victor.

DR. SHIH: Very quickly. I think just echo a couple of points that have been raised already.

So, I agree completely the fact that One Belt, One Road has turned into this big waste of money. The fact that China does not seem to be managing its, certainly its economic relationship with the United States very well, and then of course what's happening in Hong Kong, really is diminishing Xi Jinping's reputation.

Because I think when he first took power at least he saw himself, and therefore of course the rest of the party also had to agree with the perspective that he would be the savior of the Chinese Communist Party. And now we have seen, not sort of disastrous blunders yet but kind of fairly costly blunders and him having to sort of change course.

So I think going forward this is going to be interesting. It will perhaps will change the way in which he makes decisions to make it a bit more democratic, instead of just him making all the decisions. So we don't know.

I think that's an open question. There are some signs to suggest that maybe this is the case.

In terms of the reform I think, you know, a lot of it is, as the blunders accumulates, the party increasingly shifts from wanting to sort of try new things to speed up growth or to make the market more market oriented to just risk management. This is something that Andrew pointed out already.

And, again, I was also struck by this speech in the central party school where, was this the Pudong Party School or --

Yes. One of the party schools, in any event, where it seems like he is preparing senior level cadres, so these are very, the audience is pretty senior level cadres, for disasters to come.

And basically telling them that even if really hard times were to come, you should remain loyal to the Chinese Communist Party. That's very dire language, you know, at the time when we're not even, and I agree with Andrew that even though, I mean, trade itself has had some impact, but the Chinese economy is a massive economy.

The trade war certainly has not crashed the economy by any stretch of the imagination, it has just hit sectors that have been main beneficiaries of China's previous industrial policies.

COMMISSIONER FIEDLER: Thank you. Commissioner Wessel.

COMMISSIONER WESSEL: Thank you all for being here for the time you've put into your testimony, both written and oral, so thank you.

I have to say, I'm sort of confused and stymied by all of this because we're still having discussions about engagement and theoretical rebalancing, et cetera. And we're in the middle of a real challenge period about how do we address what has been taking place in China.

Dr. Economy, you talked about the issue of compliance with the rules, et cetera. I think after 18 years in we should agree that China has not complied with many of the rules. And certainly with the vision that the western nations had when China joined.

So, we're at a point, in my opinion, where it was time to confront China on its policies. We saw little engagement by our multilateral partners. Some of that was our own fault by not engaging them, and still is.

But the multilateral system doesn't seem to be willing to or capable of addressing the China challenge. And we're also at a point where we are looking at different metrics about what success is.

And we've talked a bit about investment this morning. To me opening China up for more U.S. investment will probably only continue our current path as 60 percent of China's exports emanate from foreign-invested enterprises.

We're not reaching the Chinese market or its consumers like we'd like. It's still being used as an export platform.

More investment will probably lead to more technology sharing, et cetera. So, whether you believe the problems in China have been brought about, were of their own making in the trade war, trade policies are a big or just a small contributing factor, what do we do now?

Do you believe multilateral partners are really going to engage? Do you believe that the WTO is capable of, with its rules and its decision making process, of addressing the China challenge or, and I believe it was LBJ many years ago who said when you have somebody by the ear, don't let go, to try to get a better grip. I'm paraphrasing.

(Laughter.)

COMMISSIONER TALENT: I was going to say, I don't think those are the exact words.

COMMISSIONER WESSEL: No.

(Laughter.)

COMMISSIONER WESSEL: We're on CSPAN, so those are the one I'll stick with.

So, whether you like the policy the President has engaged in or not, isn't it time that we confront China, and what would you do differently now to try and make sure that we actually get to a better, let us say Western concept of adherence to the rules?

And I'll go down each of the panelists. Dr. Economy, since I used your name first, why don't you start?

DR. ECONOMY: Okay, thank you. So, I don't disagree that it was time for a reassessment of the U.S. approach to China.

And I think actually the Trump Administration has done a good job of understanding China under Xi Jinping and coming to the conclusion that China is not moving in the direction that we had hoped for across the full range of issues in the economy, the political, domestic and in terms of its foreign policy. So, I think that has happened and that was important.

At this point, however, I think it would be useful to draw back in our allies, because in fact, they do agree with us across the board. Right.

Whether it's, on Huawei we have support, from a number of countries. Whether it's on sort of the Belt and Road initiative and concerns, the EU has stood up on that, whether it's human rights we find partners, in the United Nations. They're out there. But we are not in fact engaging with them.

And the advantage of bringing in the allies, I think, is twofold. First, it reduces that sense of the United States simply trying to contain China and that we're afraid of China. Right.

I do think it's important that we shift the narrative because, the truth is, we look weak when we're in China now. We look as though we are operating from a defensive position as opposed to a position of strength.

And so, bringing in our allies defuses that sense that this is all just about the United States and China. I think it also helps us to bring pressure to bear. Right?

The European China Chamber of Commerce and the American China Chamber of Commerce say the exact same thing, and I think that's important.

We can still use reciprocity, but I think asserting a more positive vision of U.S. economic leadership globally is equally important.

Free and Open Indo-Pacific, right, and filling that in. As I think a number of our agencies have been doing, I think it's absolutely essential.

So, from my perspective, the best defense is a good offense. And I don't think at this point that is what we are undertaking.

COMMISSIONER WESSEL: Mr. Polk.

MR. POLK: I'd echo a lot of what Dr. Economy said. I think the relationship has to change and everyone is trying to figure out what a sustainable equilibrium looks like.

We're in an unsustainable equilibrium with China right now. And the relationship needs to undergo change. I don't have the answer for you today on what a stable equilibrium looks like, but I do think there are a few things.

One is bringing along friends and allies. Absolutely. I interact with embassies in Beijing every single day and every European country, New Zealand, Australia, Japan, Korea, they all agree with the idea that China needs to play by the rules and things need to change.

So, engaging those allies and bringing them along is hugely important.

Second, Dr. Economy talked about the national security issue. On both sides of the Pacific, the idea of national security is getting bigger and bigger in terms of economic national security.

So, finding some limits of that that we can live with I think is hugely important. Otherwise, if everything in both economies is national security there is not even a starting point for discussions.

And then I think also understanding the nuance of China. The tougher stance from the U.S. and others I think has produced change in China, both positively and negatively.

I actually see more opening than I think a lot of other people do, specifically in the financial sector. I also see marketization in areas of the economy. Yes, the state is growing, but also, there is more room for markets.

In the Chinese leader's mind, that's not a total paradox because both things are both happening at the same time. So, in a sense, recognizing when China is moving in the direction we want.

There is multiple things happening at the same time. So recognizing that I think also gives it a basis for discussion.

But I would say those three issues are top of mine. Bringing along our allies, defining national security, especially what's not national security, and then recognizing actually whether there is some progress.

But absolutely the pressure needs to continue because, in my view, it's produced some good results. And if we can continue that pressure with the positive vision of what the outcome might look like, then we're moving in the right direction.

DR. SHIH: Hi. So, I also agree that things have to change. The trading relationship has to change between the U.S. and China.

But I think it's helpful here to segment between nonstrategic sectors and strategic sectors. So there are a lot of nonstrategic things, like farm goods, energy, you can say, well, it's strategic or not, and textiles and furnitures and stuff like that, where American consumers have benefitted enormously by buying these things at a relatively low cost from China, from the rest of Asia. And also, American businesses have benefitted enormously by selling a lot of farm goods, soy beans, et cetera, to China.

Now, of course, there are strategic sectors. Like IT equipments to be, as one of the prime examples, where China's stated objected has always been, since 15 years ago, to relocate the entire global supply chain from other countries to China.

They have largely succeeded in this quest, with the exception of several very high end components, like chips, et cetera, et cetera. There, of course, that needs to be restructured.

But the way that we're doing right now, what we're doing now, is to force some of our allies to move the production out of China. I don't think that's especially helpful because that's basically like a club where the only benefits that you get are bad things, right. So, it's a club for bad things.

Instead I think the U.S. should try, and its allies, should try to think of a way to form a club where there are positive incentives, right?

So, what's in it for them if they are willing to relocate some of the supply chains out of China to other countries, there has to be some kind of benefit. Whether it is if, if they meet certain standards then they qualify to get certain kinds of contracts for critical infrastructure or security related contracts.

So, I think I would urge policymakers to really think about ways to create positive incentives.

COMMISSIONER WESSEL: Thank you.

VICE CHAIRMAN CLEVELAND: Chairman Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you. Interesting testimony from all of you, thank you. Thank you for the continuing work, analytical work that you do.

I really want to associate myself with the comment about the importance of working with our allies. I think that it's a China issue, it's a global issue for us, and I think we need to rebuild those relationships and do what we need to maintain them.

I would say though that certainly the problems in the relationship, I mean, I've been doing this for 30 years now, I think some of you are probably doing it just about as long, these are not new.

And people seem to forget that we have been struggling with some of these issues which were exasperated by the World Trade Organization accession, right? It was supposed to solve the problems and it hasn't.

Dr. Shih, I would, I'm going to be like Wessel and end up talking instead of asking questions and I have questions, but --

(Laughter.)

CHAIRMAN BARTHOLOMEW: -- but I do want to say that the consequences of losing textiles and shoes and furniture for the American workers and American communities has been quite significant. It has not been cost free, right?

It has not been cost free to regions of this country, it has not been cost free to the tax-base and communities and their ability to educate their children and provide health care and all these things. So it's, to me it's not quite as simple.

Another question or issue I have is, wasn't some of this moving the production out of China happening already before because of increased labor costs?

So, it's a continuation of a trend that might be speeding up. Okay, that's it.

What evidence, again, for 30 years we've been hearing about economic reformers inside of China and how important it is to support them. And I would argue that the MFN debate that we had back in the 1990s, some of what we were trying to do was to support the economic reformists.

But what evidence exists that Xi Jinping himself actually is an economic reformer or wanted economic reform, is there any? No. It's an easy question to answer, I can move on to another one.

MR. POLK: I would just quickly say I don't think Xi Jinping cares all that much about the economy.

CHAIRMAN BARTHOLOMEW: Oh.

MR. POLK: I think he cares about politics and his project is to rejuvenate the Communist Party of China. And he has largely delegated the economic decision making now to Vice-Premier Liu He. And even it seems that Li Keqiang is still in the mix of it.

So, I think the de-risking campaign I talked about was all about Liu He grabbing Xi Jinping's ear and saying, listen, if the economy blows up while on your watch, it doesn't matter if you rejuvenate the party.

And so, I think Xi is, that's the last thing on his mind. He cares about politics, military, society, Chinese culture, and the economy is just a tool to get those things done.

CHAIRMAN BARTHOLOMEW: Dr. Economy or Dr. Shih?

DR. ECONOMY: So, I would say maybe, not that he doesn't care about the economy, because he does have built into his great rejuvenation of the Chinese nation having China be a modern innovative economy on par with the United States and Japan and Germany, doubling Chinese incomes by 2020, so he definitely has economic objectives.

But you asked about Xi Jinping as an economic reformer and I think if we take reform to mean opening up, right, reform and opening up, not just reform as change, he clearly is not an economic reformer. Everything about Xi Jinping from day one has been about reasserting the role of the party and the State into the Chinese economy and into Chinese society, right?

So whether you're talking about enhancing the role of party committees, whether in Chinese enterprises or in joint ventures, or even ensuring that multinationals have party committees or you're talking about continuing to strengthen the role of state-owned enterprises or applying the social credit system to companies, including to multinationals, all of that is about enhancing the role of the ability of Xi Jinping and the Chinese party to use companies as tools of the state. So, economic actors as political actors.

CHAIRMAN BARTHOLOMEW: Thanks. Dr. Shih, anything?

DR. SHIH: I think that one of the key points that people should realize is that Xi Jinping, I think despite the fact when he was the Governor of Fujian Province, which is in the coast, I think his understanding of how the market economy actually operates is very superficial and minimal. Because he has lived his entire life under a planned economy.

Even after the reform he was already a senior government official where all of his food, his housing, everything is arranged by the Chinese Government. So, I don't think he actually knows how the real market operates, how, and especially not the financial market, which is another level of difficulty.

So, I think a lot of high-level policymakers in China struggle with this limitation.

CHAIRMAN BARTHOLOMEW: Thank you. Dr. Economy, what you said, the phrase of using companies as tools of the state is a very important thing, and if I have a second round opportunity I want to delve into that. Thanks.

VICE CHAIRMAN CLEVELAND: Admiral McDevitt.

COMMISSIONER MCDEVITT: Thank you. As always, when we're talking about the economy, I spend a lot of time learning as opposed to questioning, but I do have a couple of things that came to mind listening to your excellent testimony.

Dr. Economy, you dwelt on the issue of hardliners. I guess I've been, perhaps, in fact, I'm quite certain, I've been dealing with Chinese hardliners for the last decade, that I can think of.

I'm talking to Chinese, either PLA or security people, and they've been talking about the U.S. trying to contain China since the pivot was announced. And that's 2010.

So, there isn't anything new I would suggest that there is a lot of people in China talking about the U.S. trying to contain them. What I am interested in is today's hardliners versus the ones that ten years ago were fulminating. Has the hardliner view expanded, are there more people who would sign up to being hardliners in China because of the trade wars and what have you?

The other question I have, and I'd like any or all of you to chime in on this, is this connection between the downturn, the slowing of the Chinese economy, and the willingness of Xi and whoever else advises him on Belt and Road to, as we heard in this past summer's global BRI conference, the new approach.

High quality projects, we're going to get a handle on corruption, et cetera, et cetera. Is this all related to the downturn in the economy or is it related to the narrative that I think Washington started by calling the BRI a debt-trap, et cetera, et cetera, and raising all of the potential problems associated to BRI?

DR. ECONOMY: Okay, so, let me say one word on the Belt and Road question and then go to your first question.

I think absolutely. The Trump Administration, Secretary Tillerson in particular, was out there very early on calling the Belt and Road debt-trap diplomacy. At the time it looked like sour grapes because we didn't have an alternative, now we kind of do. Plus the Japanese are out there with a lot of higher quality offerings than the Chinese.

In terms of whether, so I do think that that played a lot, had a lot of impact in terms of focusing the attention of many countries, right, on what was going on, and then they are realizing that some of what they were doing with China and the Belt and Road was not necessarily for, in terms of serving their long-term interest.

So I do think there was a lot of push back. And that certainly contributed to the April forum and that sort of quieter tone.

Do I think that China is going to make a significant turnaround in terms of actually addressing the corruption, improving transparency, higher quality, et cetera, I think probably not.

This is not, the Belt and Road is just built upon more than two decades since the going out strategy of the late 1990s, which was China going out for natural resource quests.

They already have in place many rules and regulations within China EXIM bank, China Development Bank, within the Shanghai Stock Exchange, et cetera, that are all devoted to trying to ensure transparency, rule of law and accountability in their overseas strategy, and has yet to come to fruition.

So, I'll see it when I see it, I'll believe it. In terms of whether or not there have always been hardliners and what's different now, I think what I'm really talking about is that we are closing down the space for the reformers and the economic reformers.

It wasn't even just the economic reformers who were quite vocal last October, et cetera, about trying to push ahead with structural economic reform. But you can talk to many people in the political sphere, and also entrepreneurs, who say, what Donald Trump is doing right now with this trade war is great because it's the last bulwark against Xi Jinping's sort of overreach and his great ambitions, right, and the fact that he's clamping down politically.

So they were encouraged by what the United States was doing. But I think at this point

we've pushed too far.

And so, when I'm talking about emboldening hardliners, I am saying that we've crowded out a lot of this space for those reformers and we've given, with our narrative and our, somewhat of our craziness, we've given Xi Jinping a scapegoat for what's going on for the challenges that he's faced and the ability to stir up nationalism.

COMMISSIONER MCDEVITT: Mr. Polk.

MR. POLK: Yes, just quickly on the hardliners issue. I would just encourage you to think, yes, there have always been the hardliners in China, but I don't conceptualize it as hardliners dragging Xi to a more conservative position or a more ideological position.

I don't think he is outflanked by anyone. And maybe there are more reformist voices that are cowed because of current dynamics. So, just Xi is a hardliner is what I'm trying to say.

So, there is no one outflanking him there. No one trying to pull him in any direction on that side.

On the BRI stuff I would just say also, Xi Jinping has characterized the BRI as a hundred year project. So, you know, we see these news stories on a day-to-day basis, the BRI has failed. Well, we won't know for 100 years, so we don't know if it's failing or being successful.

So, I think that is one of the, I think it's a misconception that China's policy makers always take this long-term view or whatever. But on that front, I think they are.

And I would also just say, they learn. As I have said, they are pragmatists. And I think frankly they got sick of throwing good money after bad. They've got burned, so have decided to recalibrate for the time being.

They also had a capital outflow issue which was fundamentally important for them reining in that spending.

Dr. Economy has been doing this longer than I have so maybe, you know, I agree with her that I'll believe it when I see it in terms of really trying to root out corruption, but at least they seem to be wanting to do these projects on a more straightforward -- not a fully transparent basis but maybe a more transparent basis.

Because there's an understanding in my view that corruption is one of the key issues that is an existential issue to the party, domestically, and that if they start to export that it may become an existential issue abroad.

DR. SHIH: Hi, very quickly. So on the softliner, hardliner question, I think the only serious debate that I've seen internally, just reading Chinese sources, is one of, so, the entire elite agrees that China should one day replace the United States as the dominant power in the world.

Either as a sort of duopoly over the world or China just being completely dominant. So that's not the difference between the softliner and the hardliner.

But there is a serious debate about when China should behave as if it is a dominant power.

So, some people I think generally believe that China should behave today as if it is a dominant power and then others says, well, let's just wait another five, ten, maybe even longer, for the United States to shoot itself in the foot. And then if the technological progress continues in China then we can assert our power, our dominant power.

So, I think that is a debate that is ongoing, especially given some of the recent development.

On BRI I think, I think the internal desire to change how BRI is done is genuine. And the reason is because China no longer has as much money as it did, say five years ago, with which to throw billions and billions of dollars around the world.

When the foreign exchange reserve was \$4 trillion, China would use money directly from the foreign exchange reserve to finance many of the BRI projects. But there were a couple of problems.

One is that the foreign exchange reserve is now a lot smaller because of capital flight in 2015. And so, a lot of the new BRI projects has to be financed by borrowing money from western banks to finance BRI.

And there of course you don't want to get trapped in a situation where you borrow money, but then to finance a complete dud that ends up like Venezuela or Angola where China lost tens of billions of dollars.

These huge losses and the dwindling foreign exchange reserves, have certainly really alarmed the technocrats. And I think the technocrats over time have been able to persuade Xi Jinping that continuing to throw billions and millions of dollars around the world is not really viable, so they have switched to only doing it when it's strategically, absolutely necessary, and also have a set of procedures to do it a lot more carefully.

VICE CHAIRMAN CLEVELAND: Commissioner Lee.

COMMISSIONER LEE: Thank you. Thanks to the panel for excellent presentations and testimony.

So, my question is following up on some of the conversation we've been having about, I think you all agree in different ways that the Chinese economy and leadership are coming under stress from various causes from the trade war, from cyclical and domestic reasons.

So, what are the biggest dangers for the U.S. from China being under stress in terms of the economy and are there steps that Congress in particular could take to inoculate or to prepare for some of the likely impacts?

And I guess one thing I would mention in particular, is the currency devaluation. Dr. Shih, I think you mentioned it in terms of the risk for the U.S. in terms of financial exposure of holdings of Renminbi, but there's also another risk, of course, in terms of the trade impact on domestic business and workers.

And so, I guess I was just curious whether you think there are particular things we ought to be doing now in preparation for sort of predictable reactions.

DR. SHIH: I guess I'll go since I opened that door. So, I agree with you that it is a potential risk because, certainly there are economists in China who have publicly advocated for sort of one step devaluation.

So, just devalued Renminbi by 20, 30 percent in one shot. As, not only as a kind of measure against the U.S. tariffs, but also generally speaking economists have believed the Renminbi has been overvalued, anyway, for quite some time and to really sort of fulfill the market's expectation that the Renminbi should be lower and just do a one shot devaluation of 20 to 30 percent.

Yes, so of course, this will have a huge impact on U.S. businesses that compete with Chinese exporters. But by and large I think, especially in the manufactured goods industry, the impact will be bigger for Japanese, Korean and German firms.

Because these are the firms, let's say in heavy machineries and autos, et cetera, that are now today directly competing with China. So they will be hit even more.

For the U.S., I think, the impact is one that we are seeing already. Which is that Chinese consumers will not buy as much U.S. farm goods as before, but because of Chinese import restrictions we are seeing that already.

So, I think the biggest kind of trade shock for that kind of stuff for devaluation is already

evident because of some other reason, which is Chinese import restrictions.

The bigger problem, I think, is the financial risks. So, banks, especially European Banks, especially United Kingdom based banks, also Korean, Japanese Banks, but also U.S. Banks, have lent trillions of dollars to China.

And to companies and banks in China whose cash flows are denominated in Renminbi, so if the Renminbi were to crash, these firms, these financial institutions will have a much, much harder time to come up with the cash flows to repay U.S. dollar denominated debt.

And that will force a large proportion of them to declare bankruptcy, to default on their debt, causing stress on U.S. financial institutions. Including banks, but including even mutual funds.

A lot of pension funds have invested in debt issued by Chinese companies and banks. So there has, I really think there should be some auditing. It could be voluntary or not, of both direct and indirect exposure to Renminbi denominated assets.

MR. POLK: I wholeheartedly agree with Victor. I think from a real economic standpoint a slowdown in the Chinese economy, even a disaster, obviously hurts global growth. But the U.S. is primarily a domestic driven economy and is largely insulated from volatility out of China on a real economic growth standpoint.

I generally take a pretty positive view on China's ability to manage its currency. And what I mean by that is, is I don't, they have learned a lot over these past two and a half years because of currency volatility.

And they're actually quite adept at managing it so I don't worry too much about the currency channel. But a financial crisis in China that hobbles Chinese Banks, I think China has, what, the four largest banks in the world, that's something that's going to be a problem for the global financial system.

And we don't have much view into how interconnected that is. Both through Renminbi flows and U.S. dollar flows.

We know China's external debt picture of about \$2 trillion USD, which is large but small obviously in comparison to our economy, their economy.

But ordering a, commissioning a study to figure that out is something that it would be hugely productive and of value to every financial system and economy in the world.

DR. ECONOMY: So, I would just make two quick points. One I think that many American companies, as was raised earlier, have already began the sort of China plus one strategy of beginning to diversify their supply chains, right, even before the trade frictions began. This was already underway as was noted.

I guess from my perspective, one of the things that I'm interested in is that distinction between sort of a multinational Chinese company is becoming almost nonexistent.

And I think American companies are going to have to become, they're going to have to make a decision each for itself about where to draw the line. So, whether you're having a party committee in a multinational or adapting to the cybersecurity law where you have to basically give over information to the Chinese government.

Or you're going to be subjected to the social credit system or you're going to be living in a situation where your employees can be detained without any rule of law at whim.

I think what I've noticed over the past few years is just the eating away of private and public that's broadly happening in China, is also now being applied to multinationals. And I think that is a big challenge that American companies are going to have to confront moving forward.

COMMISSIONER LEE: I think you both raised issues, or that had come up also earlier about sort of the vulnerability of the U.S. or some of the judgement that the U.S. companies are now so deeply embedded in China that they don't really have any choices in terms of having to deal with their employees being arrested and so on.

And I think earlier maybe, Mr. Polk, you made the point about supply chains and the lack of diversifications of supply chains. And so, these are all sort of investment decisions that have been made in the past that we are now reckoning with.

And I guess one question for us, for the Commission going forward is, just to think a little bit more about, should we have foreseen some of this, has there been a failure of policy in terms of allowing such concentration and a lack of foresight in terms of investment patterns? Thanks.

VICE CHAIRMAN CLEVELAND: Thank you. I have three areas of question, and I wanted to follow-up on Commissioner Lee's interest in debt. So I want to talk about debt, banking and bonds.

My understanding is that the debt to GDP ratio is precarious in China. It's 245 percent. Which is worrying given the fact that it's an emerging economy, not a developed economy.

Dr. Shih, you noted that, in your testimony, that Chinese debtors have presented \$3 trillion in exposure to U.S. pension funds, mutual funds and banks. Can you speak more specifically as to what banks, what pension funds, what mutual funds you think are at risk and what the nature of that debt is, is it equity in Alibaba or is it bonds issued by a local government?

That's my first question. My second question has to do with banking.

And whether the market, well, let's do the first question and then we'll do banking second. We'll get lost otherwise. Thank you.

DR. SHIH: Yes, so very quickly. So, the \$3 trillion figure that I put in the testimony is China's total, my estimate of China's total external debt to the whole world. So not just to the U.S. To the U.S. it's roughly \$180 billion in direct exposure.

So that means that U.S. based banks and investors have lent approximately \$180 billion to Chinese banks and Chinese companies.

By the way, a large portion of that was through Hong Kong. So this is why, so of the \$3 trillion that China has borrowed from the rest of the world, China has borrowed a trillion of that through Hong Kong.

And you ask, well, why would China do that? Why doesn't China doesn't just borrow it directly from Beijing or Shanghai.

And the reason is because if you ask people within financial institutions around the world, because the IMF and the U.S. legally treats Hong Kong as a separate entity as China, then the banks can say, oh, well, if the whole world is going to treat Hong Kong as separate as China, then we're going to do that also.

So when we lend money to Chinese companies, we're going to lend both to their Hong Kong based subsidiaries and to the headquarters in Beijing, that way we can lend them even more money than prudential, internal rules would allow us to do so.

And you ask, well, why would they want to do that, it's because Chinese companies will pay higher interests. So this is why they want to do it.

So this is why, if Hong Kong were to be treated as the same as mainland China, actually the credit limit of all the Chinese debtors will automatically get compressed by 20 to 30 percent.

So, it is a big deal for China when you're in debt to the tune of \$3 trillion, you don't want your creditors to suddenly compress your credit limit by a trillion dollars, that would be a big

problem for China.

And I think that that may be one of the reasons why China, thus far, has chosen, I would call it a very moderate and softline approach in Hong Kong even though, of course, most people would disagree with me.

But to me the spectrum is what's happening in Xinjiang, what's happening in, I mean, Xinjiang is the hardline approach and Hong Kong is the moderate softline approach.

VICE CHAIRMAN CLEVELAND: The Chairman had a --

CHAIRMAN BARTHOLOMEW: Just a clarifying question which is, we keep referring to bankers here and I want to understand, are you talking about investment bankers or are you talking about our FDIC insured bankers?

I mean, what are you referring to with the bankers?

DR. SHIH: So, the main data source, for me at least, is from the Bank for International Settlements. And they report two series of data.

One is for bank lending, and then the other one is for bond issuance. So, I think U.S. bank exposure, it's like \$80 to \$90 billion.

So, U.S. banks, commercial banks, not investment banks, commercial banks have lent \$80 to \$90 billion to Chinese entities. But then U.S. investors have purchased, again, both through Hong Kong and through mainland China, an additional \$100 billion in bonds issued by Chinese entities.

But the buyer of these bonds can be both commercial banks and also mutual funds, pension funds, et cetera.

CHAIRMAN BARTHOLOMEW: Sure.

VICE CHAIRMAN CLEVELAND: I do want to turn to banking and bonds. I'm reading a rhodium paper that talks about PBOC essentially trying to decide whether or not it's going to bring to bear stabilizing influences in the potential bank failures or allow the market to price risk.

And they point out there's an inherent tension between reform and financial stability. Stability requires PBOC guarantees to increasingly risky and peripheral asset markets, reform requires paring those back as the default that Baoshang has done.

But PBOC cannot distinguish between appropriate and inappropriate pricing of market risks as guarantees because there is no history of doing it. So I'm curious about your perspective on what will happen when it comes to each of you, what's likely to happen in terms of PBOC's intervention to manage counter party solvency issues?

And then the second part of my question is, it seems to me that we've seen, when we talk about this opening of the financial market, we have seen a shift in local governments from issuing financing vehicles, which were off books to issuing bonds.

And I am concerned about, as I know, I recently read a report that the World Bank has indicated, they are concerned about the fact that there is an increasing emphasis on the issue of sub-sovereign and local bonds to finance projects. So, if you could speak to the bond market, how risky it is and does it simply reflect a shift from LGFVs to a different way or raising money that is comparably risky?

MR. POLK: Sure. So, starting with the PBOC, this, part of what's going on is kind of what I started out my testimony with, is there's been a very active program to de-risk the financial system, specifically the banking system.

And the way the banking system works, most of the, most speculative stuff happens in the interbank market, which is a little bit different than the interbank markets in other countries. There is more than just banks in there.

And it's not just about closing books in between banks, you can use vehicles in the interbank market to then lend onto trust companies and other parts of the real economy.

Because of that insanity, frankly, the PBOC started with de-risking the interbank market. And from 2017 to 2018, because all of those financial structures weren't really financing real economic growth, unwinding them didn't really have an impact on real economic growth either. But that started to have an impact on growth starting in mid-2018.

So now the financial regulators are in a situation where they're trying to deal with basically the effects of the de-risking campaign. They call it the risks of addressing risks.

And so, the de-risking campaign has slowed growth at a time when you're trying to slow growth of financial assets. And what that does is, basically it's the tide going out, we're seeing who's swimming naked, right?

So, Baoshang Bank was definitely swimming naked, Bank of Jinzhou, Hengfeng Bank. Those are the three that have really blown up.

And there is an effort to try to push these banks to price risk more on a market driven basis. This is, just in the past few weeks, PBOC has introduced a new monetary policy mechanism called the loan prime rate so that they can build an interest rate curve so that banks kind of understand where risk lies, both in time and space.

I view all of these quite positively. You've got to remember that the PBOC was created in the '90s I believe, right? And so, they're building all this from scratch.

Then there has been the moral hazard issue on top of it. So they're trying to slowly address moral hazard without blowing up the system, and it's a very difficult thing to do.

So, in my view, that's the most positive thing that's happening in China is financial reform, in terms of trying to do this on a marketized basis.

I'll just quickly touch on the two other things. Your question about, which pension funds getting exposure to China, the answer is every single one of them.

And the reason is, because of MSCI inclusion, bond inclusion, all of those things. The exposure is relatively small now, but it's only going to grow over time.

You know, when we sign up to a new job and you pick a random pension fund from BlackRock or Fidelity, they all have an emerging market index. And those indices are increasingly including China.

So, we are, our financial system has come in the, you know, the pensions of our teachers and other employees in our country are increasingly intertwined with China's financial system. So, we should be aware of that at the very least.

The final part on the LGFV bonds. I also view this as a positive development. I mean, for years economists have said you need hard local government budget constraints. That's effectively what they have done.

They've said, we want all this on book rather than doing it in the shadows. They're leveraging up more slowly. They're still leveraging, but more slowly. It's a little bit more transparent.

So I think, again, this is an area that should be encouraged. It's okay for local government bonds to be used, it's actually better than using the LGFVs.

In terms of the riskiness we don't really know because we haven't had an LGFV bond default. But in general, we should view it as high quality government paper, because it's effectively going to be backed by the central government.

So, I think the bond developments in this space are actually, there are so many risks that they have to address that the problem is very big, but I am quite sanguine in this area in terms of

the proactiveness with which they've gone after the issues.

DR. SHIH: So, I just want to really echo one of the points that Andrew brought up which is the size of the domestic Chinese bond market. It is enormous.

There is probably \$6 trillion in bonds outstanding. And so, that means that a lot of the bonds mature every month and so you have to replace maturing bonds, and then you also even issue new bonds to finance new debt.

So that means every month there is \$100 to \$150 billion U.S. in new issuance. And this is what keeps China going is, it's like a big Ponzi scheme.

And I'm not the first one to have said it, I mean a lot of people say that. And actually, even the Chinese government says it is a Ponzi scheme, but guess what, we support it.

But, the Chinese government would like foreign investors to help them finance this. I mean, right now, foreign investors are buying anywhere from less than one percent to, at most, three percent of monthly issuance.

They would like that ratio to increase to ten, 20, 30 percent. Because obviously, if the whole world is involved, let's say, with their debt issuance, then it's not in the world's interest to blow it up. And the whole world can help financing.

And of course, the fact that interest rates are negative in Europe and Japan is helping China's cause because German and Japanese investors facing negative yields in their home country, they have an interest in increasing their yields.

And besides the U.S., the only other major option that they have is China. So this is, just to give you guys a big picture view.

VICE CHAIRMAN CLEVELAND: The bond terms are how long? The average.

DR. SHIH: They have everything. Oh, on average, probably five to ten years.

VICE CHAIRMAN CLEVELAND: Okay.

DR. SHIH: Because they have like 20 year and then they have short-term stuff.

VICE CHAIRMAN CLEVELAND: At what percentage?

DR. SHIH: So, sovereign bonds, Chinese government bonds and all the local government bonds now are less than three percent yield because the fed has cut rates. And that actually affects corporate bonds, four, five percentage. Something like that.

VICE CHAIRMAN CLEVELAND: Okay, thank you. Commissioner Lewis.

COMMISSIONER LEWIS: Thank you very much for your educating us today. I've been reading recently a lot about decoupling these two economies. Could you tell us, is that possible, how would it occur and what would be the impact on the two countries?

DR. SHIH: I'll give you some numbers, I guess. I don't know. So, to some extent decoupling has happened already. Especially, surprisingly I think on China's side.

So, China bought a lot of farm goods, bought a lot of energy products from the United States. You know, hundreds of billions. That has gone down by a lot. You know, 50 plus percent.

So, interestingly, despite there being all this talk about the U.S. is guilty of imposing tariffs and all this kind of stuff, if you look at the dollar amount that's being traded between two countries, China has shrunken that trade a lot more so than the U.S.

The U.S., I mean, despite the tariffs and everything, is still importing a lot of stuff from China because even with the tariffs that China is still better, so --

COMMISSIONER LEWIS: Is that one of the reasons why our deficit with China is increasing?

DR. SHIH: Yes, it's because the extent to which China has decreased imports from the

U.S. is even more so than the impact of the tariffs on U.S. imports from China. You're absolutely right.

So, if there is true decoupling it will be because the U.S. stops buying goods and services from China. But I think costs for a lot of consumers will go up by a lot actually.

COMMISSIONER LEWIS: What would be the impact on the two economies, the two countries if we decoupled more?

MR. POLK: I think it's hard to say on an overall growth perspective. I think that each economy individually would not change that much, but their relationships with other countries, economies would change.

What I mean by that is, when I hear decoupling I think generally the U.S. being concerned about selling core technology to China, that's going to enable either military applications or their rise generally.

The maybe ironic thing about that is China also wants to decouple. They don't want to be reliant on the U.S. for those core technologies, they would have preferred to decouple more slowly.

But I think the natural outcome of that is that we're creating spheres of, technological spheres, at least China and the U.S. Maybe Europe has its own sphere.

And the long-term change is, what if an American company wants to do business in Argentina, will it have to work on Huawei systems or other Chinese technological standards in order to do business there? So it's going to, I think, sort of fragment the global economy. Raise transaction costs and change sort of our interaction with other specifically developing economies.

DR. ECONOMY: So, I'll just be brief. I think Made in China 2025 was, is, in fact an effort to decouple, right, because it's basically saying that it wants Chinese companies to control 80 percent of the sort of market in ten areas of critical cutting edge area technology. Everything from medical devices to AI.

So I think that process was already underway and it continues. And it's being played out.

So I don't think we should be under the illusion that just because they're not talking about Made in China 2025 it's not happening, it is. And not only is it happening but I think it's also being exported.

So, I think when we're talking about spheres of influence, it is in part exactly as you say, things like Huawei operating system. But it's also, for example, China now helping to build the health infrastructure in Africa.

So they are doing hospitals, doing good work ostensibly. But also then ensuring that Chinese factories that are making Chinese medical devices are the ones that are providing the sort of equipment for those hospitals. Right?

So, medical devices are one of the areas of Made in China 2025. And previously China had passed a regulation in Fujian Province, for example, that said, if you don't, to hospitals, if you don't use Chinese made medical devices then you can't be reimbursed through insurance.

So, I see this very much as the first step was made by China in terms of decoupling, and now we're going to be moving toward an effort at a broader sort of export of that decoupling effort.

VICE CHAIRMAN CLEVELAND: Commissioner Kamphausen.

COMMISSIONER KAMPHAUSEN: Thank you. Thanks for a terrific panel. In the interest of time I'll dispense with my Wessel-like commentary and --

(Laughter.)

COMMISSIONER WESSEL: I'll take the time.

(Laughter.)

COMMISSIONER KAMPHAUSEN: -- two questions. First, Mr. Polk, thanks for terrific written testimony, I have a question.

I don't know if you have it in front of you, but on Page 10, the paragraph under demographics, the last sentence reads, according to projections by the World Bank, China's working age population is likely to contract by over 193,000 people by 2050. A reduction of almost --

PARTICIPANT: One hundred ninety-three million.

COMMISSIONER KAMPHAUSEN: Mine says 193,000. Just a typo?

(Off microphone comments.)

COMMISSIONER KAMPHAUSEN: Okay, that was easy. I appreciated the emphasis that all three of you have made on the notion that we can cooperate better with our allies.

The narrative, I think, matters, and, Dr. Economy, thank you for your thoughts on that. But I would submit it's not the case that our allies are just standing by waiting to be called upon.

Our staff, Dr. Economy, in preparation for the hearing, gave us a copy of the article you wrote in Democracy Journal in Spring of this year. And the first paragraph of the conclusion you say, the U.S. China trade war has already produced a near set of winners and losers. The United States and China are both losers.

Firms in some other countries are the winners. Malaysian and Japanese, Cambodia and Vietnam, Brazilian soy beans and so on and so forth.

I'd invite our panelists to comment on the degree to which this notion of our allies are just waiting for us to come back to them and then we'll proceed together perhaps overlooks the fact that they are, in the near-term, benefitting to some extent. At least companies from those countries.

DR. ECONOMY: Well, I would say, so that's one way in which they're benefitting but I would say all of our allies would still welcome the type of leadership by the United States that we've exerted in the past, exemplified U.S. foreign policy in the past.

But certainly I think Japan provides a great example. Not just of a country that can benefit in some ways from the spoils of the trade war but actively and proactively leading in the international space.

So, when we pulled out of the Transpacific Partnership, Japan recreated it in a different form. The comprehensive, progressive, whatever, CPTPP.

So that's moving forward. Japan is now the largest investor in Southeast Asia doing more infrastructure development than China. It's becoming much more active working in partnership with India and Africa on high infrastructure.

So I think they are moving forward without us in many respects but that doesn't mean that we shouldn't get back in the game. And, again, I think there are parts of our administration actually that are very much working with Japan and Australia and New Zealand to push back or to offer alternatives on Belt and Road projects.

So, a lot of things are happening that you don't necessarily know just from following what we hear out of the White House. So it's not quite as bleak, frankly, a picture as often is portrayed.

MR. POLK: Yes, I think it's complicated. Most countries, most companies want some level of certainty, right?

And so, yes, there may be short-term benefits in terms of capital flows, capital that would

have been going, Chinese capital that would have been investing in the U.S. is now investing more broadly in Asia.

German companies have been big beneficiaries of China's opening in terms of investing, BMW investing, BASF investing. Oh yes, it's getting sort of, China is wanting to show it's open to the global business community and so it's making high profile deals. German companies have been the big beneficiaries of that.

But talking to these folks, representatives from those companies and those countries, they understand that it's short-term gains and it may be long, not long-term gains.

And so, they prefer a world where they like the U.S. putting pressure on China. They'd prefer to get to a place where China was following the rules and the U.S. and China were getting along and they didn't feel like they had to choose between the two countries. Because a lot of countries and companies feel like that.

And so, it's short-term gain but from the people I talked to it seems outweighed by the sort of feeling of long-term uncertainty of present.

VICE CHAIRMAN CLEVELAND: Commissioner Talent.

COMMISSIONER TALENT: Yes, I see we're out of time --

VICE CHAIRMAN CLEVELAND: No, no, you're good.

COMMISSIONER TALENT: We have time?

VICE CHAIRMAN CLEVELAND: Yes.

COMMISSIONER TALENT: Okay. I'm going to follow up on some of Commissioner Cleveland's questions. And particularly with regard to the Chinese reserves that Beijing holds.

How valuable, I mean, how big of role do they play in all of this? What are they being held in?

And I say this because for years, when you talk about they're building up all this debt it could create instability, there could be a run, this bubble, this bubble, people will come back and say, yes, but they have \$3 trillion in reserves. I guess it's less now.

So what is that held in? Is that as big a backstop for them as people often portray it? Just give me your opinion on that.

DR. SHIH: Yes, so I guess I'll, since I've obsessed over this question for the past eight years.

COMMISSIONER TALENT: Like, how much of it is held in their own debt?

Do they invest this in their own debt?

DR. SHIH: Right. So, of course, the exact composition of China is roughly \$3 trillion and foreign exchange reserve is one of the most closely held secret in the Chinese government.

And you ask yourself, why is this such a big secret because you're supposed to reveal the exact composition to the IMF anyway. But I think even people in the IMF will tell you that they don't really know.

As far as we can tell, according to U.S. Treasury data, China holds roughly a trillion, maybe a little bit more than a trillion dollars in U.S. dollar denominated treasuries. And also agency securities.

So, a third of it we kind of know what it is, except we don't know if they have used part of their holding and treasury as collateral to get loans, in which case they don't really hold it.

Some people suspect that they have done this in 2015 and 2016 when a huge amount of money was leaving China. Okay, so that's a big question.

As for the other parts of the \$3 trillion, I would say at least \$300 billion of that has been loaned to BRI projects. And so that's not very liquid. So it's not exactly what you would want in

the foreign exchange reserve. It's not very liquid.

And then, from public records you can see that \$50 to \$100 billion of that is actually holding Chinese stocks. So the foreign exchange reserve has several subsidiaries that most people know is part of this foreign exchange reserve.

They have been buying stocks of Chinese companies and banks in the open market, in an attempt to prevent the stock prices from cratering during financial difficulties in the past couple of years.

It's not a huge amount but if you add all of it together it's \$50 to \$100 billion. Probably a little bit less than \$100 billion.

And then people believe generally that China holds a lot of euro denominated securities, that's pretty safe. But they don't think it's over half a trillion. So most people, it doesn't think.

So the question is, that leaves a gap of another sort of \$.7 to \$.5 trillion that I think very few people know what's in it. Some people believe that it's actually not really there.

So there's probably around half a trillion that's actually not there because China, the foreign exchange reserve has entered into all these complex forward agreements with banks whereby the banks really need the dollars so the foreign exchange reserve will give them the dollars from the reserve today but then take a promissory note, a forward from the banks but then count that as cash in the foreign exchange reserve.

They might have done that to the tune of several hundred billion dollars in 2015 when they were in big trouble. So, again, we just don't know.

COMMISSIONER TALENT: Yes, I really like you, Dr. Shih.

(Laughter.)

COMMISSIONER TALENT: I mean, I like the way, I mean, because I'm not an economist, I am a politician, and I know that they're under pressure, they're running out of money. And they got all these reserves there.

And the temptation to borrow against that or to use that as a way to deal with the short-term pressure has to be immense.

I mean, I just have to believe, when you called it a Ponzi game, we're being a little discursive because this is the last hearing, so I'll --

It occurred to me a couple of years ago, we're going through one of our drafting sessions and they're doing this semiconductor fund and this with BRI and pledging \$2 trillion to environmental remediation and everything, and I looked up at everybody else and I said, where are they getting all this money?

I mean, I've been in rooms, I was in the Congress and Senate, I've been in rooms and people talk about, I want to do this new program, okay, that's great, but it's going to cost \$8 or \$10 billion and people here freak out, and they're just throwing all this money around. And I don't know where they're getting it. So, I appreciate that.

I also loved your comment, the difference between the moderates and the hardliners. The hardliners are open about the fact they want to be the global hegemon, the moderates want to keep kidding everybody for another five or ten years. Thank you, Ms. Chairman.

VICE CHAIRMAN CLEVELAND: I appreciate Senator Talent's comments because this is something that I have been concerned about for some time, that if you have the kind of banking problems that we are seeing emerge with Baoshang and Jinzhou, and you are trying to prevent capital flight and you are seeing a significant decline in foreign directed investment which normally capitalizes your economy.

I have argued that it is not yet a perfect storm but I think that there is increasing pressure

on the Chinese economy that we need to pay clear attention to the early warning indicators.

Did the Chairman have some wrap-up comments? Does anybody else have a, go ahead.

CHAIRMAN BARTHOLOMEW: Yes. Well, I'm going to have to defer my discussion and questions about the private sector and how it actually exists and is defined.

But I wanted to associate myself with the comments of our Vice Chairman on Hong Kong when she, her opening comments.

And, Dr. Shih, I think it's a very important point that you mentioned that Hong Kong is an important source of capital for the mainland. And I think it's very important that people in the mainland understand that the reason that that's the case is because of Hong Kong's commitment to a rule of law and an independent judiciary.

And hardline tactics and trying to manipulate those things is only going to work against the interest of the people of the mainland. As well as the people of Hong Kong. Thanks.

VICE CHAIRMAN CLEVELAND: Any other summary comments that you all would like to offer since we've offered ours? No. Get out while you can.

(Laughter.)

COMMISSIONER FIEDLER: Thank you very much.

VICE CHAIRMAN CLEVELAND: Thank you very much.

CHAIRMAN BARTHOLOMEW: Thank you.

COMMISSIONER FIEDLER: We'll be back at 11:20. Is that all right? 11:25. How about 11:25.

(Whereupon, the above-entitled matter went off the record at 11:12 a.m. and resumed at 11:23 a.m.)

PANEL II INTRODUCTION BY COMMISSIONER FIEDLER

COMMISSIONER FIEDLER: Thank you. We'll catchup some time here. We're not too far behind.

I would like to introduce our second panel, which will explore major developments in U.S.-China security relations in 2019.

We'll start with Dr. Oriana Skylar Mastro, who is an Assistant Professor of Security Studies at the Edmund A. Walsh School of Foreign Service at Georgetown University and a resident scholar at the American Enterprise Institute.

She's the author of *The Cost of Conversation: Obstacles to Peace Talks in Wartime*, and is currently working on a book about China's challenge to U.S. primacy.

Next we'll hear from Dr. Andrew Krepinevich, who is a Senior Fellow at the Hudson Institute and Adjunct Senior Fellow at the Center for New American Security and President and CEO of Solarium, LLC, a defense consulting firm.

He's previously served as president of the Center for Strategic and Budgetary Assessments in the Department of Defense's Office of Net Assessment, and on the personal staff of three Secretaries of Defense.

He's the author of several books and monographs, most recently publishing the *Decline of Deterrence* earlier this year.

Our third panelist is Dr. Michael Green who is the senior vice president for Asia and Japan Chair at the Center for Strategic and International Studies, CSIS, as well as Director of Asian Studies at the Edmund A. School of Foreign Service at Georgetown University.

We are overrepresented by Georgetown University today.

Dr. Green has authored numerous books and articles on East Asia Security, including most recently, *By More Than Providence: Grand Strategy and American Power in the Asia Pacific Since 1783*.

I ask all of our witnesses to keep your remarks to seven minutes. Dr. Mastro, we'll start with you. Thank you.

**OPENING STATEMENT OF ORIANA SKYLAR MASTRO, RESIDENT SCHOLAR,
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UNIVERSITY**

DR. MASTRO: Thank you. Thank you, Chairman Bartholomew and Vice Chairman Cleveland and the rest of the Commissioners for having me here today.

I'm going to highlight a few aspects of my written testimony and the major developments in the last year in Chinese military modernization and focus specifically on the Sino-Russian relationship as well as the new Defense white paper and what it means for competition moving forward.

In terms of regional activities, the one, two big things I want to highlight here. The first is that Taiwan is still the driving scenario for the PLA. And what this means is that training, procurement, reforms and reorganization all have implications for Taiwan.

So, in the testimony I listed a number of platforms that are coming online in the next year. For example, China has begun, two years ago, the construction of a new nuclear attack submarine. They also have a new type of destroyer that are expected to come online soon.

These platforms, along with the platforms they already have, such as aircraft carriers, cruisers, destroyers, frigates, corvettes, the amphibious assault ships. All of these can be used in scenarios to coerce, blockade, invade Taiwan.

The Chinese Air Force has also made significant developments that would have implications for Taiwan. They're currently developing a new strategic stealth bomber. And they have a whole series of bombers, fighters, air lifts and helicopters for the ground forces that are all scheduled to be online and ready to go by 2020.

The Chinese military developments in this area are particularly concerning because of Xi Jinping's increasingly strident rhetoric on Taiwan. In his New Year's Day speech he outlined that unification is the ultimate goal of any talks in the future.

And in my analysis, based on this speech and subsequent speeches, it seems to me that Xi Jinping no longer just demands that Taiwan does not declare independence, he is now demanding that there are concrete steps toward reunification.

Now, what specifically this means, I think there is great uncertainty, but at the very least China probably wants to restart bilateral talks. And to do this they hope that the political party that's most amendable to this, that being the Kuomintang, will win the presidency in 2020.

And in the meantime, China is conducting very sophisticated exercises and in greater scope in order to intimidate Taiwan. The most recent happened in July after the United States announced an arms package.

Now, while Taiwan has been the focus of the PLA, the South China Sea has been of significant concerns, largely because of the relative improvements in Chinese military posture there.

In the past year we haven't see as much militarization happening, and that's only because a lot of that land reclamation, militarization had occurred before.

But we do consistently see the rotation of certain platforms on the islands. The J-10 fighters that are coming in and out of Woody Island. And they are extending radar capabilities.

China is also increasing the operational tempo in these waters, which suggests that they are practicing to have a more persistent presence there.

Of note in July of 2019, China conducted a series of anti-ship ballistic missile tests in the

South China Sea in Spratly Islands. This is the first time they conducted such a test over waterways versus over land.

Beyond East Asia, China military activities have increased significantly during Xi's tenure. According to the defense white paper, the Chinese 2019 white paper, China participated in 11 international humanitarian aid and disaster relief operations, 100 international joint exercises with 17 different countries and organizations. And has been active in five peace keeping operations overseas.

In 2019 alone they've already conducted 13 of these joint exercises, and humanitarian aid disaster relief operations, which suggest this pace is increasing.

Of significant concern, I think, is China's increased military presence in Africa, which has primarily expanded through their first and only military base in Djibouti. They also sell a lot of military equipment, drones and other surveillance equipment to Africa.

I think this is an area to be watched, Chinese military exports abroad.

Also, future developments in China in the Pacific Islands, in the Arctic, deserve to be watched. But right now, especially in the Arctic, the focus seems to be mainly on energy.

And China is increasing their cooperation, military cooperation, with the European nations. But again, most of this is more for the image of improved relationships.

The area I think that is most concerning to people when you look at security developments, the China-Russia relationship. And there's been a number of notable trends in this space which have been greatly covered in my testimony and other venues.

It is true that China has increased exercises, armed sales and diplomatic platitudes when it comes to their relationship with Russia.

I think this is not sufficient to suggest they're moving away from a relationship of convenience. And there are a number of obstacles to close their ties.

Specifically, China sees Russia as a liability and is interested in being seen as more of a legitimate great power.

Also, Russia still has relationships with some countries that China has poorer relationships with, such as India or Vietnam.

But while I think that we're being too alarmist about their relationship becoming closer, I think we're not concerned enough about what even the smallest degree of improvement in this relationship would mean for the United States military.

So, I think the first thing is that it seems that Russia has accepted a junior partnership. And this will change, I think, how we think about the cooperation moving forward.

I had always assumed that it would have to be symmetric. So, because China is not really willing to put its neck out for Russia, for Russian goals in Europe, I assumed Russia wouldn't be willing to help China achieve its goals in Asia.

But it seems, especially with the joint patrol that the two did over the Takeshima Dokdo Islands, that maybe Russia is willing to help China even if China is not willing to reciprocate.

This, to me, sparks a new trend in the relationship that might mean greater Russian military involvement in Asia, which will complicate U.S. military operations there.

For China they like to posit themselves as being a force of peace in the world. The Chinese defense white paper is not a national security strategy in the way that the United States has a national security strategy.

It is written by foreign audiences, and it had a few main themes that they wanted foreigners to know. The first is that the Chinese military is becoming much more comfortable with a global role, and China and the party is becoming more comfortable with the PLA

becoming more involved in promoting and implementing this role.

China also promotes itself as a force for peace, while the United States is an instigator of strategic competition and regional conflicts, arms racing, power politics, et cetera.

And also, the white paper is interesting because while it tries to estrange concerns about its military modernization, it had very harsh rhetoric for the first time about Taiwan in the maritime disputes.

The last point I'll make is about the peer, near peer competitor. I was asked whether China has reached the level of the United States, and I will just say that China does not need to be as sophisticated or as big as the United States to prevail in a conflict against the United States.

We're fighting different wars, even if it's the same war, we have different challenges. And I'm happy to go into that in the question and answers.

Also, because deterrence requires both capabilities and resolve, if we have a balance of capabilities that means we don't have a deterrent. Because China is much more resolved. They're willing to accept higher cost than the United States is in most contingencies. And therefore, to maintain deterrence the United States actually has to have better capabilities so we would suffer less than China would.

Also, there's a difference in how to assess trends of today in the future. The issue isn't that China has overcome or surpassed the United States, the issue is that given certain trends in the region, China will soon be able to outmatch the United States.

And as we know on the global stage, China is nowhere near being a peer competitor to the United States.

So, I have a number of recommendations in my testimony. Most of them focus on the South China Sea issue, which is, I think, the key area of strategic competition on the military side, between the two sides.

I think the United States needs to prioritize a diplomatic solution with or without China. Get all the claimants to agree on the sovereignty of the islands and what rights those islands give them and then have international enforcement of them.

I think the United States should consider protecting exclusive economic zone rights in their alliance commitments more clearly and improve our foreign posture in South East Asia.

Right now we're optimized for conflicts in North East Asia and not South East Asia, and it will take a great deal of political will to be able to have access in South East Asia. And I think that is what's really needed at this time.

Understandably, states don't really, leaders are worried about doing this because they want to avoid a war with a near peer competitor, but in my view, the only way to prevent a war is to deter Chinese aggression. If China doubts the United States' will to fight or our ability to prevail if we did, then they are more likely to rely on coercion and aggression. And this is what will drag our two countries into a war.

So, because of this, I think the United States needs to put all of its military resources behind maintaining a regional order, even if this means taking a few risks to ensure its success. Thank you.

**PREPARED STATEMENT OF ORIANA SKYLAR MASTRO, RESIDENT SCHOLAR,
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Statement before the US-China Economic and
Security Review Commission
On Shifting Dynamics in the US-China Security Relationship

China's Military Modernization Program

Trends and Implications

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Chinese Military Activities and Progress in the People's Liberation Army's Modernization in 2019

China's military modernization program has continued apace, with defense spending growing for the 24th consecutive year, making China the second-largest defense spender after the United States.¹ China spent an estimated \$175.4 billion on defense in 2019, with funds going to personnel, training, and procurement.² The increase in resources and effort has resulted in more frequent, sophisticated, and multifaceted People's Liberation Army (PLA) presence and activities in the region and beyond. China's main line of effort remains centered on East Asia, and its concerns are over the East China Sea, the South China Sea, and Taiwan. Below I capture the major developments in China's regional activities with a focus on the South China Sea and China's military presence beyond East Asia, as well as address recent developments in the Sino-Russian relationship and the publication of the 2019 Chinese Defense White Paper.

Regional Activities

Taiwan is the driving scenario for the PLA—in its training, procurement, reforms, and reorganization. Most Chinese military developments have implications for Taiwan. All of the Chinese navy's platforms, both undersea and surface, could be used to coerce, blockade, attack, or invade Taiwan. China currently has the largest navy in the world, with 300 ships consisting of aircraft carriers, cruisers, destroyers, frigates, corvettes, submarines, and amphibious assault ships. The construction of the Type 095s nuclear attack submarine, which began in 2017, and the first Type 055 Nanchang destroyers that China will likely put in service this year could be useful to blockade Taiwan.³ The Chinese Air Force is also developing a new strategic stealth bomber called the Xian H-20. The H-20 will join the J-20 fighters, Y-20 airlifters, and Z-20 helicopters in the PLA Air Force's "20" series of new aircraft. Many observers believe the "20" means they will be in service around the year 2020.⁴

Chinese military improvements are especially concerning given China's increasingly strident rhetoric over Taiwan. In his New Year's Day speech, Xi Jinping warned Taiwan that unification is the ultimate goal of any talks over its future and any efforts by the island to assert full independence would be met by armed force.⁵ Based on this and subsequent speeches, it seems that Xi demands concrete progress toward reunification, though it is unclear exactly what that means. At the very least, China probably wants to restart bilateral talks and thus hopes that the political party in Taiwan that is more amenable to this path, the Kuomintang, will win the presidency in 2020.

In the meantime, China has been conducting military exercises of greater sophistication and scope, partly as a show of force. In March 2019, two Chinese PLAAF J-11 fighter jets crossed the Taiwan Strait "median line" for the first time since 2011. This move was quickly denounced by the Taiwanese government, which called it "reckless and provocative."⁶ Taiwan President Tsai later warned that Taiwan would "forcefully expel" PLA warplanes the next time they crossed the median line.⁷ In May, the 74th Group Army of the PLA conducted a maritime exercise that included the ZTD-05s amphibious assault vehicle. The exercise was conducted, according to Chinese state media, to prove that the PLA was "well positioned to deal with Taiwan secessionists and potential island disputes."⁸ Then, in July, after Taiwan agreed to a \$2.2

billion arms deal with the US, China once again conducted an exercise in the Taiwan Strait that state media reported as being a “warning” to Taiwan secessionists.⁹

While Taiwan continues to be the focus of the PLA, there have also been significant relative improvements in Chinese military posture in the South China Sea in recent years. Through misinterpretation and manipulation of international law, coupled with coercive diplomacy and military intimidation, China is hoping to gain de facto control over the South China Sea. This would give China the military advantage in the first island chain, increasing the likelihood that it could prevail in contingencies over Taiwan and against other claimants such as the Philippines (a US ally) in the South China Sea. It would also give China significant leverage over other countries that rely on free access to the South China Sea for energy and their economic well-being.

On the military side, Beijing is positioning itself in a way that weakens conventional US deterrence. China wants the ability to deny foreign military vessels and aircraft access to the sea and airspace over the South China Sea. It has been making progress toward this goal by building bases in the South China Sea, specifically on Fiery Cross, Subi, and Mischief Reefs in the Spratlys (known as the Big 3). All these bases will have approximately 10,000-foot runways, and the airfield support facilities (including reinforced hangars) to accommodate fighters, bombers, tankers, large transport, patrol airborne early warning, and aircraft refueling.¹⁰ China’s largest island in the Paracels, Woody Island, is also China’s largest military outpost in the South China Sea. China has developed airstrips and port facilities and placed permanently stationed military personnel and temporarily deployed fighters, surface-to-air missiles, and anti-ship cruise missiles on the island.¹¹ In March 2019, it was reported that China was developing an island city on Woody Island with the intention of transforming the island into a “national key strategic service and logistics base.”¹² Since most of the militarization had occurred previously, there was little movement of equipment in 2019; China placed J-10 fighters on Woody Island and extended its radar capabilities on the island.¹³

China has also been increasing its exercise tempo in these waters. In February 2019, the PLAN conducted a month-long series of drills in the South China Sea, which included tests of PLA C2 systems, PLARF missile defense systems, repelling vessels, and live-fire exercises.¹⁴ These exercises were reported to have tested the PLA’s wartime command and defense systems in the South China Sea. On July 3, 2019, the US DOD confirmed that China had conducted a series of anti-ship ballistic missile tests in the South China Sea around the Spratly Islands. These missile tests were the first known time China’s missiles had flown over these waterways, as previous missile tests were conducted primarily over China’s mainland. INDOPACOM Commander Admiral Davidson confirmed a few days later that the missiles fired included a new submarine-launched anti-ship ballistic missile called the JL-3, which has a reported range that holds the entire United States at risk.¹⁵ While the Pentagon has yet to confirm all the types of missiles tested, media reports suggest it is likely that they included the DF-21D, known as the carrier killer, and DF-26, which reportedly can reach Guam and accommodate two types of nuclear warheads and several types of conventional warheads.¹⁶ The PLAAF carried out “combat condition” exercises with advanced Russian-built Su-35 fighter jets over the South China Sea the same month, including aircraft attacks on sea targets, fire-and-maneuver tactics, and nighttime operations.¹⁷ Lastly, in August, China conducted a three-day training exercise near the Paracels

and blocked ships from entering three of the island's waterways during this exercise.¹⁸ China has continued to deploy anti-ship and anti-aircraft missile systems to the Spratly Islands, including the YJ-12B land-based anti-ship missile to several outposts in the South China Sea.¹⁹

China also uses influence operations and predatory economics to coerce neighboring countries to reorder the Indo-Pacific region to its advantage.²⁰ Amid the ongoing tensions surrounding Chinese 5G technology and Huawei, China has issued warnings to countries such as Australia and New Zealand of the consequences of cutting deals with Huawei.²¹ Moreover, in 2019 alone, China has rammed and sunk a Vietnamese fishing vessel near the Paracels and a Philippine fishing vessel near the Scarborough Shoal.²² China has also deployed research vessels to hinder Malaysian and Vietnamese oil and gas drilling operations near the Spratlys.²³ China has been pushing for an agreement on the Code of Conduct (COC), likely a nonbinding document that would however commit Association of Southeast Asian Nations countries to managing the South China Sea dispute on terms favorable to China, such as prohibiting countries from military or economic cooperation with countries outside the region. While China has not publicly stated its intentions behind the COC, some observers worry that Beijing hopes to position it as superseding UN Convention on the Law of the Sea in international law, furthering its case for de facto control over the South China Sea.

On a positive note, in the East China Sea, where both China and Japan claim the Senkaku/Diaoyu islands, China had been reducing the frequency of its patrols and exercises from their highest levels in 2016 for air activity and 2012 for naval activity. This reduction may be due to the strategic focus on making gains in the South China Sea and the increased risk of confrontation with the United States in the East China Sea, as Washington has clarified that its defense obligations extend to the disputed islands. However, PLA exercises in 2018 were almost three times those in 2017, and by May 2019, PLA exercises for 2019 had already surpassed the total number conducted in 2018.²⁴ This suggests there may have been a change in policy to increased Chinese assertiveness in this area.

Beyond East Asia

The Chinese military activities have increased markedly during Xi Jinping's tenure. According to the 2019 Defense White Paper, between 2012 and 2018, the PLA participated in 11 international HADR operations and 100 international joint exercises with 17 different countries and organizations and was active in five overseas UN Peacekeeping Operations (UNPKOs). So far, in 2019 alone, China has conducted 13 joint exercises and HADR operations (compared to six in 2018).

China has greatly expanded its presence in Africa and the Indian Ocean, primarily through its first overseas military base in Djibouti, over a decade of Gulf of Aden anti-piracy missions, and its close relationship with Pakistan.²⁵ These developments have allowed the PLAN to keep a fleet of four to five surface vessels on average, plus submarine deployments in the Indian Ocean.²⁶ China has also used its "logistical support facility" in Djibouti to launch joint medical exercises and conduct live-fire military exercises in addition to the anti-piracy operations.²⁷ In 2019, China hosted the China-Africa peace and security forum, which invited both African military officers and key African Union leaders to discuss China-Africa cooperation and major

regional issues.²⁸ China also offers Africa financial support in the form of military assistance. In the past five years, 20 percent of Chinese arms exports went to Africa (the second-largest destination after Asia).²⁹ Pakistan and Algeria were China's largest and third-largest clients, respectively, for arms sales between 2014 and 2018.³⁰ Africa is a particularly robust market for Chinese drones and other surveillance equipment.³¹ In February 2019, foreign minister Chen Xiaodong pledged an additional \$80 million for the peacekeeping African Standby Force and African Capacity for Immediate Response Crisis, in addition to China's 2015 promise to donate \$100 million in military assistance to the continent.³² In terms of general investment, China has built or is planning to build 46 ports in Sub-Saharan Africa and has contributed nearly \$3.71 billion in transport investment in Africa as a whole in 2019 alone.³³

China has also been more active in its military diplomacy with the Pacific Islands, causing concern that China is seeking a permanent military presence there, in particular in Vanuatu.³⁴ While China has yet to conduct any clear military activity in this region, there are some reports that Chinese dual-use assets such as ships from China's "Distant Ocean Research Fleet" have been collecting biometric data from the South Pacific.³⁵ In the past, these types of ships have been used for surveillance or as part of China's maritime militia. The US has a unique agreement securing exclusive military access to these islands, but China is strengthening its economic and diplomatic ties with the Pacific Islands by including them in the Belt and Road Initiative.³⁶ Moreover, in July 2019, during the Fourth Forum for Senior Defense Officials from the Caribbean and South Pacific Countries, Chinese Defense Minister Wei Fenghe said that China is looking to deepen military cooperation.³⁷ It is unclear what this cooperation might look like, but China is likely looking to this region to secure natural resources, protect critical sea lanes from US control, and pressure the Pacific Islands to cut off diplomatic relations with Taiwan.³⁸

China has been slowly increasing its military activities within European countries as well, particularly in the past few years. The 2019 Defense White Paper notes that the European Union is "accelerating its security and defense integration to be more independent in its own security," and China is capitalizing on this independence (from the US). Last year, in 2018, the PLAN conducted its first-ever combined exercise with the European Union Naval Force in waters near China's base in Djibouti.³⁹ Then, in July 2019, China deployed armored vehicles in Europe for the first time. The vehicles were delivered for an HADR exercise, Combined Aid 2019, in Germany (the second of its kind after a Chinese-German training in China).⁴⁰ That same month, the PLA's guided-missile destroyer *Xi'an* docked in Toulon, France.⁴¹

Lastly, the PLA has also been making inroads, albeit limited ones, in the US's own neighborhood. China is building military ties with South American countries through military exchanges, joint trainings, arms sales, and intelligence and information sharing agreements. Of these, the most worrying are Chinese access to ports and technology transfers. In the past five years, China has increased port calls to South America by 70 percent.⁴² A particular area of concern is the increased Chinese presence in the Panama Canal. Two-thirds of US ships pass through this canal, and China has secured a \$1.4 billion contract to build a new port and bridge.⁴³ Given China's penchant for dual-use port investments, the US's worst-case scenario in this regard is the "possible loss of commercial neutrality of the services and infrastructure" of the canal, which would severely threaten US shipping lanes and allow for blockades in a wartime scenario.⁴⁴ Another area of concern is China's technology transfers—particularly surveillance

equipment to Argentina and Venezuela. Many South American satellites and surveillance aircraft are launched, developed, or paid for by the Chinese, providing China with nearly real-time surveillance data about goings-on in the Western hemisphere.⁴⁵

Lastly, there has been significant concern over China's growing interest in the Arctic, which remains mostly energy focused for now.⁴⁶ In January 2018, China released its first-ever white paper on its Arctic strategy, which laid out China's desire to be an "active participant, builder, and contributor in Arctic affairs."⁴⁷ This white paper not only inspired an internal restructuring in China with the establishment of the Chinese Arctic and Antarctic Administration but also spurred regular Chinese Arctic expeditions (eight in 2018).⁴⁸ To support these efforts, China is building the world's first "ice-strengthened condensate tanker" to transport oil from the region and Arc7 vessels, which are polar-capable liquefied natural gas carriers.⁴⁹

China-Russia Military Cooperation

Over the past year, there have been a number of indicators of closer cooperation and coordination between China and Russia, raising concerns that US policy is pushing the two countries into a strategic alliance. Vladimir Putin and Xi Jinping have met seven times over the past year. In the past, the two have typically met five times per year, with a total of 24 meetings since 2013. By comparison, Xi has met with his US counterpart a total of 16 times since 2013, and Putin has met with US presidents a total of eight times since then.⁵⁰ Xi Jinping has asserted several times over the past year that Russia is Beijing's most important strategic partner and foreign policy priority.

The most notable trends, however, have been in the military and security space. Historically, China has been Russia's largest arms export destination, but China has been buying less arms from Russia since the early 2000s. The total market share of Russian arms exports to China dropped from 47.7 percent in 2006 to 8.7 percent in 2012 and has only risen slightly since.

In 2018, China accounted for 14 percent of Russia's total arms exports, second to India (27 percent). In 2017, Russia sold around \$15 billion worth of weapons to China.⁵¹ In 2019, Russia completed a \$2.5 billion delivery of Su-35 multi-role fighters and agreed to jointly develop a heavy lift helicopter.⁵² The Su-35 is a multirole fighter that will carry air-to-air and air-to-ground missiles, unguided rockets, and guided and unguided bombs.⁵³ Russia also sent the first of four to six S-400 *Triumf* long-range inceptor-based air defense systems to China. The system will complement China's existing air defense platforms like the HQ-16 and HQ-17 and give new surface-to-air and anti-stealth capability. The main implication of this system is that it can essentially guarantee a no-fly zone over Taiwan and the Senkaku/Diaoyu islands, which are contested between Japan and China.⁵⁴ China has sent 100 PLA personnel to Russia for S-400 Air Defense System training as part of an ongoing training operation.⁵⁵

But this year the scope and depth of the military exercises have caused some observers to wonder if an alliance-like relationship is on the horizon. In September 2018, the PLA participated in Russia's largest-ever military exercise, the Vostok-2018 exercise, by sending 3,200 military personnel. This was the first time the exercise was not a counterterrorism scenario, but instead an interstate conflict scenario to test "joint defensive and counter-attack operations capabilities"

that, according to Chinese media sources, are relevant for a North Korea scenario. The two countries have also conducted joint naval exercises⁵⁶ such as Joint Sea 2019 in Qingdao and annual anti-terrorism exercises within the context of the Shanghai Cooperation Organization.⁵⁷ As recently as July 2019, China and Russia conducted their first joint patrol near the contested Dokdo/Takeshima islands to test US allies' air defenses. South Korea and Japan accused Russia of violating their airspace after Russian A-50 airborne early warning and control aircraft entered airspace claimed by both Seoul and Tokyo. But Russia denied the allegations, saying it was merely conducting its first-ever patrol with China over the East China Sea and the Sea of Japan.⁵⁸

On the one hand, I think that exercises, arms sales, and diplomatic platitudes are not sufficient to suggest that China and Russia are moving away from a relationship of convenience to something more closely resembling an alliance. For example, the establishment of joint naval command systems was not completely recent or new in principle. Joint command systems between China and Russia started to appear in 2010 during the "Peace Mission-2010" joint military exercise, when fighter jets from both sides merged into one squadron and performed joint tasks with the goal of practicing joint command codes and interoperability. On Volstok-18, the fact that most Chinese reporting on the exercise was in English suggested that the purpose was political signaling to the United States, not the improvement of interoperability.

The uptick in activity must also be understood in the broader context of increasing Chinese presence more generally. China is expanding its military relationships around the world. For example, the most recent defense white paper stated that China has signed 26 major nuclear and arms control treaties and five major counterterrorism treaties and is part of 10 major regional security dialogues and cooperation platforms. In practice, China has conducted 17 major joint exercises with foreign counterparts (10 of which are annual exercises), participates in five ongoing UNPKOs, and has conducted 11 HADR exercises with foreign countries since 2013.⁵⁹

And there are obstacles to closer ties. Russia has extensive defense ties with countries that are not on the best of terms with China, such as India and Vietnam. Another potential area of Russia-China friction is Central Asia. Right in Russia's backyard, the region is geographically important for Chinese Belt and Road aspirations to secure energy land lines. In 2019 alone, China made \$9.09 billion in energy and transport investment in West Asia.⁶⁰ For example, this past August alone, China participated in the International Army Games in Kaliningrad, which welcomes Central Asian militaries, and participated in joint exercises with Kyrgyzstan and Tajikistan.⁶¹ China is also increasing its arms sales in the region; for example, in 2018, China was Turkmenistan's second-largest arms supplier. (Russia was its third.)⁶²

But the larger issue is that China continues to see close ties to Russia as a liability; Beijing is interested in becoming a "legitimate" great power and does not want to be associated with Russian revisionist and disruptive tactics that receive international opprobrium. In the words of the *Economist*: "An angry declining power like Russia is dangerous; it may feel tempted to lash out to show it is still a force to be reckoned with, by bullying Belarus, say, or by stoking the old fears of Chinese expansion into Siberia. But China has no appetite for international crises, unless they are of its own devising."⁶³ The economic imperative for a closer relationship is also absent. China is Russia's largest import origin and export destination, making up 20 percent of total

Russian imports and 11 percent of Russia's total exports.⁶⁴ However, Russia only makes up 1.8 percent of China's total exports (tied in 11th place with the Netherlands) and 2.5 percent of China's total imports (12th place).⁶⁵

On the other hand, there are legitimate areas of concern. First, China has begun to work more closely with Moscow to protect its equities on the Korean Peninsula as the United States adopts more aggressive unilateral policies. Through adept diplomacy, China has made Moscow "increasingly receptive to Beijing's agenda."⁶⁶ Granted, Russia's role is far from decisive. Russia–North Korea trade in 2018 totaled just \$34 million, significantly less than the \$2.43 billion between China and North Korea in 2018.⁶⁷ But Moscow can support Chinese initiatives on the Security Council as it did for the 2017 UN resolution on the Freeze-for-Freeze proposal, or play bad cop when certain initiatives, such as softening sanctions against North Korea, are desirable but too politically costly for Beijing to lead.

Second, China and Russia could coordinate more closely to undermine US goals in the international system. The countries share a growing threat perception with respect to the US, and they are interested in working together to offset Western pressures and to create an alternative regional power center to push back against US hegemony. Chinese strategists use the term "strategic echoing" to describe the nature of bilateral indirect coordination. There is a tacit understanding that if one country takes an action, the other will do something to support or follow up on it. Most recently, both countries vetoed UN action for aid access and fair elections for Venezuela.⁶⁸ At the G20 Summit, Putin and Xi discussed free trade and the markets, criticizing the United States' protectionism.⁶⁹

Lastly, Russia seems to have accepted its junior partner position, suggesting that it may be willing to help advance China's goals in the Indo-Pacific to weaken the United States even if China does not reciprocate by supporting Russian goals in Europe. If this is the case, it opens up the possibility of greater Russian involvement in Indo-Pacific security issues in support of Beijing. Full-fledged Russian military involvement in contingencies, such as on the Korean Peninsula or across the Taiwan Strait, would not be necessary to create severe operational dilemmas for the United States. In short, although fears of an alliance may be overblown, even minimal military cooperation is enough to hurt the US's ability to deter conflict and defeat China if a war breaks out.

If China and Russia began to cooperate on missile defense or nuclear deterrence, worked together to achieve common goals in third-party countries, or allowed each other to operate from their territories (e.g., giving China naval access through Vladivostok), this would indicate a level of strategic cooperation that would be highly problematic for the United States.⁷⁰

China's Defense White Paper: A Sign of Confidence?

On July 24, 2019, the State Council Information Office released a new white paper titled "China's National Defense in the New Era."⁷¹ The white paper is divided into six main sections: "the international security situation," "China's defensive national defense policy in the new era," "fulfilling the missions and tasks of China's armed forces in the new era," "reform in China's national defense and armed forces," "reasonable and appropriate defense expenditure," and

“actively contributing to building a community with a shared future for mankind.” *Xinhua* reported that this is the 10th white paper on national defense since 1998 and the first one since the 18th National Congress in 2012.⁷²

The Chinese defense white paper is not the equivalent of the US National Security Strategy; its primary purpose is to shape foreign perceptions of Chinese military modernization. But its content still provides information about how the PLA wants the world to perceive it. Specifically, three main themes become apparent.

First, China is becoming more comfortable with a greater global role and with a PLA that is more involved in promoting and implementing, if not shaping, Chinese foreign policy. This change reflects Xi Jinping’s overall priority of improving China’s stature on the international stage with his programs of national rejuvenation, Belt and Road Initiative, and a new type of major power relations. China is no longer hiding and biding, and it believes its military has a legitimate role to play on the global stage, especially given the extension of Chinese interests across the world. The white paper contains a newly expansive interpretation of national defense, asserting that “one of the missions of China’s armed forces is to effectively protect the security and legitimate rights and interests of overseas Chinese people, organizations, and institutions.”⁷³ This statement suggests that China is shifting from an internal focus to reacting and adapting to a “new global era” in politics, spurred by US strategic competition. The white paper also covers Chinese military modernization for the first time, suggesting a greater comfort with showcasing its capabilities and progress toward becoming a “world-class force.”⁷⁴

Second, China wants to present itself as a force of peace and the US as an instigator of strategic competition. The white paper characterizes the People’s Republic of China military developments as peaceful, defensive, and rational, with the PLA contributing to the global good through UNPKOs, HADR, joint exercises, major security dialogues, and multilateral treaties. Unlike the previous defense white paper, China argues that it can and should play a leadership role, such as through building the Asian “community of common destiny.”⁷⁵ A full section compares Chinese defense spending with that of other countries, with the goal of arguing that its spending is appropriate and less than that of other actors (if metrics are selectively evaluated). In contrast, it criticizes the United States for undermining global security with “growing hegemonism, power politics, unilateralism, and constant regional conflicts and wars,”⁷⁶ as well as arms racing. In addition to the US, China accuses NATO countries, the EU, the UK, France, Germany, Japan, India, and Russia of causing a rise in global military competition.

Third, while the white paper attempts to assuage international concerns about China’s military modernization, it also tries to provide justification for more assertive Chinese protection of what China sees as its interests, such as territorial integrity. On Taiwan, for example, the wording is much stronger than in previous editions. The white paper says: “To solve the Taiwan question and achieve complete reunification of the country is in the fundamental interests of the Chinese nation and essential to realizing national rejuvenation. . . . China . . . will never allow the secession of any part of its territory by anyone, any organization or any political party by any means at any time.”⁷⁷ In terms of maritime disputes, the previous white paper made no mention of the Senkaku/Diaoyu Islands and little mention of the South China Sea (SCS) (besides pointing out that “some external countries are busy meddling in SCS affairs”). In the 2019 white paper, the Communist Party of China emphasizes that the SCS islands and Senkaku/Diaoyu islands are

“inalienable parts” of Chinese territory and that China will “deploy necessary defensive capabilities on the islands and reefs” in the SCS and “conduct patrols in the waters of the Diaoyu islands.”⁷⁸

US-China Military Balance: Peer or Near-Peer Competitor?

What follows are a few points about how I think we should understand the debate about whether the Chinese military is a near-peer or peer competitor with the US military.

First, the United States military is still vastly superior to the Chinese military. In a global context, the Chinese military is not even a near-peer competitor with respect to the United States, as it still has limited ability to project power and sustain operations far from its shores. But this fact is largely irrelevant for a number of reasons. First, China dedicates all its resources to planning and preparing for a contingency in East Asia, while the United States has additional responsibilities in the Middle East, Europe, and worldwide. If the context is confined to East Asia, then the Chinese military is closer to on par with the United States. Second, in any contingency, we would not be fighting the same war: China would have the advantage of fighting from home, while the United States would be projecting power across a vast distance. With this distance would come the vulnerabilities of relying on enablers such as satellites, tankers, and bases in other countries—all of which China could exploit without opening itself up to the same issues.

Thus, China need not have a military as sophisticated and big as that of the United States to be able to prevail in a conflict against the US. But it used to be the case that the US would always prevail; the only uncertainty was about what the cost would be and how long victory would take. Today, China could prevail in some situations. The issue is that we do not know how risk-averse China is—what Xi is willing to risk for the sake of, for example, reunification with Taiwan. As China’s confidence in its relative capabilities versus the US’s ability to thwart them increases, it will be harder to deter China from taking action.

Second, deterrence is defined by not only balance of power but also balance of resolve. China is willing to lose more for its goals than the United States is willing to sacrifice to deny these objectives to China. That means that for deterrence to hold, the United States has to convince China that it is resilient or, in other words, that our military is so superior that although we are not willing to sacrifice much, we won’t have to. In other words, the balance of capabilities has to be disproportionately in the US’s favor to outweigh the imbalance of resolve if deterrence is going to hold. I think China is close to being a peer competitor in the region, meaning that soon it will be difficult for the United States to deter Chinese aggression and coercion.

Third, there is a difference between an estimate of where we are today and the trends. The issue is not that China *has* surpassed the United States in military power; it has not. The issue is that given current trends, China will meet or outmatch US regional capabilities in the next five to 10 years. China will soon have a modern military capable of conducting joint operations, such as those necessary to deny access to the South China Sea, retake islands, or forcibly reunify with Taiwan. If, in the meantime, the United States military does not improve and strengthen its force posture in Asia, improve its resiliency, and increase its ability to forcibly deny China these

objectives, then Chinese leaders may decide it is worth the risk to use force. This is how we end up in a war with China—not because we are overly provocative or push back too much, but because we do not do enough to maintain deterrence in the region and China gains the confidence to jettison a cautious approach.

Policy Recommendations

It will be important to change the dynamics of the competition in the South China Sea. China's military position in the South China Sea has improved greatly without relying heavily on the military arm of its power. China understands that how other regional players react and respond is critical to strategic success, and the use of lawfare to confer legitimacy on one's policies complicates US responses. The United States needs to counter this approach by competing in the same diplomatic, legal, and political space.

First, we should spearhead and prioritize a diplomatic solution to the South China Sea disputes, with or without China. Countries in the region disagree with China's interpretation of international law—that Beijing has the right to draw baselines around its islands and claim internal waters; that some features, including artificial ones, get territorial seas and exclusive economic zones (EEZs); China's overly expansive EEZ claims; and that China has the right to regulate noneconomic activity, including military activity, within its EEZs. If the rest of the claimants agreed about not only the sovereignty of the islands themselves but also the rights granted by those islands and asked the international community to help enforce the agreement, China would have difficulty pushing its claims and pressuring states unilaterally to concede to its demands. A diplomatic solution that empowers Southeast Asian countries would serve multiple purposes: It would help maintain the US freedom to maneuver, present the US as a leader in the region beyond just the security partner of choice, and help countries be resilient to China's malign influence. Moreover, for many countries, the United States' military approach to addressing the South China Sea, in particular Freedom of Navigation Operations, are overly confrontational. In addition to a major diplomatic effort to resolve the disputes, the United States should pursue more legal initiatives against China.

Second, the United States needs to improve its force posture in Southeast Asia. Right now, U.S. forces are concentrated in Northeast Asia, which is less helpful if we need to deter and defeat Chinese aggression in the South China Sea. Access to new bases and ports in Southeast Asia is crucial—this means prioritizing relationships with Malaysia, Indonesia, Singapore, and Vietnam, to name a few. Upgrading such relationships can be politically challenging, especially given the latent threat of China lurking in the background. We need to ask these countries what would be necessary to get their support and a closer military relationship—and be open-minded about what such relationships may require.

To balance against the Soviet Union during the Cold War we had the strategic mindset and political will to look beyond China's political system to normalize relations and move that relationship forward. We need that degree of strategic thinking and political will; adhering to the same policies but expecting different outcomes will not change current trends in East Asia. We need to think differently: consider putting countries' rights to their EEZs within the context of our commitment to defend our allies, organize an international task force like the one in the Gulf

of Aden to ensure freedom of navigation for all nations in these waters, and consider provoking a strong Chinese response by militarily denying Beijing the ability to resupply and increase the militarization of islands in the South China Sea.

Militarily, we need to change how we think about and evaluate risk. For example, we need to focus on proportionate effects, not actions. So if China uses fishing boats to prevent other countries' access to economic resources, our response needs to be to allow that access, by whatever means necessary. We need to decide what exactly we are trying to deter. Is it just Chinese use of force or coercion more generally?

And we need to prioritize defense over deterrence. There is an implicit assumption that actions taken to enhance defense strengthen deterrence, and vice versa. But in practice, these can often be opposing goals. For example, some commentators call for the US to establish a more robust forward presence. However, given China's A2/AD capabilities, this puts even more US assets within range of Chinese cruise and ballistic missiles. On the other hand, if the United States moves toward a more agile basing concept in which US forces plan and prepare to operate from bases far from mainland China, for example in Australia or the southern Philippines, or some Pacific Islands, the US would be in a better position to defend its interests and its allies. But moving forces farther away may give regional partners and allies, and China, the idea that the US lacks the resolve to fight. In other words, some actions designed to strengthen the US deterrent weakens our ability to fight if deterrence fails.

All of this requires really making Asia, and in particular the South China Sea, the strategic imperative. On paper it may look like it is, but in practice it is not. President Trump has never publicly raised the issue of the South China Sea directly with Chinese leader Xi Jinping. He has never even tweeted about the issue during his time as president. President Obama did not push back against Chinese land reclamation or the militarization of the islands, allegedly because he did not want to fight a war over a bunch of rocks. The bevy of democratic candidates for president have been criticized for avoiding the issue of security competition with China: In the first democratic debate, China did not come up once in the context of national security.

Understandably, most national leaders want to avoid a war with a near-peer competitor such as China. But the only way to prevent a war is to deter Chinese aggression. If China doubts the US's will to fight and our ability to prevail if we did, then China will be much more likely to rely on coercion and aggression to accomplish its goals. This is what will drag our two countries into a war, thus maintaining deterrence needs to be the top priority. The United States needs to put the economic, diplomatic, and military resources behind maintaining the regional order in East Asia—and be willing to take some risks to ensure its success.

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⁵⁸ Brad Lendon, “Why China and Russia are wading into centuries’ old dispute over a tiny island cluster,” *CNN*, July 27, 2019, <https://www.cnn.com/2019/07/26/asia/south-korea-russia-japan-china-warplanes-analysis-intl-hnk/index.html>.

⁵⁹ “Full text: China’s national defense in the new era,” *Xinhua*, July 24, 2019, http://www.xinhuanet.com/english/2019-07/24/c_138253389.htm.

⁶⁰ “Chinese Investments and Contracts in West Asia,” *AEI China Investment Tracker*, last accessed August 27, 2019, <http://www.aei.org/china-global-investment-tracker/>.

⁶¹ Kinling Lo, “China increases its presence in Russia’s former Central Asian backyard,” *SCMP*, August 25, 2019, <https://www.scmp.com/news/china/diplomacy/article/3024261/china-steps-its-presence-russias-former-central-asian-backyard>.

⁶² “Trends in international arms transfers,” *SIPRI*, March 2019, https://www.sipri.org/sites/default/files/2019-03/fs_1903_at_2018.pdf.

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⁶⁶ Oriana Skylar Mastro, “Pyongyang is playing Washington against Beijing,” *Foreign Policy*, August 5, 2019, <https://foreignpolicy.com/2019/08/05/pyongyang-playing-washington-beijing-china-us-nukes-kim/>.

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- ⁷⁸ “Full text: China’s national defense in the new era,” *Xinhua*.

**OPENING STATEMENT OF ANDREW KREPINEVICH JR., SENIOR FELLOW,
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COMMISSIONER FIEDLER: Thank you. Dr. Krepinevich.

DR. KREPINEVICH: Thank you, Chairman Bartholomew, Vice Chairwoman Cleveland, Members of the Commission for the opportunity to present my views on U.S. China relations.

Given my background and expertise, I'll focus my remarks on the military aspects of the relationship. And in particular, look at three issues.

First, the military balance of the Indo-Pacific, second, the open-ended and long-term military competition between the United States and China. And third, aspects of deterrence.

It's my opinion at present, the Indo-Pacific military balance appears favorable to the United States. That said, I haven't seen anything in the public domain or in terms of military literature that comes close to the kind of analysis and assessment of the military balance that, for example, you saw during the latter stages of the Cold War between United States and the Soviet Union.

I think for us to really get a handle on what the true military balance is, there needs to be a rigorous set of regional and functional net assessments done looking at various key aspects of the competition between the United States and China.

As the competition with China is open-ended, we also need to take a long view. It's not just a snapshot of the balance, it's trends that are going to shape the balance over time and how can we improve our position.

And using Sir Michael Howard's Four Dimensions of Strategy, the logistical, social, operational and technical, it's my preliminary assessment that the trends right now do not favor the United States. So while the current balance may be favorable, the trends are generally unfavorable.

If you look at the social dimension, the ability to immobilize and orient your population, in Dr. Wortzel's term to eat bitterness if necessary, it seems as though the Chinese have a distinct advantage over the United States. Both in terms of our elites and in terms of the U.S. public in general.

Logistical or the, this beats to the scale of the challenge. If you look at, let's just look at GDP. I know it's just one element of national power, and we can get into others.

But if you look at GDP alone, China's GDP, according to current exchange rates and the World Bank is roughly two-thirds that of the United States. And if you add Russia, it's about 80 percent.

If you look at some of the historical data, which I admit is imperfect, you see that Imperial Germany in World War I, the Axis powers of World War II, and Soviet Russia in the Cold War never really exceed roughly 40 percent of U.S. GDP.

So, if you're looking at the scale of the challenge, it's roughly double in GDP terms, in a relative sense, to what we saw in the great power challenges that we confronted during the course of the 20th Century.

And then when you add to that, looking at the Cold War for example, our advantage in allies, our advantage in manpower relative to Soviet Russia, and also our advantage in technology, those advantages have either withered considerably relative to China, or perhaps have gone away entirely.

What also interests me is, given the scale of the challenge, if you look at some of the recent reports on U.S. fiscal standing, you'll find that according to the Congressional Budget Office, interest on the U.S. debt, which was \$263 billion in FY '17 will, unless things change, rise to about \$915 billion, or roughly \$650 billion more, over the course of the next decade.

That's tax money coming in that's got to go out to service the debt.

The Social Security and Medicare trust funds, late 2020s, early 2030s, will be exhausted. And state and local governments have roughly \$5 trillion in unfunded pension liabilities.

CBOs', in my estimation, rosy estimate is that about 2.5 percent of U.S. GDP will be available for defense. During the Cold War, against a 40 percent Soviet Russia, we averaged over six percent. So we're going to average less than half that against a set of rivals that is roughly 80 percent of our GDP.

So, in terms of scale, it seems as though the trends are negative.

In terms of the technical and operational dimensions, one of the things that senior leaders in the Pentagon worry about is circumstances in which there could be a disruptive shift in the military balance. All of a sudden things look very different.

And we find that with the diffusion of technology to China, and also advances in technology where they have set themselves some ambitious priorities, there are potentially two disruptive shifts in the balance that the U.S. military has to worry about.

One is, what the Pentagon calls the maturing precision strike regime. We had a near monopoly in precision strike warfare since the first Gulf War.

The Chinese are clearly catching up. We haven't seen them put it into practice, but certainly a number of their capabilities and what they've accomplished are impressive.

And so, for our military, looking at the precision strike regime, we're losing a major source of military advantage. And so, a couple of important questions are, is this the new normal, are we going to be shutout of certain parts of the Indo-Pacific as these Chinese capabilities mature or is there a different way to project power.

The second disruptive shift could occur with an emerging military revolution. Everything from artificial intelligence down to the manufacturing, advances in the biosciences, directed energy, hypersonics, nanotechnology, quantum computing and advanced robotics suggest that there is quite a high likelihood that the kind of warfare that's waged in the mid-2030s will be very different, even from what we anticipate today.

And so, that is a source of great potential advantage for us, but also a potential source of great weakness if the Chinese get it right before we do.

Operationally, how you fight. The People's Liberation Army seems to figure out, better than we have, how it plans to fight in the Western Pacific in particular.

We really have not, and I've served on the National Defense Strategy Commission that was appointed by Congress, the U.S. military really hasn't stated clear operational challenges, let alone develop operational concepts to meet those challenges.

And of course this is critical because if you have challenges and you have a defense program, the defense program and the capability should within -- you should be able to look at those capabilities and say, this is how they're going to be deployed to accomplish our security objectives. And I don't think we've reached that stage yet.

Finally, a few words on deterrence. It's a major problem. Deterrence is becoming much more difficult. It's becoming much more difficult in part because of a lot of new kinds of military equipment coming into play, which people don't understand particularly well.

New domains, if you look at the relatively new domains that warfare has moved into over

the past 20, 30 years, space, cyberspace and the undersea, or the sea bed, you see that in terms of deterrence, the competition favors the offense. Which means the offense has the advantage. And attribution is relatively difficult.

And so, deterrence through punishment or deterrence through denial becomes a more challenging proposition.

With modern weaponry and emerging weaponry, it becomes easier to miscalculate the military balance. And if both we and the Chinese are very conservative, that could be a very good thing.

But if we both start to calculate the balance as being in our advantage, that might lead us to be overly aggressive on both sides.

And then there are a lot of advances in the cognitive sciences with respect to limits of rational human behavior. I'll just mention a few. Prospect theory, optimism bias, risk tolerance and cultural variance. I'm happy to talk about those during the discussion period if you like.

That concludes my summary of my testimony, I'd be happy to respond to your questions. Thank you.

**PREPARED STATEMENT OF ANDREW KREPINEVICH JR., SENIOR FELLOW,
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U.S.-China Relations in 2019: A Year in Review

Testimony before the

U.S.-China Economic and Security Review Commission

Dr. Andrew F. Krepinevich, Jr.

September 4, 2019

Thank you, Vice Chairman Cleveland and Commissioner Fiedler for the opportunity to offer my views on the topic of “U.S.-China Relations in 2019.” I will focus my remarks on the relationship’s military aspects.

Key Trends in U.S.-China Military Competition and Their Implications

The character of the Sino-American military competition is dynamic and open-ended. This is very unlikely to change over the foreseeable future. There are several principal reasons for this.

First, the competition is open-ended in that the two powers have conflicting fundamental interests and objectives that neither are willing to abandon. They also have the means to pursue these interests over an extended period of time. Thus the military competition will likely be protracted, with all that this implies for crafting an effective defense strategy.

Second, we are witnessing the maturation of the precision-strike regime, which was introduced in its earliest form by the United States military in the First Gulf War. After nearly 30 years of dominating this form of warfare, characterized by battle networks and precision-strike systems—what Russian military theorists call a “reconnaissance-strike complex”—these capabilities are being fielded by other militaries, with the People’s Liberation Army (PLA) constituting the leading, or pacing, threat. This trend is highly unfavorable to the U.S. armed forces, as it represents the loss of several key advantages in the overall military competition. In particular, the PLA is deploying anti-access/area-denial (A2/AD) capabilities designed to shift the military balance in the Western Pacific increasingly in China’s favor.¹

A third, related trend finds the military competition moving increasingly into relatively new domains, to include space, cyberspace and the seabed. The competition in these three domains is “offense-dominant,” which may have important implications for deterrence, and for military operations should deterrence fail. The American military appears to have an advantage in these domains, but the Chinese are working to close the gap.

Consistent with their strategic culture, the Chinese continue seeking opportunities to gain positional advantage. In particular, Beijing’s positioning military assets on South China Sea islands places them astride one of the world’s busiest trade routes, while also denying the Philippines and Vietnam strategic depth.

¹ Andrew F. Krepinevich, Jr., *Archipelagic Defense* (Tokyo, Japan: Sasakawa Peace Foundation, 2017), pp. 29-43.

Finally, there is growing likelihood that the next decade or so will witness one or more disruptive shifts in the military competition—a military revolution.² Among the new forms of warfare we may witness are:

Algorithmic Warfare: operations dominated by artificial intelligence (AI) systems (such as robotic systems employing machine learning);

Hyper War: operations conducted at unprecedented speeds, enabled by advanced cyber weaponry (such as malware developed and/or informed by AI); as well as directed energy and hypersonic weaponry; and/or

“Precision” Biological Warfare: operations that are enabled by advances in genetic engineering techniques, such as CRISPR-Cas9, and synthetic biology.

Most likely we will see a mix of these new capabilities employed in combination with current forces.

From a U.S. perspective, the prospect of downstream disruptive shifts in war’s character can be viewed in both a positive and a negative light. It’s positive in the sense that it offers the U.S. military an opportunity to create new sources of competitive advantage, even as its existing advantages in precision-strike warfare fade. It’s negative in that the PLA may prove more adept than its American rival at exploiting the potential of these emerging technologies and their associated capabilities. Indeed, the U.S. defense establishment has shown itself to be slow in developing new warfighting concepts for great power competition, and exceedingly slow at fielding new capabilities.³

The Indo-Pacific Military Balance

At present, the overall Indo-Pacific military balance appears favorable to the United States, its allies, and like-minded security partners.

It must be noted that a great many factors and assumptions are involved in determining the balance, in addition to the size and structure of a state’s armed forces.⁴ Consider, for example, geography. The military balance is likely to be more favorable to China in a clash with the United States over Taiwan than it would be in a contest over islands in the South China Sea, or for control of the Indian Ocean sea lines of communication, or in blockade/counter-blockade operations. Time is another major factor in calculating the balance, such as the time each side would have to mobilize forces prior to the onset of hostilities. Time also plays a role in terms of the balance of forces across the length of a conflict which, in the case of wars between great powers, is often protracted. This relates to how quickly a side’s ability and will to continue fighting may be exhausted. Then there is the form the fighting takes. As recent history shows, the U.S. military is far more effective in

² The literature on military revolutions, or “revolutions in military affairs,” is extensive. For an overview, see Andrew F. Krepinevich, Jr., “Cavalry to Computer: The Pattern of Military Revolutions,” *The National Interest*, Fall 1994, pp. 30-42.

³ Mac Thornberry and Andrew F. Krepinevich, Jr., “Preserving Primacy,” *Foreign Affairs*, September-October 2016, pp. 30-31.

⁴ For a discussion of the discipline of net assessment, which focuses on methodologies for calculating the military balance, see Andrew F. Krepinevich, Jr., and Barry D. Watts, *The Last Warrior* (New York: Basic Books, 2015), pp. 179-89.

waging conventional war against an adversary equipped and waging this form of war, than it is in conducting counterinsurgency operations.

Although the overall balance appears to favor the United States, for nearly two decades now it has shifted increasingly in China's favor across the four dimensions relating to military strategy.⁵ They are:

The Logistical Dimension: China's economic growth rate continues to surpass that of the United States and its principal allies in the region. The PLA's budget continues growing at a higher rate than the U.S. defense budget. Both China and the United States, however, show signs of structural and fiscal weakness that could exert great influence on their ability to support an open-ended military competition.⁶

The Technological Dimension: Much of the military-related technologies underlying the maturation of the precision-strike regime, as well as the prospects for a military revolution, are being developed in the public sector, and are generally available to those with the resources to acquire them (or skill to steal them, or the economic leverage to coerce access to them). China has made it a priority to establish world-class competence in many key technologies (AI, Biosciences, Hypersonics, Quantum Computing) that will likely exert a significant influence on the military competition. The U.S. weakness here stems primarily from a lack of national purpose in this area of the competition, and its lack of competence in time-based competition—the ability to translate rapidly emerging military-related technologies into fielded military systems.

The Operational Dimension: The PLA appears to know what it needs to do to conduct an offensive campaign in the Western Pacific, and is going about fielding a military capable of doing it. Toward this end it is working to field forces and conduct operations designed to establish air and sea control, along with the information dominance required to enable such a campaign.

The U.S. military, on the other hand, has yet to develop anything like the detailed operational concept for defending the nation's vital interests and security obligations in the Western Pacific that it had during the Cold War for Europe.⁷ While the latest U.S. National Defense Strategy directs the military services to work on developing innovative operational concepts, progress to date has been astonishingly slow.⁸ Such operational concepts that

⁵ The four dimensions of strategy are discussed in Michael Howard, "The Forgotten Dimensions of Strategy," *Foreign Affairs*, Summer 1979, pp. 975-86.

⁶ Andrew F. Krepinevich, Jr., *Preserving the Balance* (Washington, DC: CSBA, 2017), pp. 38-43.

⁷ For an example of a detailed point-of-departure operational concept for the Western Pacific Theater of Operations, see Krepinevich, *Archipelagic Defense*, pp. 62-111. This operational concept has been briefed by the author at Japan's Five-Power Strategic Dialogue Conference in Tokyo, as well as to senior U.S. defense officials and military leaders, to include flag officers from the Joint Staff, the U.S. Indo-Pacific Command, the U.S. Army Staff, and the U.S. Navy Staff, to include the chief of naval operations.

⁸ See, for example, this author's observations on the issue of operational challenges and concepts in "Providing for the Common Defense," *National Defense Strategy Commission*, 2018, pp. 72-75.

have been developed on the U.S. side have come primarily from members of the strategic studies community, not America's military professionals.⁹

The Chinese are putting their limited resources to good use, building capabilities designed to create strengths that can be leveraged to transform the U.S. military's strengths into weaknesses. Thus we see the PLA emphasizing attacking the U.S. military's "nervous system" with its anti-satellite (ASAT) systems and cyber malware, as well as its deployment of missile and other strike forces designed to hold at risk the American armed force's "muscle:" its handful of forward air bases and aircraft carriers.

The United States defense investments are, in some important ways, underwriting China's strategy. The U.S. Air Force and U.S. Navy continue investing heavily in capabilities the PLA is focusing on holding at risk. Both Services plan to procure large numbers of relatively short-range, or tactical, aircraft like the F-35 that operate from increasingly vulnerable carriers or forward air bases. Meanwhile, the Air Force's aging penetrating bomber fleet comprises only a handful of B-2s, with its follow-on bomber, the B-21, not projected to enter service until the middle of the next decade, at the earliest. The Navy's unmanned aircraft program, the MQ-25, is being designed as a tanker to support its short-range tactical aircraft, rather than as a long-range penetrating reconnaissance-strike system. Moreover, the Navy's SSGN four-boat fleet is reaching the end of its service life, with no follow-on system in sight.¹⁰

The U.S. military continues relying on large, increasingly vulnerable satellites as critical elements of its battle network, especially for communications as well as for precision navigation and timing. To be sure, alternatives to the current satellite constellation are likely to prove either challenging to develop and/or expensive to procure.

In summary, based on an assessment of open-sourced intelligence, the Chinese are much superior to their American rivals when it comes to pursuing strategies that develop strengths to align against their rival's weaknesses.

The Social Dimension: Given the United States' progressively weakening fiscal standing, sustaining an open-ended military competition with China will very likely require significant sacrifices on the American people's part, if not in the near term almost certainly by the end of the coming decade. The same might be true of the Chinese people. But the Chinese Communist Party (CCP) appears to have an advantage when it comes to getting its people to "eat bitterness."¹¹ The Party also appears to have bested America's political elite in mobilizing their people to support such an effort. The Social Dimension of the competition is, in my estimation, where U.S. competitiveness is most lacking.

⁹ See, for example, Krepinevich, *Archipelagic Defense*. See also Jan van Tol, with Mark Gunzinger, Andrew Krepinevich, Jr., and Jim Thomas, *AirSea Battle: A Point of Departure Operational Concept* (Washington, DC: CSBA, 2010).

¹⁰ Each SSGN is capable of firing up to 154 cruise missiles. This represents the bulk of the U.S. submarine force's extended-range strike capability.

¹¹ I am indebted to Colonel (Retired) Larry Wortzel for introducing me to this term.

Implications for Deterrence

Deterrence in general is becoming a more difficult proposition.¹² This is also true, in particular, with respect to the U.S.-China military competition.

Since the end of World War II, the United States has placed great reliance on deterrence as the centerpiece of its defense strategy. This emphasis endures in the Trump administration's new National Security Strategy and National Defense Strategy. Yet the strategic environment in which deterrence must function has changed dramatically, and continues changing. Moreover, some lessons that we thought had emerged from our Cold War experience regarding the robustness of deterrence strategies have proven false. Similarly, some critical assumptions regarding how rationally humans behave when making decisions under conditions of risk have been overturned by remarkable advances in the cognitive and behavioral sciences.

Like its recent predecessors, the Trump administration has spent little time explaining exactly how the United States intends to deter existing and prospective rivals. The implicit assumption is that it needs no explaining, since modern weapons are so destructive that no sane leader would risk igniting a general war. Thus it follows that the requirements for deterrence are relatively modest.

But such confidence is profoundly misplaced. In fact, deterring aggression has become increasingly difficult, and it stands to become more difficult still, as a result of developments both technological and geopolitical.

Multipolarity, Technology and New Domains. The shift from the Cold War bipolar to the unipolar system that followed was more accommodating for deterrence than the emerging multipolar system where, in addition to lesser rivals, several great power rivals must be deterred. Advances in military capabilities are blurring the firebreak between conventional and nuclear warfare. As noted above, relatively new warfare domains like space, cyberspace and the seabed favor the attacker; furthermore, attacks in these domains are relatively difficult to attribute. These trends undermine deterrence.

Modern Weaponry. Political leaders typically make the decision to start a war in the belief that the military balance favors them. The problem in contemporary times, especially for modern military powers like the United States and China, is that most of the military systems in their armed forces have never been put to the test against a major military power. Thus it is difficult to say with any sense of clarity how effective these systems will be in combat. This opens the door for each side to draw some very different conclusions regarding the military balance. If both Washington and Beijing conclude the military balance favors their rival, deterrence is likely to prove robust. But what if both sides

¹² For a detailed assessment of the growing challenges associated with implementing deterrence strategies, see Andrew F. Krepinevich, Jr., *The Decline of Deterrence* (Washington, DC: The Hudson Institute, 2019). See also Andrew F. Krepinevich, Jr., "The Eroding Balance of Terror," *Foreign Affairs*, January-February 2019, pp. 62-74.

calculate the balance lies in their favor? Here the implications for deterrence are worrisome, indeed.

The Limits of Rational Behavior. Advances in the cognitive sciences are revealing how fragile deterrence may be. Recent insights into the nature of human decision-making raise questions about the very logic of deterrence. As a theoretical concept, deterrence rests on the assumption that where risk is involved, humans act rationally, in the sense that they base their decisions on a cost-benefit calculus and act only when the expected gains outweigh the anticipated costs. Over the past 40 years, however, research in behavioral economics has cast great doubt on this assumption. Humans, it turns out, cannot be counted on to always maximize their prospective gains. And even when they do, they are remarkably inept at understanding how the other side—the opponent in a conflict—calculates its own costs, benefits, and risks. Human nature hasn't changed, but our understanding of it has—in ways that bode ill for defense strategies built on deterrence.

One problem has to do with our understanding of how leaders conceive of losses. According to prospect theory, people will risk more to avoid losing what they already have, than to gain something of equal value. Thus, for example, policymakers will run higher risks to retain their own territory than to seize foreign territory of equal value. In theory, this phenomenon would seem to strengthen deterrence, since it predicts that leaders generally prefer to stick with whatever land and resources they already own, rather than attempt to seize what belongs to another. But the matter does not end there.

This is because of how decision-makers set their so-called reference point, which determines whether they consider their current situation to be one of loss or gain. One might expect that people always base their reference point on the status quo—the state of things at the time they make a decision. But such is not the case. After a series of gains, for instance, individuals normally adjust their reference point to the new status quo. Any subsequent setback looks to them like a loss rather than a gain forgone. We should therefore expect them to be relatively risk tolerant in their efforts to defend their latest gains, which they now see as a potential loss.

But this dynamic does not cut both ways. After individuals suffer losses, they tend not to adjust their reference point to the new, less favorable situation. Instead, they cling to the status quo ante. They therefore see their own attempts to retake what has been lost not as the pursuit of gains but as the recovery of losses. As a result, they are often ready to take great risks and accept high costs to achieve this end. To understand how a similar dynamic could play out today, look to the South China Sea, where Beijing is occupying and fortifying disputed territory, apparently intent on creating new facts on the ground. The United States and its allies, however, continue to view China's actions as illegitimate and retain the original situation as their reference point. If the dispute comes to a head, both the United States and China and its opponents will be operating from a reference point of loss. So deterring either side from pressing the issue may prove difficult.

Some Modest Recommendations

The following are some modest actions that Congress can pursue through hearings and other means at its disposal, but which have the potential to significantly improve the U.S. military's competitive position relative to the PLA.

Focused Hearings. Congress plays an important role in setting the defense agenda and educating the public on matters of strategic importance to the country's security. Hearings on the issues raised in this testimony, and on those topics listed immediately below, could make an important contribution toward this objective.

Time-Based Competition. A major source of U.S. competitive weakness is its inability to compete effectively based on time. Ways must be found to accelerate the fielding of new capabilities.

Cost-Imposing Strategies. Oftentimes Congress focuses its attention on how the U.S. military will respond to a particular new PLA capability. This is appropriate. But more attention needs to be accorded to encouraging the Defense Department to explore ways the U.S. military can impose disproportionate costs on the Chinese. Efforts along these lines were an important part of American defense strategy during the Cold War, but have often been discounted in recent years.

Promoting Innovative Operational Concepts. All too often Congress goes from identifying a threat to U.S. security to focus on a specific capability in the defense program without asking how that capability fits within military operations designed to address a challenge at the operational level of war. Secretary Mattis recognized this in his National Defense Strategy as a major problem for our military, and set developing innovative operational concepts as a priority. Congress can perform an important service by ensuring the Defense Department follows through on this initiative.

Conclusion

The current military balance in the Indo-Pacific region appears favorable. Key trends affecting the balance, however, are generally negative from a U.S. perspective. Relative to China, the United States has lost most of the large security cushion it inherited at the Cold War's end, and is accumulating security risk at an increasing rate. Moreover, the military competition with China is highly dynamic, providing both the PLA and the U.S. military with a rare opportunity to effect a disruptive shift in the balance.

OPENING STATEMENT OF MICHAEL GREEN, SENIOR VICE PRESIDENT FOR ASIA AND JAPAN CHAIR, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES; DIRECTOR, ASIAN STUDIES, EDMUND A. WALSH SCHOOL OF FOREIGN SERVICE, GEORGETOWN UNIVERSITY

COMMISSIONER FIEDLER: Thank you. Dr. Green.

DR. GREEN: Thank you very much for inviting me to appear before the Commission. I want to begin by commending your staff who did an outstanding job giving us guidance and preparing us for this hearing so we could be useful to you.

I'm going to focus on what might be called the Phase 0 dimension of war planning, which is the part before what Dr. Krepinevich and Dr. Mastro focused on before war fighting, before deterrence.

The area that we are now in, competition for influence without fighting a war. China would of course like to supplant the United States in Asia without fighting a war. And we're already in that strategic competition and it's intense.

And in particular, I'd like to focus on the roles of allies and partners, who get a vote in this competition.

Our worst mistakes, strategically with China, have come when we either tried to form a bilateral or bipolar condominium with Beijing, ignoring our allies interests or conversely when charging full kilter at Beijing without aligning with our allies to make sure we were effective.

So as we gear for not only the challenges in deterrence you've heard about, but also the very real competition for influence and leadership in Asia right now, we have to think carefully through where our allies and partners are and are they with us or not.

I'd make three broad overarching points in that respect at the outset. The first is that China is clearly targeting U.S. alliances. Not only in the Indo-Pacific but more broadly.

They recognize what Dr. Krepinevich said that our alliances in many ways are our center of gravity in the region. Chinese declaratory policy and the use of Chinese coercive tools, military and commercial, have sharply increased against our allies and partners in the last six, seven years.

A strong signal came in 2014, in April, when Xi Jinping gave a speech in Shanghai arguing that Asians should decide their own security without foreign blocs, meaning without U.S. alliances.

It was a line very similar to one Gorbachev used in 1986 to try to, ultimately without any success, break up American alliances knowing how important that was to our containment strategy. But there have been much more specific cases of coercion against allies.

And efforts to entice the U.S. into a bipolar condominium where we set aside our allies. Xi Jinping's offer of a new model of great power relations to the Obama administration was clearly designed to demote the interests of Japan, Taiwan of course, Australia, South Korea and others.

There's a debate in this town that will not be resolved about whether China is a revisionist power. I think it's more ambiguous on a global scale.

Historically, rising powers, including the United States, Imperial Germany and Japan, were free riders on the prevailing hegemon globally, but actively revisionist in their own regions. Ask Mexico.

So, to me there is no question about China's deliberate and obvious and declared revisionism in Asia and it's targeted largely at U.S. alliances.

The second point I'd make, overarching point, is that for the most part China strategy, for now, is failing. It is back firing.

If you look at the foreign policy or defense white papers of Australia, Japan, New Zealand, if you look at the EU's new policy on China, these like-minded democracies are clearly stating that Chinese coercion is against their interests. Even as many of them pursue more economic opportunities with China.

Opinion polls across the major democracies are trending very negatively for China. And the trend in Japan, Korea, Australia, with our NATO allies, the major ones, is towards more jointness and interoperability, not hedging, not the alignment, not bandwagoning with China.

The British and French decision to do freedom of navigation operations in the South China Sea is another example. And there are others I can give.

The third point I'd make though is that while governments, major democracies are trending towards alignment with the U.S. to counter the Chinese challenge, if you peel open the cover and look more closely, there are some disturbing trends.

For example, in most of our major alliance countries, public opinions show increasing support for alliance with the United States. And for our security treaties.

But in Japan, polls show that while the number of people supporting the alliance with the U.S. is up, when Japanese are asked, and there are similar questions in Korea and Australia, when they're asked, do you trust the United States to do the right thing, those numbers are very bad for us and are trending badly.

It didn't begin with the Trump administration, although that has added some skin to the ball, it began earlier with questions about commitments on the Senkakus or Taiwan. Or Syria. Even out of area commitments are watched very closely.

So we have to recognize alliances are a force multiplier for us in, I would argue in deterrence and war fighting, but especially in this Phase 0 competition. But we can blow it. And we're at some risk of making mistakes.

Very briefly, to touch on some of the major allies, and I think it's worth noting that smaller friends, allies, partners in the front lines, the Philippines, Mongolia, where I spent the summer, they are the most vulnerable and under the most pressure.

But ultimately, our ability to prevent and counter Chinese coercion in those smaller and weaker states, depends on how well aligned we are with Japan's, Australia's, Korea's, Britain's France's and Germany's.

Let me briefly touch on them. Japan is, has been competing with China since the Japanese emperor was given the title emperor in the 7th Century to signal to the Chinese that they were at least nominally co-equal.

The Abe government has built its entire national security strategy around competing with China.

Japan has got a declining demographic picture and Abe has largely countered that with more of what scholars would call external alignment.

The quad you've heard about. The U.S., Japan, Australia, India arrangement was an Abe idea.

The Free and Open Indo-Pacific strategy was an Abe idea. Abe is not only aligning more closely with other Asian powers, which is useful for us, he's doing away with six decades of Japanese alibi defense policies saying that the peace clause in the Japanese constitution means that they cannot do joint operations with us.

He has changed that. In 2015 new legislation said, no, Japan can do joint operations with

the U.S., he is moving with us.

The weak point in Japan strategy we can talk about. And a problem for us in this larger chess board is the deteriorating Japan-Korea situation.

Korea is also wary of China. Polls in Korea about China are not good for Beijing. But Korea has a very different history and a very different geopolitical situation from Japan.

And the Chinese view Korea as a much more likely candidate for de-alignment from the United States. When Xi Jinping gave a speech in Shanghai in 2014 calling for essentially an end to U.S. alliances, this was a conference of Eurasian leaders, continental leaders. The Koreans were there.

The Chinese put enormous pressure on the Korean foreigners to sign this speech as a joint statement agreeing that there should be, not be alliances, and the Korean's held firm. But it's recent that Beijing thought Korea would bend.

The boycott of Korean goods, which costs billions of dollars after Korea accepted THAAD missile defense systems, is another indicator.

Korea has not explicitly signed on to the Free and Open Indo-Pacific strategy like almost every other ally and partner. And I think Beijing sees opportunity there that is a problem, particularly given the Japan, Korea situation.

Australia has come under huge pressure from China, including internal interference and politics. And the Australians are pushing back. And generally aligning more closely.

Europe, when I was in the Bush administration we had huge problems with Europe. The EU was going to lift an arms embargo on China set after Tiananmen. We're way beyond that with the major European powers.

The European statement on China policy was very tough and talked about systemic competition over economic and political models.

The problem we have with Europe is the EU is a consensus based organization and Beijing has learned how to break consensus by buying off weak powers that block action. Hungary, Greece, in Southeast Asia, Cambodia and Laos.

When the EU has tried to take a position on things like the South China Sea or Taiwan, China has found ways to reach inside and block it.

So we have to think about how to work with Europeans in a different way. With Britain and France, with Germany, while helping them shore up the EU as a whole.

I'm happy to go into more of the opportunities and challenges we have but I'll just end by emphasizing that to get China policy right we have to get Asia right, we have to get our allies right.

China is targeting them, we need to be conscious of that. And not only think to ourselves, yes, allies are important, but really reinvigorate our alliances, make them more joint, reach across our bilateral alliance in Asia to have more collective cooperation and collective security.

It's going to take a very active administration policy, but we have very willing partners in the region and in Europe, which is, I guess, a good news story to end on. Thank you.

**PREPARED STATEMENT OF MICHAEL GREEN, SENIOR VICE PRESIDENT FOR
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Testimony before the U.S.-China Economic and Security Review Commission

“U.S.-China Relations in 2019: A Year in Review”

In this testimony I will focus at the request of the Commission on how growing strategic rivalry between the United States and China is reverberating among major U.S. allies and partners. Before going into specific country cases, I want to emphasize four overarching points.

First, China is targeting U.S. alliances in the Indo-Pacific as the “center of gravity” of U.S. power and influence in the region. Chinese strategy has shifted in recent years towards a much more deliberate use of carrots (the Belt and Road Initiative) and sticks (grey zone military coercion and mercantilist boycotts) to drive wedges between the United States and its allies. China’s declaratory policy has also become more explicitly opposed to U.S. alliances, with prominent examples including Xi Jinping’s April 2014 speech in Shanghai calling for an end to “external blocs” in the region and Xi’s seemingly more benign effort to downgrade the importance of U.S. alliances with the proposal to the Obama administration for a “new model of great power relations” premised on a Sino-U.S. condominium and a U.S. retreat from traditional alliance commitments in exchange for “win-win” solutions with Beijing.¹

The second point is that China’s assault on alliances is generally backfiring with democratic allies in the region, who tend to view U.S. leadership in the region as *sine qua non* for maintenance of their own values and security, even as they increasingly look to China for economic growth. Foreign policy and defense white papers from Japan, Australia and New Zealand in recent years have focused on Chinese coercion and revisionism, while opinion polls in these countries as well as South Korea and Western Europe demonstrate rising fears about Chinese capabilities and intentions.² Increased jointness and interoperability with the United States is the predominant trend among allies and partners in the Indo-Pacific rather than dealignment or hedging.

The third point is that there is growing anxiety in the Indo-Pacific about American staying power and strategic competence even as allies try to stay closely aligned with Washington. Polls demonstrate strong support for alliance with the United States in Japan, Korea and Australia –but

¹ Shannon Tiezzi, “At CICA, Xi Calls for New Asian Security Architecture, *The Diplomat*, May 22, 2014, <https://thediplomat.com/2014/05/at-cica-xi-calls-for-new-regional-security-architecture/>; Dindeng Chen, “Defining A New Model of Great Power Relations,” *The Diplomat*, November 8, 2014, <https://thediplomat.com/2014/11/defining-a-new-type-of-major-power-relations/>. Beijing quietly dropped the “New Model” formula with the arrival of the Trump administration.

² For example, Pew’s Global Survey found in 2018 that majorities in the Philippines, Vietnam, Japan, South Korea, Australia, and India consider the growing military might of China a “bad thing” for their country. See: <https://www.pewresearch.org/global/2018/10/01/international-publics-divided-on-china/>

also decreased confidence that these allies can count on the United States to “do the right thing.”³ This anxiety did not begin with the Trump administration-- conservative governments in Japan, India and Australia viewed the Obama administration as too slow to respond to Chinese coercion in the South China Sea and have welcomed the Trump administration’s Free and Open Indo-Pacific vision and explicit recognition of strategic competition with China. However, President Trump’s attacks on the multilateral trading system, excessive use of tariffs, criticism of allies and praise for adversaries have combined to accelerate uncertainty about American leadership and have undermined the tactical successes of the Free and Open Indo-Pacific vision.

In short, the United States is positioned to consolidate alliances and increase networking among allies to counter Chinese revisionism, but we are not playing our best hand.

Japan

From a Japanese perspective the recent American shift towards overt strategic competition with Beijing is overdue. As Japan’s 2013 National Security Strategy document put it: “the balance of power in the international community has been changing on an unprecedented scale” with “an increasing number of cases of unilateral actions in an attempt to change the status quo by coercion with paying respect to existing international laws.”⁴ The problem has only become more complex since then. The 2018 Ministry of Defense *White Paper* chronicled repeated Peoples Liberation Army (PLA) overflights and circumnavigation of Japanese territorial waters and regular incursions in the contiguous zone around the Senkakus, including military exercises on the East China Sea and Pacific Ocean sides of Japan, detection of Shang-class submarines and a grey-hull Jiangkai II-class frigate in the Senkaku Islands contiguous zone (the first confirmed case in which a submerged submarine entered into the contiguous zone). Meanwhile, the Defense Ministry reported that China’s military aircraft flights through the strait between Okinawa and Miyako Island increased from 5 per year through 2016 to 18 in 2017 alone.⁵

After decades of holding the United States at a distance on regional security issues and using the Japanese peace constitution as an alibi to avoid participation in U.S.-led conflicts from Vietnam to the Gulf War, the Japanese Diet passed new legislation in 2015 that reinterpreted the Peace clause of the Constitution (Article Nine) to allow limited “collective self-defense”—in effect joint operations with the U.S. and other like-minded states when their forces come under attack in scenarios that are “vital to Japan’s national survival.” This shift from alibi alliance relations to greater jointness reflects the reality that with China’s growing military expansion in the East

³ For example, in a December 2018 Yomiuri Shimbun Poll in Japan: Only 30% of Japanese said that they trust the United States, down from 39% in 2017 and the lowest since 2000. See: <https://www.yomiuri.co.jp/election/yoron-chosa/20181217-OYT8T50011/>

⁴ See The Government of Japan, “National Security Strategy of Japan,” December 17, 2013. https://www.cas.go.jp/jp/siryou/131217anzenhoshou/pamphlet_en.pdf

⁵ 2018 Japan Defense White Paper, January 2019, https://www.mod.go.jp/e/publ/w_paper/pdf/2018/DOJ2018_1-2-1_web.pdf

China Sea, Japan is now on the front lines and must have seamless security coordination with the United States.

Japan is also engaging in what international relations scholars call “external balancing” –or networking security cooperation beyond just the United States, but importantly not *in lieu* of the United States.⁶ Abe has championed the “Quad” U.S.-Japan-Australia-India security cooperative framework and launched an energetic campaign of leader-level diplomacy in Asia and Europe – visiting every leader of Southeast Asia and consolidating new levels of security cooperation with Turkey, Israel, Canada and other middle powers.⁷

The weak point in Japan’s strategy to compete with China is clearly in relations with South Korea. The Trump administration has failed to make even modest efforts to help reconcile the two allies –something earlier administrations had always prioritized—and in late August China stepped in to offer mediation in a trilateral foreign ministers’ summit that will be seen by historians as a signal defeat of American alliance management and influence.

Japan’s influence on U.S. strategy has been considerable, however. The administration’s Free and Open Indo-Pacific vision was based on a Japanese policy planning document; the Build Act and establishment of the International Development Finance Corporation were modelled on the Japan Bank for International Cooperation; and the Quad was originally proposed by Abe in 2006. Some of these strategic ideas had their genesis in Washington, but a Trump administration searching for bearings for its competition strategy has borrowed wholesale from Tokyo –to Japan’s reassurance and satisfaction.

Where Japan clearly takes issue with current administration policy –both out of self-interest and concern that the United States is creating a vacuum for China to fill –is on international trade. Japan has sustained momentum on a regional trade agreement that would pressure China to follow international rules through the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) –essentially the TPP minus the United States. Together with Australia, New Zealand, Canada and other close U.S. allies, Japanese leaders hope that the United States will find its way into the agreement in future to give them enough collective leverage to shape Chinese economic decision-making. Moreover, while Japan welcomes a more competitive U.S. approach to China, decision-makers in Tokyo are conscious of the fact that their corporations have more direct investment in China than any other country and that they rely on Chinese tourism and consumer demand to add to Japan’s own limited growth scenarios. After going toe-to-toe with Xi across Asia and coming out with a far higher level of affection in opinion polls across the region –and proving to Beijing that he will not be easily removed from power –Abe is now courting a more

⁶ For details, see Japan Ministry of Defense, *National Defense Program Outline and Mid-term Defense Plan* (mod.go.jp)

⁷ For details see, Andrew Shearer, *Australia-Japan-U.S. Maritime Cooperation: Creating Federated Capabilities for the Asia Pacific*, CSIS April 4, 2016 (CSIS.org).

stable and productive relationship with Xi.⁸ This is not primarily as a hedge against the United States as some pundits have argued, but because Japan cannot afford to decouple from China.

In many respects Japan has achieved the mix of competition and cooperation with China that has eluded U.S. policy in recent years. Tokyo has not gone soft. The Japanese government banned Huawei from 5G before the United States did, for example.⁹ But Japanese business and political leaders have learned where they must cooperate, where they must decouple, and where they must take steps to deter China.

Australia

Like Japan, Australia has come under increasing pressure from China. And like Japan, Australia has refused to buckle under that pressure. For Canberra, the broad concerns about Chinese revisionism in Asia were captured in the 2017 Foreign Policy White Paper.¹⁰ As Prime Minister Malcolm Turnbull put it that June at the International Institute of Strategic Studies annual Shangri-La Dialogue, “a coercive China would find its neighbours resenting demands they cede their autonomy and strategic space and look to counterweight Beijing’s power by bolstering alliances and partnerships between themselves and especially with the United States.”¹¹ And that is exactly what Australia has done.

Specific Australian concerns include:

- Chinese interference in domestic Australian politics through campaign contributions that until recent legislation were entirely legal;
- Increasing Chinese presence in the Pacific Islands with the aim of displacing Australia as the partner of choice; establishing dual-use military installations for the PLA; exploiting the region’s fishery stocks and other natural resources; and using tools of bribery and corruption to advance Chinese influence.
- Mercantilist boycotts and disruptions of coal exports from Australia to China in retaliation for Canberra’s decision to ban Huawei from 5G procurement;
- China’s militarization of the South China Sea.¹²

⁸ Ministry of Foreign Affairs of Japan, “Prime Minister Abe Visits China,” October 26, 2018, https://www.mofa.go.jp/a_o/c_m1/cn/page3e_000958.html#section2

⁹ See Ministry of Internal Affairs and Communications, “第5世代移動通信システムの導入のための特定基地局の開設計画に係る認定申請の受付結果,” February 26, 2019, http://www.soumu.go.jp/menu_news/s-news/01kiban14_02000375.html; Yomiuri Shimbun, “Japan to ban Huawei, ZTE from govt contracts,” *Reuters*, December 6, 2018, <https://www.reuters.com/article/japan-china-huawei/japan-to-ban-huawei-zte-from-govt-contracts-yomiuri-idUSL4N1YB6JJ>; Isabel Reynolds and Emi Nobuhiro, “China Says Unfair Treatment of Huawei Could Damage Japan Ties,” *Bloomberg*, March 29, 2019, <https://www.bloomberg.com/news/articles/2019-03-29/china-says-unfair-treatment-of-huawei-could-damage-japan-ties>

¹⁰ <https://www.fpwhitepaper.gov.au/foreign-policy-white-paper>

¹¹ https://foreignminister.gov.au/speeches/Pages/2018/jb_sp_180719.aspx

¹² For details and further analysis, see: Rod Lyons, “What Happened to the ‘Canberra Consensus’ on Australia-China Relations,” *The Strategist*, Australian Strategic Policy Institute, 3 July 2019 (aspistrategist.org.au).

China is a major market for Australian exports, particularly of coal, and Australian public opinion has been slower to identify China as a threat because the economic interaction is less disruptive to Australian domestic economic interests as it has been for manufacture-based economies like the United States or Japan. However, the government's pushback against Chinese coercion has received broad bipartisan support --with the exception of a handful of former ministers of government on the Chinese payroll. Had the opposition Australia Labor Party (ALP) won the recent election as expected, there would not have been a significant change in the trajectory of Australia's approach to China. ALP also supported banning Huawei, participating in the QUAD and tightening alliance cooperation with the United States. But like Japan, Australian officials worry about the vacuum being created by the U.S. retreat from TPP and institution-building in the region.

South Korea

Korea was historically more associated with the Chinese tributary state system than Japan and Beijing has put significant coercive pressure on South Korea to dealign from the United States since Xi Jinping came to power. At the April 2014 CICA conference in Shanghai the Chinese government pressured the South Korean Foreign Minister—without success—to sign on to Xi's statement opposing alliances in Asia. In 2017 China boycotted Korean firms and discouraged tourism to Korea to punish Seoul for accepting the deployment of U.S. Terminal High Altitude Air Defense (THAAD) systems to defend against North Korea's growing ballistic missile threat. The boycott cost Korean companies billions of dollars and led several companies to withdraw from China's market.¹³

Seoul has not given in to Chinese demands, but has been far more circumspect about the need to counter Chinese coercion than the Japanese and Australian governments have (Seoul took over a year to participate in the Free and Open Indo-Pacific, for example, and South Korea ambassadors in Southeast Asia often steer clear of the like-minded coordination meetings of U.S, Japanese, Australian and European embassies). In part this is because of relatively higher Korean trade dependence on China, but Seoul's reticence has also reflected a conviction in both the previous Park Geun-hye and current Moon Jae-in governments that Beijing will have a critical role in the process of unification. For its part, China supports what it calls "independent" unification – meaning that the peninsula must be independent of any foreign alliances. This runs in direct contradiction to the U.S., Japanese and South Korean positions that a unified peninsula will be more secure tethered to alliance with the United States. Nevertheless, Seoul continues to cling to the notion that improved relations with Beijing will be useful in managing the threat from North Korea.

That said, support for the alliance is solid among the Korean public. When the respected Asan Institute asked in a public opinion survey in the first quarter of 2019 whether Koreans preferred

¹³ "Korean Brands Still under Pressure in China Despite Warming Ties," *Nikkei Asian Review*, January 30, 2018.

relations with the United States rather than China, 75% answered yes and 67.7% said that they would choose the United States even if Sino-U.S. strategic rivalry intensifies.¹⁴ Nor does China even come close to U.S. importance to Koreans on the question of North Korea. When the Chicago Council on Global Affairs asked in a survey in 2019 why North Korea does not attack the South, only 6% cited China's constraining role while more than 70% pointed to some combination of U.S. forces, the U.S.-ROK alliance, or U.S. nuclear deterrence.¹⁵

Nevertheless, the geopolitical dynamics in Northeast Asia continue to entice Chinese wedge strategies on the Korean peninsula. As Japan and Korea feuded this past summer, China and Russia intruded on Korean and Japanese airspace on July 23, 2019 with joint bomber flights for the first time. Instead of responding jointly, the South Koreans escalated their fight with Japan by terminating the Japan-ROK intelligence sharing agreement.

Europe

Despite the enormous diplomatic headwinds in trans-Atlantic political relations today, the European Union is increasingly tracking with U.S., Japanese and Australian views on China. This is a significant change from fifteen years ago when Beijing viewed Germany and France as counterweights to American power in a global multipolarity that favored China. The earlier divergence in U.S.-EU China policy peaked with Brussels' attempt to lift the arms embargo put in place after Tiananmen Incident in 1989. Those of us working on Asia in the Bush administration put in considerable effort convincing our European allies that it would not be wise to approve arms sales to Beijing in the same year the Chinese government was promulgating an "anti-secession law" that would legalize military attacks on Taiwan. In the years since Europe has grown alarmed at Chinese coercion in the South China Sea; influence campaigns in the South Pacific (an historically French area of interest); repression in Xinjiang; and predatory economic policies with respect to intellectual property rights.

In its March 2019 "EU-China Strategic Outlook" report, Brussels noted that "China is simultaneously, in different policy areas, a cooperation partner with whom the EU has closely aligned objectives, a negotiating partner with whom the EU needs to find a balance of interests, an economic competitor in the pursuit of technological leadership, and a systemic rival promoting alternative models of governance." [emphasis added]¹⁶ Meanwhile, Britain and France have agreed to conduct joint Freedom of Navigation Operations (FONOPS) in the South

¹⁴ Asan Institute, "South Koreans and their Neighbors" April 26, 2019 (<http://en.asaninst.org/contents/south-koreans-and-their-neighbors-2019/>)

¹⁵ "South Koreans See Improved Security, Confident in U.S. Security Guarantee," Chicago Council on Global Affairs, January 18, 2019 (thechicagocouncil.org)

¹⁶ <https://ec.europa.eu/commission/sites/beta-political/files/communication-eu-china-a-strategic-outlook.pdf>;

China Sea.¹⁷ Where governments have sought more nuanced cooperative relations with China, their parliaments have called for stronger measures to counter Chinese coercion. For example, the British House of Commons Foreign Affairs Committee in April 2019 expressed doubt whether, “given the consolidation of the power of Xi Jinping in China, it would be appropriate for the UK to commit itself to seeking such a close relationship” [as some in Her Majesty’s government were considering]. The European Parliament has similarly put pressure on Brussels to get tough.¹⁸

While European attitudes towards China have hardened, however, the EU’s China strategy faces important structural constraints. Beijing has demonstrated an ability to neutralize EU action by using weaker proxy states such as Hungary or Greece to block consensus, as happened when the EU attempted without success to issue a statement on the International Tribunal’s ruling on the South China Sea in July 2016. There is also evidence that Chinese political interference campaigns within Europe, including Britain, have gone unanswered by governments (in contrast to Australia).¹⁹ Europe is also beset by internal distractions from Brexit and more proximate political interference and grey zone coercion from Putin’s Russia.

Conclusion

I have focused in this testimony on the most powerful democratic U.S. allies because ultimately resistance to Chinese coercive strategies against smaller powers in Southeast Asia and beyond will depend on solidarity among those larger states that have the capacity, capability and values needed to uphold a free and open Indo-Pacific and international system.

It is clear that the major democracies’ views of the China challenge are converging -- but the seams among us offer too many opportunities for Beijing to pursue wedge strategies. Solidarity must begin with principled and persistent strategic vision from Washington. While the Free and Open Indo Pacific vision offers exactly such a path, the President himself has too often undermined his own officials. These closing recommendations to the committee are premised on what new policy measures might be effectively implemented to reinforce the Free and Open Indo-Pacific vision without having necessarily to rely on Presidential leadership for success.

¹⁷On France-Britain Joint Operations, see: <https://navaltoday.com/2018/06/06/france-uk-announce-south-china-sea-freedom-of-navigation-operations/>; <https://thediplomat.com/2018/09/are-france-and-the-uk-here-to-stay-in-the-south-china-sea/>

¹⁸ <https://www.parliament.uk/business/committees/committees-a-z/commons-select/foreign-affairs-committee/news-parliament-2017/china-international-rules-report-published-17-19/>; for EU Parliament examples see: https://eeas.europa.eu/archives/docs/china/docs/joint_communication_to_the_european_parliament_and_the_council_-_elements_for_a_new_eu_strategy_on_china.pdf

¹⁹ See for example, Charles Parton, “China-UK Relations: Where to Draw the Border between Influence and Interference,” The Royal United Services Institute, February 20, 2019 (<https://rusi.org/publication/occasional-papers/china-uk-relations-where-draw-border-between-influence-and>)

First, the administration should re-energize the G-7 process to reinforce the leading democracies' commitment to a rules-based international order and to call out Chinese predatory behavior. The G-7 Summit meetings are only one arena, with significant possibilities for enhancing a common strategy at the level of Sherpas in each government.

Second, the administration should act more decisively to resolve Japan-Korea tensions and reformulate trilateral security cooperation.

Third, the administration should avoid excessive demands on Japan and Korea for host-nation support that lead to a debilitating confrontation and further divisions with our key allies in the region.

Fourth, the administration should move expeditiously to complete the U.S.-Japan Free Trade Agreement and explore concrete steps to implement President Trump's stated preference for bilateral trade agreements so that the aggregate of these agreements brings some of the rule-making leverage lost with U.S. withdrawal from TPP.

Finally, the administration should avoid using the Huawei ban, democracy protests in Hong Kong, or Taiwan arms sales as cards in trade negotiations with China. Allies will not expose themselves to pressure from China in these areas if they believe the United States will undercut them in transactions with Beijing.

To close, it should be obvious that without allies, we have no China strategy.

PANEL II QUESTION AND ANSWER

COMMISSIONER FIEDLER: Thank you. Roy.

COMMISSIONER KAMPHAUSEN: Thank you very much. It's a wonderful panel. I apologize that I have to leave early, and so, thank you to our hearing co-chairs for allowing me to ask my questions first.

Our Commission has been engaging on the topic of the juxtaposition of China as a near peer competitor potentially and Xi Jinping's assertion that the PLA should become a world class Military power by 2050. And we've been wrestling with this topic.

My question is not about that, it's really, from what you've said today it seems that as we consider the question, near peer competitor, we ought to focus more naturally and more intentionally on that degree to which China is competing with us, in a military sense, within the region. So, thank you for your insights.

I guess my first question, Dr. Green, because you focused on the allies, is this a formulation, the question of whether the PLA is a near peer competitor to the United States within the region, is that even a formulation that is a useful or meaningful construct for how our allies think about the challenge?

DR. GREEN: The answer is yes. And behind the Australia white paper and Japan's natural security strategy and most recent mid-term defense plan, was intense gaming planning discussions within those allied capitals about this very question.

And the conclusion, I think, is evident between the lines in the white papers. China is approaching near peer competitor status with the U.S. military in the region. And that is deeply problematic for allies who have to respond by being more joint and interoperable with the U.S. and get over some of the historic allergy they've had to that.

And so, every crisis is an opportunity, but I think particularly Japan and Australia see a challenge. And they also see, not only a contested South China Sea, but they see PLA operations, they see influence campaigns, they see dual use military port building in places like Vanuatu and the Pacific Islands, Myanmar, in Pakistan or in Djibouti.

Which from their perspective means that China is taking the fight well beyond the first island chain, at least in the early phase of a crisis, so that they and we or others like India have to mind our flanks and give the Chinese, they can manipulate more of an advantage than we've even heard.

So, I think from their perspective it's a game on problem, and the near peer problem is not just the South China Sea it's spreading out beyond them in ways that affect their interest.

COMMISSIONER KAMPHAUSEN: Great, thank you. My second question relates to your, Dr. Green's, final recommendation.

In which you say the administration should avoid using the Huawei ban, democracy protest, Taiwan arm sales as cards, specifically in the trade negotiations. But your argument, I think, is based on the second sense, which is, that's in view of how our allies would see that.

So I wanted to give you a chance to comment on that and then ask a follow on question to the rest of the panel, I've frankly been surprised to the degree to which your arguing for a sort of de-linkage on this so that we get this negotiation right. But I've been surprised to a degree to which the Chinese has, themselves, preemptively de-linked.

When the Commission was in Beijing in May it was clear that military pressure has a tool for enhancing the Chinese negotiating position was not being given a high priority. So I'd welcome your thoughts on how they might consider doing that, that we should be alert to.

But first, maybe describe a little bit what you're thinking your way?

DR. GREEN: So, my own personal view is that we will decouple from China on 5G. And most of our allies will join us if we play this right.

And yes, China will indigenize, will try to create champions, in particularly in the areas where they're weak, semiconductors and so forth, but they're way behind.

And if you look at the, beyond some of the alignments where Huawei has made advances in putting things to market, if you look at some of the emerging technologies, they reside in the U.S., Japan, Korea, Taiwan primarily. So, the 5G competition, I think, is leading to some decoupling.

But it's very much contested. Australia made a decision very publicly to ban Huawei and other Chinese companies from their 5G market.

Japan has made the same decision. It's been less public and it's not legislated but it was an administrative decision. India, Britain and others are debating this.

And the reason I mentioned that recommendation is, if we were to announce suddenly, as our allies are taking enormous heat, when Australia banned Huawei, coal exports to China suddenly stopped.

Our allies are taking huge heat for this. And if we were to suddenly say, you know what, we've decided to change our position on Huawei to get a good trade deal, we would obviously undercut them but we would lose that fight in governments that have a national security impulse to work with us, like Britain. But an enormous commercial pressure to work with Huawei.

So steadiness on this one is really critical.

DR. MASTRO: If I can just add two points? The first on linking kind of secured in economics more broadly. I agree with Dr. Green's assessment of why that might not be beneficial at this stage, but I think it largely, in my view, depends on who's in the White House.

So my primary concern about linking economics and security is, it's my assessment that President Trump prioritizes the economic issues with China over the security issues. For example, he has never brought up the South China Sea with Xi Jinping.

The last time I can see he even tweeted about it was before he was President. And so, my concerns is that linkage would be done in order to gain an upper hand in the economics, but in the end he would sacrifice some of our security goals. And so, for that reason I would like to keep the two issues separate.

On the allies, just to add, I do agree that there has been a shift in the viewpoints in a lot of capitals, but I might have a slightly different assessment about why that happened. And I think it's important for U.S. strategy in moving forward.

It seems to me that the allies and partners are primarily were awakened by political interference. The fact that China and Chinese behavior finally reached out and touched them in their countries and what was happening at home and because of domestic economic issues.

It seems that they are, besides the freedom of navigation operations, the Brits and the French do, there seems to still be a very low appetite for security competition with China.

And so, while the allies and partners, I think, are much more on the U.S. side about pushing back on China on the political and economic side, I think that there is still a lot of progress that can be made on getting them on the same page with the United States about being able, or being willing to take a few more risks or even upsetting or provoking China to reverse some of the negative security trends that we discussed.

DR. KREPINEVICH: I'll add a couple of points. Apropos of what Dr. Green said, it seems to me that given the Chinese focus on comprehensive national power, that they will look

to use all the instruments of power.

And unlike us on occasions, they won't say, well economics is just about the bottom line in profit, they'll introduce that when they think it's appropriate and they can gain advantage.

And so, the point about the deployment of the THAAD battery to South Korea and all of a sudden there is economic consequences for the Republic of Korea, the Japanese seizing the fishing boat and all of a sudden you don't have rare earth metals going to Japan. And we used to do that.

Those of us who are old enough to remember the Suez in 1956, President Eisenhower stopped the British and French cold basically through economic means, not Military means. So, again, I think the Chinese take a more comprehensive view than we do.

The other thing I will say about peer and near peer, is just that I think it's very circumstantial. Depending upon how you look at it, we could have considered North Vietnam a peer competitor back in the 60s and 70s.

So, again, it depends on the contingency, the circumstance, the nature of the conflict. And you can only go so far, I think, with those kinds of terms.

COMMISSIONER FIEDLER: Thank you. Commissioner Wortzel.

COMMISSIONER WORTZEL: I want to thank all three of you for being here. I've got a few questions and I'm going to throw them out there. And if we don't get through, maybe I'll get to some of them in a second round.

Dr. Mastro, in Page 5 of your testimony you have this very interesting thing about the five AGORs going out into the South Pacific.

The last time the PRC did that, if I remember right, was 1981 for their very first DF-5/CSS-4 open ocean missile shot. And they concentrated there on positioning, salinity, bathymetrics and things that you would use for ballistic missile submarines. So, tell me what you think they were doing out there.

Now, for, Dr. Krepinevich, a specific one. You've written on archipelagic defense and Dr. Green mentioned Phase 1, I want to take you into Phase 2 and 3.

Decisions about going to war, mobilization. If you were going to recommend when to deploy or employ a Marine Corps expeditionary advanced base operation or an Army multi-taskforce or Japan Southwest Island defense, it seems to me, if you reach Phase 4 and you're in combat, it's a little late. And if you do it in Phase 1 they become big targets. So, what would you call the sweet point?

And then for Dr. Green, and this goes back to something Dr. Krepinevich raised, have we locked ourselves into an untenable position by our own legalistic policies in refusing to take positions on the disputed islands and the reefs out in the South China Sea?

I mean, we're pretty clear on the Senkakus, we're clear on second strike because of the grounded LST, but if we're going to use legal means, as Dr. Krepinevich suggests, have we hemmed ourselves in?

DR. MASTRO: Thank you for your question. Just to begin, are you asking about the distant ocean fleet and the --

COMMISSIONER WORTZEL: Right.

DR. MASTRO: Okay. So, this is obviously just speculation but I think China's main concern, especially when they're talking about the South China Sea, if you talk to the Chinese military, they'll say one of the number one reasons they have to have de facto control of the South China Sea is because they need to get out. They're concerned about the United States keeping them in.

And in order to maintain a nuclear deterrent as their concerned about a secured second strike, their submarine force needs to be able to get out of their bastions, out of the South China Sea and be able to roam a bit farther.

Now, I have talked to some people, I'm not an expert on antisubmarine warfare, but in discussing that with some other individuals, it seems that you have to get data on the density and salinity temperature that you mentioned, but that that is also a constant and routine process.

With climate change, those statistics actually change much more frequently and rapidly over time, so it's no longer the case that a country can gather data and then go home and still be able to conduct that type of warfare, it's going to have to be constant.

So I think it's probably a combination of wanting to get information to be able to better track the U.S. submarines combined with conducting their own training to be able to have more routine presence farther from their shores.

And so, I think those are, the main issue here is a strategic deterrent and less a nuclear deterrent.

And if I could just add one thing on the South China Sea islands. To me the main issue is not actually the sovereignty of the islands, it's that China's interpretation of what that rock gets you is basically control of all the waterways.

They manipulate it in such a way that they misinterpret internal waters, territorial waters and exclusive economic zones such that they can dictate the rules.

And so my personal position is, the United States needs to take a position, not that we decide what's what, but as I mentioned in my testimony that this should be as important, if not more important, than a Middle East peace process.

We need to spearhead shuttle diplomacy, get all the countries together and if they come to an agreement, at the very least about what these features grant in terms of rights and China is the only one on the outside that disagrees with that, I think it will be more problematic. So I think the legal initiatives are very important. And the diplomatic initiatives in addition to military posturing.

DR. KREPINEVICH: Following the Cold War, we shifted much more from a forward-based, forward-deployed posture to an expeditionary posture. That won't work in the Western Pacific.

In the event of a crisis, you start flowing expeditionary forces into the Western Pacific, it's viewed as provocative. You know, it's shifting the military balance, and you create an incentive for the Chinese to go now before the balance shifts further against them.

After a war starts, given Chinese A2/AD capabilities, it makes it harder still to reinforce, which is one of the issues with Japan's rethinking of its defense posture in these mobile land forces.

We have to move to a more forward deploy posture. And typically, when I mention that, people say that's really hard, you know, for a lot of reasons. And it's going to involve a lot of diplomacy if we get it right. And it's not going to happen overnight.

And the way I kind of talk myself off the ledge on this issue is you look back at the last time we called out another great power as a rival. It was 1947, we called out the Soviet Union. And the American people weren't even thinking about Europe anymore.

We had no allies in Europe, no alliances. We had hardly any troops in Europe. But we took a long view. And we began to say this is where we need to go, and we had to make course adjustments over time.

But we saw what was necessary. And we understood that we were in a

competition with another hostile power, that we wanted to avoid war, and we realized it was going to be hard. And we realized it was going to be a long term effort.

And what really strikes me is, if you look at where we ended up, you know, the Pentagon started something called Air Sea Battle a few years ago which ended up at a dead end. If you look at where we were in Europe by the end of the Cold War, there was something called AirLand Battle. And our Army and Air Force created that.

And the idea was there were waves of forces coming out of the Soviet Union, and we felt we could stop the first wave, but we needed capabilities to break up the second wave. And we began to field those capabilities.

Then the Navy got involved and said, you know, we need to keep these guys north of Greenland, Iceland, UK so they can reinforce. And we had the Navy develop something called the Outer Air Battle.

And the Marine Corps, with their maneuverable warfare doctrine, said, you know, we can help out in Norway, protect the Northern flank. Our allies bought into it. They understood what was going on.

We have nothing like this in the Western Pacific. I mean, and how do you make decisions and set priorities in your defense program where you don't have a clue even of where you want to go.

And that was one of the critiques of Secretary Mattis in the national defense strategy, said we need innovative operational concepts. We need to figure out how we're going to do our job here.

And so again, without that, and I wrote a dissenting opinion in the Commission, because I was sufficiently exercised over that issue, without that, it's very hard. And our allies, I've had senior Japanese officers come to me.

Until you tell us how you're going to do this, it's very difficult for us to make decisions about what aircraft to buy, what kind of ships to buy, where we should position them. Very politely, get your head in the game. And I think this gets back to what Dr. Green said.

And then secondarily, I went up to the Naval War College. And there's a former Japanese CNO, Admiral Takai, up there. And I went to visit him. And you go in his office, and he's got a table like this. And he's got a map of the Indo-Pacific that he has white stones and black stones. And he says let's play Wei-chi.

And, you know, part of the conversation is, well, what's going on in the South China Sea? Well, it's not only building runways, and this, and that. It's about positional advantage. It's about playing Wei-chi, not chess, not kinetics, but position.

And what we've lost in the South China Sea, if you look at my concept, which is archipelagic defense, is you've lost strategic depth. We have very little strategic depth along the first island chain.

Well, by positioning those stones in the South China Sea, we've lost the strategic depth we had in the Philippines or we could have in the Philippines.

And when I ran a Defense Department summer study a couple of years ago looking at these sorts of issues, I was told very pointedly, come back and tell us not where you'd like to be, not who are allies are, tell us where you need to be in this competition in the Indo-Pacific.

DR. GREEN: If I could pick up on Dr. Krepinevich's excellent point, another way to think about this defense in depth problem we have is, my first job in the Pentagon, 28 years ago now, came right after the Taiwan crisis.

You remember well, Larry, that saw U.S. carrier battle groups, two of them, lollygag

through the South China Sea, in effect threatening China's southern flank.

China's strategy for Taiwan, Senkaku, any fight now is to use that as a bastion to outflank us and threaten Guam and Hawaii. So that's the chess board problem we face.

You raise a very interesting question about expeditionary forces. And Dr. Krepinevich answered very ably the limitations of expeditionary forces when we're into the higher end warfare fighting in the island chain.

That is why you are hearing more from Japan and Korea about surface-to-surface missiles which can deter without preempting a conflict by deploying if they have the right range.

I think this is going to be an increasingly important issue for the U.S. and its allies, vis a vis China. I think we should be supportive and encouraging. It is one more reason why we have to work harder at jointness and interoperability with our allies.

We do not want independent surface missile doctrines across the first island chains that could pull us into a fight we don't want. And so one of the things I would emphasize over and over is we are more joint and combined with Japan and Australia than we have been in this region but not enough.

There is a role for expeditionary forces that's very important in my view. If you look at the defense doctrine in emerging capabilities and concepts of, you know, go down the line, Canada, Korea, Japan, Australia, and New Zealand, they all want marine corps. They all want expeditionary amphibious capabilities.

We have bilateral alliances. Part of our cost and position strategy on China is integrating them more across these bilateral arrangements. If everybody wants expeditionary capabilities, if they're all building, you know, flattops, and they're all building amphibs, we ought to be doing more jointly with them, more joint operations, more training, more equipment.

And great power competition results in war usually because of a deterioration around the periphery of the great powers. So what happens in South and Southeast Asia is incredibly important if we have a combined expeditionary capability to deal with natural disasters, neo-civil wars. We get there before China. We lock that in.

On your question about territory, my view is that international law matters. It is a strong card for the United States. And it would be a mistake for us to suddenly change decades and decades of State Department legal counsel position and suddenly say we've now decided that the Senkakus are, in fact, Japanese territory, et cetera, et cetera, et cetera.

The main negative impact would be it would undermine the credibility of our rule of law tool in diplomacy. But it would also open up Pandora's Box. Because then all of a sudden it would be a test of American credibility everywhere in the world.

And so I would not impose a cost on China by recognizing or changing our position legally on the question of territoriality. But we do, to get to the thrust of your question, we do have to think more creatively about cost imposition, to include possibly sanctions on entities involved in artificial island building, to include things like more robust exercise schedules, and so forth, punishment for coercive tools.

But I would not use the State Department Office of Legal Counsel to punish China by suddenly changing our well-considered ---

COMMISSIONER WESSEL: And what would they do to enforce it?

COMMISSIONER FIEDLER: I'm going to have to stop this discussion to move on. It was twice as long as we should have permitted but, Robin?

VICE CHAIRMAN CLEVELAND: I'm going to follow-up on Commissioner Kamphausen's point. And I do want to talk about what near peer looks like. We've had a

conversation in the staff and with commissioners trying to come up with a taxonomy or a matrix to define near peer. And I think we tend to get bogged down in very broad categories like weapons systems.

So Dr. Krepinevich, I was very interested in your testimony in terms of characterizing the importance of leadership, decision making, precision strike regimes, new domains, and the capacity to exercise disruptive shifts.

If you were to define what the elements of near peer would be, how would you think about that? You mentioned contingencies and the nature of conflict, but if you were looking at some kind of matrix or taxonomy, would the things that you mentioned in your testimony be included?

I'm interested in each of your views on the whole construct of near peer. Because I think part of the problem in making the case to have forward-basing and to be more engaged with our allies is certainly the public is not thinking in terms of what's the threat. So I think a taxonomy may contribute to that discussion.

DR. KREPINEVICH: I haven't thought much about it, but that's never stopped me before.

(Laughter.)

DR. KREPINEVICH: In terms of a near peer competitor, based on my testimony, I guess I would look at several metrics. One would be, with respect to China, our ability to preserve our vital interests in the Indo Pacific in various contingencies against the Chinese military threat to those interests.

Another metric might be, and I think they certainly merit near peer and possibly peer competitor status, is they're the only other military that I can see that can plausibly conduct advanced precision strike, what the Russians call reconnaissance strike operations, you know, a combination of battle networks and precision strike capability that we first demonstrated in primitive form back in the first Gulf War.

I think another metric for peer competitor is where do they stand in terms of being able to affect disruptive shifts in the military balance. And so we have seen them, you know, invest a lot in areas like AI, and hypersonics, and small sats, and so on, even the 5G networks that have the potential to really, mostly in combination, to affect significant shifts in the balance. So that would be another.

And my own sense is that if their development of Anti Access/Area Denial capabilities creates kind of a new normal in the Western Pacific, where our freedom of offensive maneuver is very limited, then I think one possible attractive approach for us to gain advantage will be to move the competition either into those domains that favor the offense, which is space, cyberspace, and sea bed, or horizontal escalation. You know, we talked about positional advantage to begin to pick off a lot of their assets beyond the Western Pacific.

So those, at first blush, those are the sorts of metrics I'd be looking for to see how well the Chinese can compete in these areas. And if they can compete on a level with us, then I'd say they're a peer. And if they can't, then they're a near peer, or maybe they're not quite in the game yet.

VICE CHAIRMAN CLEVELAND: Thank you. Either of the other?

DR. MASTRO: If I can add a few points, the first is that we're not on a level playing field, and this is the issue that I have with the peer or near peer. Because even if they're only near peer, we can't even get to that point, right.

Just some of the examples that were given, if we have, like, land-based missiles that we

can therefore more effectively attack Chinese bases that are lobbing the assaults at our bases, it's much easier for China to re-supply and reconstitute those bases, because they are just moving stuff around Mainland China.

We're going to have one or two vectors of approach from waterways to try to get supplies in to our bases to reconstitute them. And so in a lot of these scenarios, as was mentioned, it's like who's going to prevail in the conflict.

But it's also much harder for the United States than it is for China. So even if we do take the competition to space or to cyber, China doesn't rely on space and cyber to conduct military operations the way that we do.

If they lose comms through space, they have fiber optic cables they can use on the ground. And so one of the issues that we often think about is proportional, like, if we're acting in a proportional manner in terms of effects but not sort of outcomes, right.

The idea should be not that China hits a ship, we hit a ship, or China hits a base, we hit a base, but what is the effect it's having on our war fighting effort, and then be able to respond in a way that has the same effect on them.

Also, when it comes to China's global interests, one of my concerns about looking more broadly at the peer competitor status is I fear we're focusing on the world class military language and China moving more global, because resolving or dealing with the competition in the region is too hard.

And so just in my personal experience, it seems that a lot of the discussions about this, maybe in defense, it's like we can't deal with the A2/AD of the South China Sea. So maybe if -- but we have an advantage in the Indian Ocean. So we'll hold Djibouti at risk, and then they'll give in on the South China Sea.

In my understanding of China, that's not how this is going to work. And they're not going to be distracted from what they consider their core interests, because we're imposing costs on them elsewhere. The competition in this way, I think, really does have to stay local.

For me, the near peer competitor, two more things I'll say that I think are important, does deterrence hold? This is my main concern, it has to do with the confidence, not only capabilities but in resolve.

And then maybe globally, one thing we have to think about is whether the United States is the security partner of choice. As China is building relationships with countries in Africa and Central Asia, you know, beyond our alliances, they're becoming a more popular security partner of choice.

And the U.S. strategy has always been get the most important, prosperous, strategic countries to be on our side, right. As the Chinese would complain, we got first dibs on allies, and we got the best ones. But in this world, especially with international institutions, numbers matter.

And so even if we have four or five countries who are on our side about a certain issue, in the UN if 150 of them are on China's side, then we lose.

And so I think we also have to think about the weakest links that China exploits, the Laos, the Cambodias, the Hungaries of the world. And we also have to build up our numbers to be the security partner of choice beyond just our immediate allies.

VICE CHAIRMAN CLEVELAND: Thank you.

COMMISSIONER FIEDLER: Jim Talent.

COMMISSIONER TALENT: This has been fascinating. And thanks to the three of you. Dr. Krepinevich, 25 years ago when we were both young whippersnappers you wrote a long

article about the Revolution in Military Affairs that really opened my eyes. And I'm grateful for that and your service over the years.

I do have a question for you. You evaluate that the balance of power in China's near seas currently favors the United States, although you have great concerns in the intermediate and longer terms.

I'm sort of the opposite. I kind of think that we're in trouble now, but I'm kind of encouraged about trends. Because a lot of this messiness that you're all concerned about with American policy is what happens in our system when everybody's eyes open and they go, whoa, we've got to do something now. And so now everybody's running in to do things. And I think we'll figure that out.

But, Andy, okay, so the Chinese have a tremendous advantage in logistics. They have more force in the region. Their platforms, as currently constituted, are better suited to the kind of conflict that would likely occur.

And you're right, we're way behind in terms of operational concepts. So explain why you're saying that the balance now, at least, favors us? And it's not a rhetorical question. Is it ISR, you think, is it their failure. I mean, they're very concerned about the operational effectiveness, particularly in joint operations of the PLA. So maybe you share that.

And then, Dr. Mastro, you suggest an idea that's intrigued me a lot which is, hey, let's get together with all the claimants in the South China Sea and negotiate an outcome and leave the Chinese on the outside. I think that would be a really good outcome from a lot of different perspectives.

But they're not just, Beijing's not just going to sit there while we're doing that, right. And haven't they developed enough clout with enough of those claimants, just as they do with ASEAN now, to basically block any kind of consensus approach? Those are my two questions.

DR. KREPINEVICH: Thank you. I may have misspoke, I meant the military balance in the Indo Pacific region, not within the first island chain. But the reasons for that, I think right now, in terms of our ability to escalate vertically, horizontally, I think we have advantages there that give the Chinese pause.

I think they also, I think, view themselves as being far more economically vulnerable to certain things we might do. Although I must say, I don't think that issue's been looked at carefully enough, especially when you start to look at global markets, global supply chains, what happens when you start to corrupt the global financial system and so on.

I think they also have pause when they look at our equipment, our people, and our experience in war fighting. It's a very impressive capability. So for those reasons, I think the balance is generally favorable.

My caveat was I'd really like to have Jim Baker do some serious net assessments over there in OSD with access to all the classified information they have and some of the best thinkers that they have.

And again, it's interesting. I think if you look at the long term competition, I'd rather be in our position than theirs. But if you look at the trends right now, so we're in a much better position to fix things than they are. And I like our stuff and our assets better than theirs. But we're not doing a very good job of exploiting our advantages.

COMMISSIONER TALENT: Now that I agree with. We're just starting to draw on the reservoirs of strength that we have. I agree totally. Dr. Mastro?

DR. MASTRO: Thank you for that question. My greatest frustration dealing with these issues is it seems we want the exact same policies but different outcomes.

And I understand that there's a lot of desire not to be provocative. But I think what we first need to do is brainstorm all of these different solutions and then rule out which ones kind of might be crazy and which ones aren't.

COMMISSIONER TALENT: I'm all for being provocative. I just want it to work.

DR. MASTRO: Yes. So let me go through a bit more detail about kind of what I'm thinking here.

I mean, my premise is this. The United States maintaining a military advantage in the first island chain has to be our national priority. In going back to a point that was made, it does not seem not only that the American people but even some scholars who focus on these issues understand the threat, in terms of what can the United States military no longer accomplish if we cannot operate in the first island chain?

I mean, then we're basically blind to a lot of what China is doing. China can coerce the whole region without U.S. interference. It's a very problematic situation.

If we want to do the diplomacy, you say China won't just sit there. I will note that we just sat there for the past couple of years while they did the code of conduct.

But I agree, we don't want to do it through ASEAN, right. Those are consensus-based systems. What I'm saying is if we have, like, a separate initiative in which we are trying to spearhead diplomacy between the claimants and then we ask, you know, what do they need?

Like, I get certain points like, you know, Vietnam, I always get Vietnam will never agree to this or, you know, they will never agree to that. I think we need to do some more brainstorming about what do they need to agree to these issues.

And then we can say, for example, this is a separate issue, but if we need access in Southeast Asia, which I think we do, if we wanted a base in Vietnam, what would we have to give to get it? And I think if you told Vietnam that we would recognize the Paracels is theirs, we would get our base.

Then we could have a disagreement between me and Dr. Green about whether that's worthwhile. I think it is. I understand he thinks it's not.

But the point is, we need to start brainstorming some of these ideas and think strategically on the level of normalizing relations with China, allying ourselves with the Soviet Union during World War II, and stop just saying we want to do the same exact stuff but have completely different outcomes or trends.

COMMISSIONER TALENT: Thank you. I think we've discovered the George Kennan of this national competition in Dr. Mastro. Mike?

COMMISSIONER MCDEVITT: Thank you. I was sitting here agreeing with 99 percent of what all three of you were saying, having spent the last 25, actually since 1985, thinking about many of these same issues.

So I have a couple of questions or observations that I want you to respond to, to kind of move the discussion along in a little bit different direction.

First, I certainly agree with Dr. Mastro that Taiwan remains the center of the security universe between the United States, and China, and what have you, and East Asia, and the first island chain. And all those things are very important.

I think the other thing though that is being lost in all of the discussion about this is the growth of Chinese expeditionary capabilities and, more importantly I think, Chinese expeditionary ambitions.

And I'd like to have your reactions to the fact that if you, maybe it's because I'm a sailor, you read Chinese defense white papers, and other documents, and what have you, and they have

a severe case of SLOC anxiety, I guess, is what I'd call it.

They're really worried that we're going to go out and, as well they should be, I should say, and start, in case of crisis or conflict, start interdicting their sea lanes. So they're building a capability to be able to do a deal with that.

Today, of course, if the PLA Navy sails out from underneath the Air Force, land-based Air Force and missile system, they're very vulnerable. But they're thinking longer term.

And I just wondered if any of you have given any thought to the longer term implications, perhaps in the framework of a world class navy, of an expeditionary oriented, capable PLA and what that might mean for the United States around the world.

The second question I want to ask is it's often, I've heard people say it, I've said it as a matter of fact, that the possession of nuclear weapons by the United States and China is going to keep the peace between the United States and China. Do you all believe that?

COMMISSIONER FIEDLER: Don't all jump.

DR. MASTRO: I guess I'll go first. And I'll say, on both of these questions, I have maybe a less popular view than the conventional wisdom. So the first on the expeditionary capabilities, you know, I've written extensively about the types of things that they are trying to develop and what they would have to develop specifically in terms of ISR, lift to be able --

PARTICIPANT: A whole bunch of stuff.

DR. MASTRO: -- a whole bunch of stuff to be able to do it.

I think their ambitions are quite limited in this area in terms of the military side. They still think they can largely rely on political and economic tools to protect their economic interests abroad.

Now, the SLOC situation is one they're concerned about. They saw what happened in World War II. They don't want the United States to do it to them. But at least from what I hear about the Chinese military themselves, they think if they do have that control of the first island chain then they do have the capabilities, for example, to blockade all sort of U.S. allies and partners, such that you kind of have mutual vulnerability there that potentially could protect them in a conflict.

If the United States tries to cut off their access, maritime access, then, you know, Japan no longer can get anything if China is controlling those waters. So I think that's kind of their strategy. It is much more limited.

But I will say that my personal view is, if China was more ambitious than how I think they are, that's how the United States wins this competition, right. We're at a disadvantage, because we're trying to project power across vast distances. We have interests all over the world. And China can basically use their defense budget for a small area that is close to home.

So if this were more like the Cold War in which we were both, you know, not the home team, I think that's how the United States perseveres. So I'm not as concerned about their desire to be able to basically push out beyond sort of the Indo Pacific.

I do think they want to expand more into the Indian Ocean. But if they did have the mentality like the United States, that they need to be present everywhere, I think that's how we win.

On nuclear weapons, I don't think they play a role in terms of deciding whether or not we have a limited conventional conflict. We don't have a mutually assured destruction relationship with China. It's not the same as the Cold War.

It's questionable whether or not they even have a secure second strike. China thinks differently about nuclear weapons, not only based on their writings, but how they train. They do

train to launch on attack, not on warning. So I firmly believe in their no first use policy. I have a hard time believing that the United States would use nuclear weapons first.

And so because of this, I think it creates a situation that allows for much more conventional conflict. So I always say this is not like the Cold War, because I think there's a higher likelihood of hot war between the two sides. And this might be generational, but the nuclear weapons just don't really play a big role in the thinking.

COMMISSIONER MCDEVITT: So you think we could conduct a limited war with China in East Asia without escalation to nuclear weapons?

DR. MASTRO: Yes.

COMMISSIONER MCDEVITT: That's what the Chinese say. I don't believe it. But go ahead, Andy?

DR. KREPINEVICH: Well, interesting questions. In looking at the Indo Pacific, I agree with you. The Chinese certainly have SLOC anxiety.

Interesting to me is, you know, last time we had a war between big navies was about three quarters of a century ago. And there's about the same amount of time between Pearl Harbor and today as there is between Pearl Harbor and the beginning of our Civil War.

So you think about, you know, timeframe and how things change, I try to tell myself you can't think about things in World War II terms. But if I were to look at things in World War II terms, I think one of the things we see, I'll use the phrase the oceans are shrinking to Mediterranean size.

And, you know, the ability to scout over great distances from the land, and strike over great distances from the land, and you see what happened to poor Admiral Cunningham and the Mediterranean fleet trying to stop the Germans at Crete, they lost a lot of ships trying to do that.

You know, despite our enormous advantages, Okinawa was a tough go for us, the Brits and Falklands, you know, if they know where you have to be and, you know, the scouting area is reduced, so I think it's a really interesting question for our Navy in terms of how you'd operate in this new kind of environment.

I think the Navy today talks about itself being a maneuver force. But I think it's not just sailing and plowing through the water, it's maneuvering fires. And I think one of our Navy's great disadvantages is it hasn't sought opportunities to increase the range of its scouting and strike capabilities. So I'll just put that out there.

As far as the nuke issues go, I agree with Dr. Mastro. I think it's possible to have this kind of a war. I think there would be enormous incentives if a war broke out between us and the Chinese not to go to Armageddon.

And the question is, do we even know what an escalation ladder looks like now? We used to worry about that during the Cold War. You know, you push some hypersonics in there that can do strange things, put some cyber in there that can do strange things, you know, war going into space, blockades that, you know, if you had a really effective blockade, how effective would you want it to be?

You know, would you drive the Chinese leadership into escalating, because they really feel the heat? You know, how do you get out of that kind of war once you get into it?

And it's not going to be on the Battleship Missouri. It's going to be kind of like the end of Seven Years War in 1763 where the Brits and the French, you know, they kind of negotiate. I mean, your king goes back to doing his thing, my king goes back to doing my thing, and we just keep competing. And, you know, you get some islands in the Caribbean, and I get Canada, you know, these sorts of things.

But it's not going to be, you know, we get to occupy China or they get to occupy the United States. There is, it's like being at the Cumberland Gap in the 1820s, you know, when you think about the strategic issues that have to be addressed in this relationship between us and the Chinese.

DR. GREEN: So on the question of China's expeditionary maritime ambitions, a prominent Japanese historian, Makoto Iokibe, argued that Japan's biggest strategic mistake was trying to expand on the continent as a maritime power. Because, among other things, it caused other maritime powers to counter balance against them, the U.S. and Britain.

And he's argued that China is making a mistake of being a continental power, like Germany did 100-plus years ago, trying to expand in the maritime domain which is not its advantage.

And Chinese strategic thinkers know this. The PLA promulgated the near sea doctrine in around 2008, and it was briefed to the Central Military Commission. And Dai Bingguo, who was state counselor for Foreign Affairs convinced Hu Jintao not to implement it initially, because he was worried that it would cause counterbalancing among the maritime powers to what we are now seeing.

I am told by people who follow domestic Chinese politics quite closely in various countries that essentially what happened was, in order to reform the PLA to go after corruption in the PLA, the payback was the PLA could now implement, and particularly the PLA Navy, this doctrine, COCOMs and other, you know, war fighting dreams that they had, without Dai Bingguo and others on the scene to wisely say you're going to create counterbalancing.

Geopolitically, that will cost us. So I agree with the earlier comments. I think it is an operational challenge for us to be sure. But the net effect geopolitically, and when historians look back on it, they'll say it was stupid move. Because it's pushing large maritime powers together to deal with this threat.

On nuclear deterrence, I'm quite certain that the PLA would like to fight a limited war without risk of nuclear escalation. But I'm very doubtful that, in their heart of hearts, they believe that or can go to the Central Military Commission in a crisis and promise there won't be escalation. I think deterrence matters enormously.

Any scenario in the East China Sea, or the South China Sea, that involves hitting U.S. bases or major carrier battle groups could potentially trigger nuclear retaliation. So I personally think nuclear deterrence is quite important and at play here.

But I do, echoing what Dr. Krepinevich says, I do think there are dangerous scenarios. Because we don't understand escalation, and particularly we don't understand the limit or the connection between escalation, and cyber, and space, and nuclear. And they're not linked.

And, you know, a seemingly elegant strategy by China to avoid a nuclear fight by blinding us with space and cyber could ironically have the effect of rapidly increasing the nuclear escalation problem.

So I think we do have to worry about whether or not deterrence works the way we traditionally thought it did and how we manage it. But I do think it's a very, very powerful deterrent on the use of force by the Chinese.

COMMISSIONER MCDEVITT: Thank you. Did you have something, Andy? Andy had one --

DR. KREPINEVICH: Yes, on deterrence, I think there's a whole can of worms that needs to be opened here. There's been writings over the last 30 years about prospect theory. And I'll try and say it real fast.

Basically, people are more likely to fight to hold on to something they have than acts of aggression against something they don't have. So the people who won the Nobel Prize for this said a lot depends on whether you feel like you're in a domain of loss or in a domain of gain. Are you trying to gain something you don't have or lose something you have.

Flash forward to the South China Sea. And this is sort of a classic case of two sides that may think they're both in a domain of loss which makes them both risk tolerant. The Chinese over time, one could argue, will come to see these as the new normal. Well, we own these islands, you know, we've had them for 10, 15 years. They're ours. Whereas the United States and other countries say no. What you've done is illegitimate.

So both are operating from a domain of loss in a crisis, you know, our side fearing to pull back and legitimize something that we don't think the Chinese have a legitimate right to, and the Chinese having assumed that now they do, and the fear of pulling back on their side.

So advances in the cognitive sciences in a number of areas suggest that this notion that governments and people act rationally according to cost benefit analysis, and risks, and so on, don't necessarily play out. And I think if we see kind of a test case for this, it could come in the South China Sea.

COMMISSIONER FIEDLER: Thank you. Carolyn?

CHAIRMAN BARTHOLOMEW: Thanks very much. And thank you to our panelists. It's always interesting to listen and learn from you.

I have two sort of baskets of things. One is, so we've been having a discussion, and most of the discussion seems to be sort of the bigger strategic picture and the weapons systems, right, I mean, sort of the tactical there.

But Senator Talent made brief reference to the concerns in Beijing about the operational effectiveness of the PLA. And I wonder if you could talk a little bit about how to factor that in, right.

I mean, are they going to be able to make the improvements, the systemic improvements that they believe need to be made? Is this an issue, is this not an issue? That's one set of issues.

The other one is on this question of economic security, and national security, and the balance of that. I think we have, in the past, really talked about economic security sort of from the U.S. domestic perspective, which is that if you want to have a strong security you need to have a strong economy. And we have had differences here about how you link those two things together.

But I think the fact that China has demonstrated its willingness to use economic tools for national security purposes has really shifted this.

And, Dr. Mastro, you sort of focused on, when you mentioned weaknesses, you were talking about countries, right, countries that we didn't know that we could depend on, because they've moved into the Chinese orbit.

But I'd like to broaden that to the economic interests in a number of countries that are our allies. So we've got influence operations, but the business communities in these countries are enormously important. I mean, Australia's continued economic growth has been because of its trade with China.

So how do we factor those in? I mean, there's going to be public opposition to some of these positions that are being taken, because there are people's monetary interests at stake.

DR. GREEN: Let me start off on that second question, if I may. The increase of growth in the Japanese, Korean, Australian economies is linked to China. That's clear. But I think people sometimes, I'm not suggesting you're saying this, Madam Chairman, but sometimes in the

commentary people mistake flow and stock, and mistake FDI and trade.

Yes, most of our key allies trade more with China than they do with us. But first of all, that is, in immediate trade it's supply chains. It's not purely bilateral trade.

Secondly, international financial flows are overwhelmingly global not regional.

Third, foreign direct investment flows are overwhelmingly US-Australia, US-Japan, US-Korea, not China. So there are many, many other much, much deeper economic interests that bond these countries to the US, including the hegemony of the dollar, among other things.

So I don't think that our alliances are as vulnerable to Chinese economic pressure as one might think. And the Chinese effort to cut off Australian coal to punish them for Huawei, for example, did not work. Politically it had the opposite effect.

In the most recent election, the Labor Party generally aligned with the coalition on taking a firm stand with China, because these are countries that are proud of their sovereignty and democracy.

I spent, as I mentioned, most of August in Mongolia, three million people next to 1.4 billion Chinese. Beijing would love for Mongolia to become a Belt and Road member, it is, but accept massive infrastructure which Mongolia needs.

They won't do it. They won't do it because they've seen what happened with Hambantota in Sri Lanka. And people on the street can tell you this. They will not sell their sovereignty or democracy for money.

So we have a better playing field than one might think. And for us, the key is a couple of things, very quickly. Transparency, we need to get the story out about Chinese economic coercion through all sorts of means but in particular just, you know, think tanks, media, Congressional delegations.

Secondly, the BUILD Act and efforts to provide financing alternatives, we will not outpace the Chinese, but we are a much more attractive alternative. Japan, Australia, the U.S. are working on this.

And third, frankly we need a trade strategy. We can set aside whether or not this ever goes back to TPP. But we need something to demonstrate that we're in the rulemaking game in Asia with our allies and partners.

And given all those things, and the continued attractiveness of the U.S. itself as a destination for foreign direct investment, we have a much stronger hand to play in this regard than perhaps appears on the surface. And you'll hear that consistently from business leaders, more so in Japan and Korea but I think increasingly in Australia as well, the natural resource-based economies.

CHAIRMAN BARTHOLOMEW: So just an observation. When we were in Singapore, the concern that was being expressed, of course, is that the manifestation of the Chinese economic relationship with different countries is, I mean, they don't necessarily see our investment in those places, right.

I mean, they see a trade in goods and services and that that works against us in the sense that people don't see necessarily the strength or the value of the economic relationship with the US.

Dr. Mastro?

DR. MASTRO: Just to add, I agree with everything Dr. Green just said. To start with the economic interests, I think there's still part of the U.S. strategic community that thinks that being a security partner of choice is going to be enough.

And the way I view the region at least is we have to have security plus, right. We can't

compete, we're not going to be able to compete with the Chinese economic machine, I think, in the region. A lot of countries are going to benefit much more with the closer economic relationship.

So we have to ask ourselves, in addition to economics, which I think we do have to have a better trade strategy and policy to strengthen that area, we also bring all these other things to the table.

And to the point of kind of messaging, my biggest frustration is that China has this message, which I hear a lot from other countries in the region, which is they're just like us. That's what the Chinese are trying to do is create moral equivalencies, right.

You know, you use foreign aid for political purposes, we use our economics for political purposes, you know, you have police brutality issues, we have police brutality issues. You have fake news, we have fake news. It doesn't matter what the issue is. China tries to create this moral equivalency.

And just with an un-named allied partner that I met with yesterday, they were, like, we have to manage both of you. And that's their view. And it's very frustrating. Because my view is we are not the same.

So we need to do a better job of saying, you know, yes, China does economic policies, we have economic policies. But we're not stealing your stuff through cyber means. We're not selling it to our companies. So that can be very frustrating.

And we also have to think how can we best compete. It's not infrastructure. The U.S. advantage is not infrastructure building, right.

So I'm not in business, but it seems like when you want to compete with another company, you don't decide to do what they do best and not as well. You think about what are my comparative advantages. And so I think the United States needs to do some more thinking on what are we good at and bring that to the region.

On the operational effectiveness, I mean, the bottom line is I don't know. But the thing that concerns me is, for most that focus on this issue of the military competition, the thing that lets us sleep well at night is this belief that our people are better, right? We're trained better, you know, we have better morale. You know, the best of part about the U.S. military is the people.

And that concerns me. And I believe that. In my heart of hearts, I believe that which makes me think I have biases that is going to lead to underestimating China's ability to get this right. They've gotten everything else right when it comes to improvements in the military. So is it kind of my American-centric view that makes me think they're not going to get the personnel part right?

So I think we have to plan on them getting it right and see as they test and train that they're going to get it right, even though I like to believe that they won't.

CHAIRMAN BARTHOLOMEW: All right, thanks.

COMMISSIONER FIEDLER: Yes? Commissioner Lewis has a quick question. And we have to end --

COMMISSIONER LEWIS: Dr. Mastro, I have a question for you, and I have one question for all of you that staff asked us to consider.

You said we're fighting two different wars. Could you expand on that, please? And then the question I have for all of you is, given the modernization in the Chinese military, what is their ability and willingness to use that force to take Taiwan? What's your assessments?

DR. MASTRO: So my point on the two different wars is just to say that a lot of times when you're trying to compare militaries, is we compare, like, fighters to fighters, ship to ship.

But that's not how wars are fought. The threat to a fighter is an air defense system on the ground, for example.

And so when we're trying to project power from vast distances, and our access is largely reliance on partners and allies in the region, China, for the most part, is trying to project power.

You know, for Taiwan, contingency is the distance from here to Richmond, Virginia. I mean, that is a lot easier for them to do. And so I like to equate it to, you know, if we're in a boxing match, the United States has completed a triathlon before we get into the ring. And so that's what I mean by, that we're fighting two different wars.

What is required for China to prevail in a conflict over Taiwan is different than what is required for the United States to stop them from prevailing. And our issues, I think, are actually in many cases, especially the South China Sea, more difficult.

When it comes to Taiwan, I think China currently does not have the ability to take Taiwan by force. That's largely because they haven't finished some of their modernization efforts. They need to be able to conduct joint operations to have some sort of amphibious landing for say, to actually physically take Taiwan.

My concern is that China thinks they'll have that capability in the next five to ten years. And so while I'm not concerned today, because I think it's be very risky for them to make a move in the middle of this modernization effort, what happens when they think they're done?

And on top of that, Xi Jinping seems to have staked his legitimacy on moving towards reunification. And originally, I dismissed everything he said, because I thought, well, he's out in 2022, so no one can hold him to it. But then when he extended the term limits, that put all those things he said about Taiwan in a different light.

COMMISSIONER LEWIS: So you think that he would be willing to use force to do that when their military is more modern than it is now?

DR. MASTRO: So if they believe they have the capabilities to do it, and they think that future trends are not in their favor, historically, China tends to use force in order to reverse trends. If they think that things are getting worse for them over time, and they need to quickly switch it so their position is better, then they'd be willing to use force.

Now, of course, China would prefer to coerce Taiwan into some sort of an agreement. That's always, like, step number one, can you use force against them to compel them to some sort of agreement, I think all of those stages would come before a full scale invasion.

So I think we'd have many indicators and warnings before that would happen. But in the end, I think that, you know, the Chinese military is ultimately preparing to take Taiwan by force. And if the party thinks that the trends are worsening, and this is the time to do it, and if they don't do it now, then they can't accomplish it later, then we're in a very risky situation.

COMMISSIONER FIEDLER: Can I have a quick answer to the Taiwan question from the two of you before we go to lunch? We're already running late.

DR. KREPINEVICH: Very quickly, I agree with what Dr. Mastro said. I think a lot depends on how does this war start. Does it start with a Pearl Harbor-like event that angers, you know, United States and a lot of countries in the region, or is it more of a slow, is it a despicable attack on a Sunday morning, or is it a blockade that basically says, you know, Taiwan's ours, it's territory. We'll decide what goods go into Taiwan and out. All they have to do is, you know, agree to these six things, and you start the process of absorbing Taiwan into China.

And again, does the war, do we give up after a month if Taiwan is taken, or do we say this is, you know, we're going to get involved in a protracted conflict?

Final point is I think, again, what Dr. Mastro said is the Chinese don't want to fight. I

totally agree. What they want to do is Finlandize Taiwan. They want to shift the military balance progressively to the point where the Taiwanese say it's useless to resist.

COMMISSIONER FIEDLER: Dr. Green?

DR. GREEN: So if you imagine the conversation of the Central Military Commission on whether or not to use force, one question the PLA would have to answer is can we decisively defeat the U.S. and break its will to go to the next stage of warfare, either escalating, reinforcing, whatever it is.

But a question that would be no less important is can we survive the isolation and blowback from the international community that follows?

There are a lot of lessons to be learned from China's decision on use of force, but they haven't used force since they were integrated in the international economy. And the Chinese Communist Party is very brittle and vulnerable to legitimacy crises.

And if the Central Military Commission is told no, we've divided Europe, and the US, and Japan, they will not come together and punish us and isolate us, we can survive the political, economic, geopolitical blowback after a decisive military blow, they're more likely to do it.

But if the answer is we can't really say for sure, because there is a real chance that Europe, Japan, and the U.S. will come together, will boycott us, will punish us, that enhances the trend.

So the excellent points made by my co-panelists on deterrence matter for this Phase Zero influence game. If your allies don't think you can win in a war, you're going to be less influential, and China's going to start breaking apart your influence.

But also, the alignment we show, the will power, the management of our partnerships, is important for deterrence, because it's a factor, inevitably going to be factor in how the Central Military Commission would decide whether or not they can survive not only the military conflict but the subsequent geopolitical and economic isolation they would face. So we've got to get them both right.

COMMISSIONER FIEDLER: Thank you very much. And we'll see you all again at 1:45. Thank you, panelists, very much.

(Whereupon, the above-entitled matter went off the record at 12:58 p.m. and resumed at 1:47 p.m.)

PANEL III INTRODUCTION BY COMMISSIONER FIEDLER

VICE CHAIRMAN CLEVELAND: Good afternoon. I'd like to welcome our third panel which will explore major developments in China's relations with Taiwan and Hong Kong.

We'll start with Ms. Bonnie Glaser, who's the director of the China Power Project and a senior advisor for Asia at the Center for Strategic and International Studies.

Ms. Glaser has written extensively on China's foreign policy, US-China relations, and cross-strait relations. She's also published widely in academic and policy journals as well as popular media outlets.

Next we'll hear from Dr. Shirley Lin who is a founding faculty member of the Master's Program in Global Political Economy at the Chinese University of Hong Kong and teaches in the Department of Politics at UVA.

Dr. Lin is the author of Taiwan's China Dilemma: Contested Identities and Multiple Interests in Taiwan's Cross-Strait Economic Policy. And her commentary on the political economy of Greater China frequently appears in English and Chinese media.

And finally, we'll hear from Dr. Victoria Tin-bor Hui who is the professor of Political Science at the University of Notre Dame. Dr. Hui is the author of War and State Formation in Ancient China and Early Modern Europe and maintains a blog, Hong Kong: From the Umbrella Movement to the Anti-Extradition Protests.

Dr. Hui has written on Hong Kong and Democracies Movement for Foreign Affairs, ChinaFile, and other outlets.

I ask all of our witnesses to keep your comments to seven minutes so that we can ask lots of questions which we all are very good at. So, Ms. Glaser, we'll start with you.

OPENING STATEMENT OF BONNIE GLASER, SENIOR ADVISER FOR ASIA AND DIRECTOR, CHINA POWER PROJECT, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

MS. GLASER: Commissioners Cleveland, and Fiedler and other members of the Commission, thank you so much for the invitation today to contribute to your deliberations regarding the trends in Taiwan and Hong Kong and the implications for the United States.

So as you all know, this year marks the fourth year of deteriorating relations between China and Taiwan. This began with Beijing's decision to suspend official cross-strait communication channels after Tsai Ing-wen was inaugurated in May 2016.

And since then, we've seen China employ a range of diplomatic, economic, military tactics including poaching several of Taiwan's diplomatic partners, recently even more radically reducing the number of mainland tourists allowed to visit Taiwan and ramping up of military exercises and information operations.

And in response to this mounting pressure, we have seen President Tsai adopt tougher rhetoric, but she has staunchly defended, of course, Taiwan's democracy and attempted to secure greater support from the international community while, at the same time, maintaining a policy of securing the cross-strait status quo.

This past January, we saw a major speech by Xi Jinping. It was his first comprehensive speech on Taiwan since taking office. And he emphasized that unification under one country, two systems is inevitable. And he reiterated that China could use force to achieve its goal.

So we're in the run-up now to Taiwan's January 11th, 2020, election. And it's my view that China is unlikely to undertake significant overt political, military, or economic actions against Taiwan in this period.

They know quite well that anything really remarkable could backfire and help Tsai Ing-wen and the DPP retain, of course, its majority, her get re-elected and the DPP would retain its majority in the LY.

I think it's also unlikely that China will completely take a hands off approach. We will see continued military pressure. We've already seen one flight across the central line of the strait on March 31st. We could see that become a new normal, though I don't think that would happen until after the election.

But we will continue to see flights around the island and measures, of course, to constrain Taiwan's participation in the international community.

In the near term, I think the biggest threat to Taiwan really is in the form of Chinese interference in Taiwan's democratic politics. And we will see this in the run-up to the election.

I'm still not sure we understand completely what the degree of the interference was in the 2016 election or even the 2018 local elections.

And interference can take many forms. Disinformation campaigns in social media aimed at discrediting Tsai and her administration, media manipulation to promote support for Beijing's preferred candidates, and even local level efforts. There's financial support that goes through temples and agricultural associations, for example, to boost supporters and turnout for pro-China candidates.

I think it's important, and glad that the Commission has asked me to talk about the red media in Taiwan. And this is a term that's been coined to highlight Chinese Communist Party penetration of Taiwan's media organization. And this has resulted in pro-China coverage, self-censorship, and promotion of specific candidates that are preferred by

Beijing.

It's my view that evidence abounds of direct and indirect CCP intrusion into various media outlets. And there's been some very good reporting that demonstrates that there's actually been regular payments to Taiwan media groups by the Taiwan Affairs Office in China for positive reporting about China.

Beijing, of course, makes no secret of the fact that it pins hope on Taiwan's media to spread the Communist Party's messages in Taiwan. We saw at the Cross-Strait Media Summit earlier this year the Politburo Standing Committee, Wang Yang, told Taiwan media representatives to achieve peaceful unification, and carry out one country, two systems, the party depends on its friends in the media and told them that they would be remembered by history once unification occurs.

I will leave it to others to talk about the protests in Hong Kong, but I can say that they are having a major impact on Taiwan. We know that one of the activists, Joshua Wong, is in Taiwan this week and trying to promote more support for demonstrations and protests in Taiwan, not just in Hong Kong.

But signs that Beijing is backing away from its pledge to preserve the autonomy in Hong Kong, I think, has really stirred fears among people in Taiwan about their own future.

There's a lot of anxiety about the potential application of one country, two systems to Taiwan. And even KMT supporters who favor better relations with Mainland China, value the broad freedoms they have. They're not willing to give them up.

And we even heard Mayor Han Kuo-yu, the KMT candidate, say over his dead body one country, two systems would be implemented in Taiwan.

In the event that we end up with violence in Hong Kong of any kind, it will have a deep and enduring impact on Taiwan and its relationship with China. I think that goes without saying.

So cross-strait relations are not, in my view, heading inexorably toward a crisis. I think if Tsai wins re-election, she is not likely to take radical pro-independence measures that could back Xi Jinping into a corner and provoke a military response.

China would certainly adopt some tougher measures, but I don't think it will actually jettison its current policy across the strait simply because of the re-election of the DPP.

Chinese confidence, of course, would be bolstered if the KMT wins a majority in the legislative UN. Then there will be political gridlock. But even if the DPP retains control of the LY, I think that the cost benefit calculus of simply squeezing Taiwan, what my friend Richard Bush has referred to an anaconda strategy, I think is more favorable to China than going to war.

Even if Han Kuo-yu wins, I think, or an independent pro-Beijing candidate, we may yet see more candidates emerge by the 17th, there would be a period of improvement in cross-strait ties.

But I think that worries by the people, the majority of the citizens in Taiwan, about getting too close to Beijing would probably constrain even a sort of pro-Beijing candidate in Taiwan from launching political talks or taking other measures that really could provoke a domestic crisis.

My view is that a tipping point might come later, perhaps in five or ten years. If the Chinese don't get what they want from a KMT president, they become less confident, perhaps more impatient.

Perhaps the PLA makes an assessment that it can prevail against the U.S. in a Taiwan conflict. And perhaps we could then see a miscalculation by Beijing. They may believe that there is a window of opportunity to resolve the Taiwan problem once and for all.

So I've laid out just a few specific policy recommendations for the US. One is to assist Taiwan in its efforts to counter Chinese interference in Taiwan politics and society. We've heard some U.S. officials talk about that, but I haven't heard much detail. It would be great to hear more detail about what they're doing and see whether it's enough.

Perhaps compelling social media companies to notify users when they're interacting with accounts that are suspected to be dealing, if they're suspected to be foreign state actors. It's important for social media to have easy ways to report fake accounts. Taiwan is doing a little bit by itself, but this is a larger problem.

I'm sure somebody has talked today about the need to have a free trade agreement with Taiwan, economic, and political, and security. These are all really interlinked. And the one area where I think that this administration has fallen short is its absence of promoting closer economic ties with Taiwan.

And of course, we have two bills that stand before Congress. One is countering the Chinese government and Communist Party's Political Influence Operations Act and also the Taiwan Assurance Act of 2019. And I think passage of those would be very important. So thank you very much again for this opportunity.

**PREPARED STATEMENT OF BONNIE GLASER, SENIOR ADVISER FOR ASIA AND
DIRECTOR, CHINA POWER PROJECT, CENTER FOR STRATEGIC AND
INTERNATIONAL STUDIES**



Statement before the
U.S.-China Economic and Security Review Commission
“U.S.-China Relations in 2019: A Year in Review”

A Testimony by:

Bonnie S. Glaser

Senior Advisor and Director, China Power Project
Center for Strategic and International Studies (CSIS)

September 4, 2019

419 Dirksen Senate Office Building

Co-chairs Commissioner Cleveland and Commissioner Fiedler, members of the commission, thank you for the opportunity to contribute to the Commission's deliberations regarding trends in Taiwan and Hong Kong and their implications for the United States.

Recent Trends in Cross-Strait Relations

This year marks the fourth year of deteriorating relations between China and Taiwan, which began with the inauguration of Tsai Ing-wen as president of Taiwan in May 2016 and Beijing's decision shortly thereafter to suspend official cross-Strait communication channels. China's overarching goal over this period has been to pressure President Tsai to accept the 1992 Consensus, an understanding reached between the Chinese Communist Party (CCP) and the Chinese Nationalist Party (KMT) that both sides of the Taiwan Strait belong to "one China" that the Democratic Progressive Party (DPP) opposes.

More recently, Beijing has also sought to undermine Tsai Ing-wen's re-election prospects. In the service of these goals, China has employed a range of diplomatic, economic and military tactics, including poaching several of Taiwan's diplomatic partners, radically reducing the number of mainland tourists allowed to visit Taiwan, and ramping up military exercises and information operations designed to intimidate Taiwan.

In response to mounting pressure from China, Tsai Ing-wen has adopted tougher rhetoric against Beijing, while staunchly defending Taiwan's democracy and attempting to secure greater support from the international community. At the same time, she continues to adhere to a policy of maintaining the cross-Strait status quo and remains open to talks with China, although she has recently insisted that Chinese leaders be willing to promote democracy and renounce the use of force against Taiwan as conditions for dialogue.¹

Below are key developments that have taken place so far in cross-Strait relations in 2019:

1. January 1, 2019: In a New Year's Day speech, President Tsai Ing-wen proposed a foundation for improving relations between Taiwan and China which she termed the "Four Musts." Tsai said the Chinese government must recognize the existence of the Republic of China (ROC), respect the commitment of Taiwan's 23 million citizens to freedom and democracy, peacefully handle cross-Strait differences "on a basis of equality," and engage in negotiations with the Taiwan government or government-authorized representatives.²
2. January 2, 2019: On the occasion of the 40th anniversary of the "Letter to Taiwan Compatriots, Xi Jinping delivered his first speech focused exclusively on policy toward Taiwan. Xi reiterated that cross-Strait reunification is "the inevitable requirement of the

¹ Lawrence Chung, "Taiwan President Tsai Ing-wen open to cross-strait talks, but has some demands for Beijing first," *South China Morning Post*, May 1, 2019, <https://www.msn.com/en-sg/news/world/taiwan-president-tsai-ing-wen-open-to-cross-strait-talks-but-has-some-demands-for-beijing-first/ar-BBRPXW1?li=AAaGkVj>.

² Website of the Office of the President, Republic of China (Taiwan), January 1, 2019, <https://english.president.gov.tw/News/5618>.

great rejuvenation of the Chinese nation in the new era,” a position that he first put forward at the 19th Party Congress in October 2017. For the first time since assuming the post of CCP General Secretary, Xi publicly reaffirmed China’s long-standing policy that employing force to achieve reunification is an option. He also called for both sides to “start in-depth democratic consultations for a cross-Straits relationship and the future of the Chinese nation,” as well as talks aimed at creating a version of “one country, two systems” for Taiwan.³ Tsai Ing-wen claimed that Xi Jinping’s speech proved that the “1992 Consensus” was tied to “one country, two systems,” which was unacceptable to the people of Taiwan.⁴

3. March 25, 2019: Kaohsiung Mayor Han Kuo-yu endorsed the “1992 Consensus” as “the anchor of cross-Straits relations,” when he met with the head of the State Council’s Taiwan Affairs Office, Liu Jieyi, in Shenzhen.⁵
4. March 31, 2019: For the first time in twenty years, two People’s Liberation Army Air Force (PLAAF) fighter jets deliberately crossed the median line of the Taiwan Strait, violating tacit rules of engagement between the two sides. The J-11 fighters reportedly flew 43 nautical miles into Taiwan’s airspace. Taiwan’s Ministry of Foreign Affairs called the action “intentional, reckless and provocative.” President Tsai ordered a “forceful expulsion” of PLA warplanes if China repeated the provocation.
5. May 10, 2019: In a speech in Beijing at the fourth annual gathering of media organizations from China and Taiwan, Wang Yang, a member of the Politburo Standing Committee and Chairman of the Chinese People’s Political Consultative Conference, declared that both time and momentum are on mainland China’s side. He also rebuked the DPP for “placing their bets” on the United States and expressed doubts that the U.S. would go to war on Taiwan’s behalf or be able to defeat China.⁶
6. June 13, 2019: Tsai Ing-wen delivered a statement about the Hong Kong protests, siding with the people of Hong Kong whom she said have the right to pursue their own democracy and freedom, as well as their own political system. She emphasized that “one country, systems” is not viable in Taiwan and warned that anyone who tries to undermine Taiwan’s sovereignty and democracy, or use them as political bargaining chips, will fail.⁷

³ President 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” (speech, 19th National Congress of the Communist Party of China, October 18, 2017), Xinhua, http://www.xinhuanet.com/english/download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf.

⁴ Website of the Office of the President, Republic of China (Taiwan), January 2, 2019, <https://english.president.gov.tw/NEWS/5621>.

⁵ Zhang Yi, “Exchanges with Taiwan will benefit ‘one family,’” *China Daily*, March 26, 2019, <http://www.chinadaily.com.cn/a/201903/26/WS5c9964ada3104842260b278d.html>.

⁶ “Chinese official bashes U.S. at cross-strait media gathering,” *Focus Taiwan*, May 12, 2019, <http://focustaiwan.tw/news/acs/201905120012.aspx>.

⁷ Website of the Office of the President, Republic of China (Taiwan), June 13, 2019, <https://english.president.gov.tw/News/5755>.

7. July 31, 2019: The PRC's Ministry of Culture and Tourism announced it would stop issuing permits for individuals to travel to Taiwan from 47 mainland Chinese cities because of worsening ties between Taiwan and China. It remains unclear whether the travel restriction is a temporary measure in the run-up to the January 2020 presidential and Legislative Yuan elections in Taiwan.

Chinese Media Influence in Taiwan

As Taiwan's January 11, 2020 election nears, China is unlikely to undertake significant or unusual overt political, military or economic actions against Taiwan. With the polls only four months away, such steps could backfire, helping Tsai Ing-wen get re-elected and the DPP retain its majority in the Legislative Yuan. Instead, Beijing is more likely to emphasize the benefits that Taiwan will enjoy if voters remove the DPP from power and elect a president who favors closer ties with the mainland and accepts the core element of the "1992 Consensus" that Taiwan is part of a broader Chinese nation.

However, it is also unlikely that China will take a completely hands-off approach. Military pressure will probably continue in the form of air and naval drills around Taiwan. Measures to constrain Taipei's participation in the international community, including in relatively benign and unofficial arenas such as culture, sports and the private sector can also be expected. Some restraint is likely in both these areas to avoid giving the DPP ammunition that it can use to tip the momentum of the election campaign in its favor.

There is growing evidence of Chinese interference in Taiwan's democratic politics, and it can be expected that the CCP will use various means to influence the outcome of the election. Such interference could take several forms: disinformation campaigns in social media aimed at discrediting Tsai and her party; media manipulation to promote support for Beijing's preferred candidates; local level efforts through temples and agricultural associations to boost supporters and turnout for backers of the "1992 Consensus" and pro-unification candidates; mobilization of Taiwan business people and their families living in mainland China to return to Taiwan to vote and to encourage extended family members and friends to cast China-friendly votes; and financial support by the CCP through indirect means to the campaigns of specific candidates opposing Tsai Ing-wen and DPP legislators.

As former Los Angeles Times correspondent and adjunct instructor of journalism at American University Maggie Farley explained at a panel discussion hosted by George Washington University's Sigur Center for Asian Studies, "Taiwan's social media community is fertile ground for China's disinformation campaigns." This susceptibility to Chinese influence stems from four factors: 1) the very high use of social media by Taiwan's citizens; 2) the polarized debate over identity and cross-Straits relations in Taiwan, and limited options available to the government due to laws that protect free speech; 3) the common practice of Taiwan journalists violating ethics principles of the media, including being motivated by their story's spread on social media rather than accuracy; and 4) China's massive "50-cent Army" – state-backed internet commentators

who are hired to manipulate online opinion to the benefit of the CPP – which reportedly launches at least 2500 attacks per day against websites in Taiwan.⁸

Prior to the January 2016 presidential election, Tsai Ing-wen's Facebook page was attacked by Chinese netizens, while the KMT candidate Eric Chu's social media page was largely unaffected. Use of simplified characters and echoing of Chinese government slogans provided evidence that the attacks were launched by mainlanders, although it was impossible to trace whether the attackers were nationalistic citizens or paid trolls.⁹

China's spread of disinformation on social media to discredit Tsai Ing-wen and her party has occurred periodically since the DPP took power. One such example was widely shared posts that falsely charged Tsai of refusing to disembark from an armored military vehicle while visiting Tainan flood victims, portraying her as unsympathetic.¹⁰ The goal was obviously to discredit Tsai's administration and sow doubts about her ability to govern.

The term "red media" has been coined to highlight CCP penetration of Taiwan's media organizations, which has resulted in pro-China coverage, self-censorship, and promotion of candidates preferred by Beijing. Evidence abounds of direct and indirect CCP and Chinese government intrusion into leading media outlets, including regular payments to Taiwan media groups for positive reporting about China in various publications and on television. Editorial managers at Want Want-owned media outlets *China Times* and CTiTV take daily instructions directly from China's Taiwan Affairs Office (TAO) in return for remuneration, an arrangement that may have begun as long as a decade ago.¹¹ The TAO is known to have commissioned feature stories about China's policies to provide incentives to Taiwan business people to invest in mainland China.¹²

One study of the China factor in Taiwan's media concluded that the integration of Taiwan media companies in Chinese capital, advertising, and circulation markets enabled Chinese authorities "to co-opt them with various economic incentives and threats, leading to self-censorship and biased news in favor of China." According to the study, by the mid-2000s over 90 percent of Taiwan media companies were doing business in China.¹³

⁸ Sigur Center for Asian Studies, The George Washington University, *Asia Report*, issue no. 44, January 2019, <https://cpb-us-e1.wpmucdn.com/blogs.gwu.edu/dist/3/1216/files/2019/01/AR-44-Countering-Chinas-Sharp-Power-1w8awff.pdf>.

⁹ Jessica Drun, "Taiwan's Social Media Landscape: Ripe for Election Interference?" Center for Advanced China Research, November 13, 2018, <https://www.ccpwatch.org/single-post/2018/11/13/Taiwans-Social-Media-Landscape-Ripe-for-Election-Interference>.

¹⁰ Ibid.

¹¹ Kathrin Hille, "Taiwan primaries highlight fears over China's political influence," *Financial Times*, July 16, 2019, <https://www.ft.com/content/036b609a-a768-11e9-984c-fac8325aaa04>.

¹² Yimou Lee, I-hwa Cheng, "Paid 'news': China using Taiwan media to win hearts and minds on island – sources," Reuters, August 9, 2019, <https://www.reuters.com/article/us-taiwan-china-media-insight/paid-news-china-using-taiwan-media-to-win-hearts-and-minds-on-island-sources-idUSKCN1UZ0I4>.

¹³ Huang Jaw-Nian, "The China Factor in Taiwan's Media: Outsourcing Chinese Censorship Abroad," *China Perspectives*, March 2017, <https://journals.openedition.org/chinaperspectives/7388>.

A recent spat between Taipei Mayor Ko Wen-je (independent) and chairman of the Want Want media conglomerate Tsai Eng-meng provides an example of links between pro-Beijing media in Taiwan and the island's politics. According to Mayor Ko, the Want Want China conglomerate shifted its support from him to Mayor Han because he refused to sign on to the ten-point pro-China manifesto proposed by Tsai Eng-meng prior to the November 2018 local elections. The manifesto, titled "colorless awakening," includes acknowledging that "Taiwanese are Chinese," helping the people of Taiwan understand the CCP and the people of the Mainland to understand the needs of the people of Taiwan; discussing a unification process and model that both sides of the Taiwan Strait can accept; supporting Chinese direct investment in Taiwan; and supporting the death penalty. Tsai Eng-meng has since asserted that any political candidate pledging allegiance to this manifesto will have the backing of his media conglomerate.

Taiwan media was manipulated during the local elections in 2018, notably in the mayoral race in Kaohsiung, although it has not been proven that CCP interference was pivotal in Han Kuo-yu's victory. Confirming an assessment reached by a review committee of independent experts, Taiwan's National Communications Commission (NCC) found that CTiTV carried a disproportionate number of stories about Han Kuo-yu in its news coverage.¹⁴ It is widely believed that lop-sided media coverage helped create the "Han Wave" that transformed a former KMT legislator who was famously unemployed for 12 years into a superstar. There is also some evidence that a professional cyber group originating in China actively drove Han's campaign and popularity.¹⁵

Beijing makes no secret of the fact that it pins hopes on Taiwan's media to spread the CCP's message in Taiwan and promote unification. The theme of this year's Cross-Strait Media Summit in Beijing was the media's responsibility in cross-Strait exchanges. The official Xinhua report on the meeting stated that the "media on both sides must jointly play the role of communication to the people on both sides of the Strait by promoting Chinese culture, deepening the integration of emotions, and continuing to promote the process of peaceful unification of the motherland and strive to realize the China Dream." CCTV video of the event, which was later removed from official mainland media websites, quoted Wang Yang saying that to achieve peaceful unification and carry out "one country, two systems," the Party depends on its friends in the media. Acknowledging that promoting unification within Taiwan was a difficult task, he stressed to Taiwan media representatives that their efforts would be remembered by history once unification occurs.¹⁶

¹⁴ Shelly Shan, "NCC fines CtiTV NT\$1m for failing to fact-check," *Taipei Times*, March 28, 2019, <http://www.taipeitimes.com/News/front/archives/2019/03/28/2003712314/2>.

¹⁵ Paul Huang, "Chinese Cyber-Operatives Boosted Taiwan's Insurgent Candidate," *Foreign Policy*, June 26, 2019, <https://foreignpolicy.com/2019/06/26/chinese-cyber-operatives-boosted-taiwans-insurgent-candidate/>.

¹⁶ Dave Brown, "Why Did Beijing Suppress Wang Yang's Remarks on Taiwan?" *The Diplomat*, May 30, 2019, <https://thediplomat.com/2019/05/why-did-beijing-suppress-wang-yangs-remarks-on-taiwan/>.

The challenge is daunting, but Taiwan's government and society are taking measures to crack down on fake news, illegal funding of political candidates, and illicit arrangements between Taiwan media organizations and the CCP.¹⁷ Last year, just before Taiwan's local elections, the Ministry of Justice's Investigation Bureau revealed that it was investigating 33 cases of alleged Chinese funding to candidate campaigns opposing the DPP. Many of those cases allegedly involved donations made through Taiwan businesses operating in China. Four of the cases under investigation are being treated as vote buying. Taiwan's laws, including the Political Donations Act and the Act Governing Relations Between the People of the Taiwan Area and the Mainland Area prohibit political donations by mainland Chinese individuals or entities.¹⁸

Taiwan has also stepped up fact-checking and efforts are being made to promote news literacy among the public. In mid-2018, Taiwan Media Watch and the Association for Quality Journalism, two non-profit organizations, joined hands to establish the Taiwan Fact Checking Center. Users who register on the website can submit reports of fake news and include evidence to disprove false news stories.¹⁹ Government regulatory agencies are increasing monitoring and enforcement. Individuals and organizations who deliberately spread false information are being fined. The Ministry of Justice Investigation Bureau has set up several task forces to cope with potential foreign influence via disinformation and illicit funding in the run-up to the 2020 election.²⁰ Facebook, Line, Yahoo-Kimo, and Google, have also committed to crack down on fake accounts and combat misinformation in Taiwan.²¹

The Impact of Hong Kong on Taiwan

The protests in Hong Kong have had a major impact on Taiwan and, depending on how the differences between the protesters and the Hong Kong government play out, may be a factor in Taiwan's election next January. Signs that Beijing is backing away from its pledge to preserve the former British colony's autonomy has stirred fears among people in Taiwan about their own future. Anxiety about the potential application of "one country, two systems" to Taiwan has increased as Hong Kong's pro-Beijing government ignores the demands of protesters. Even KMT supporters who favor better relations with mainland China value the broad freedoms they have in Taiwan's democratic system and are not willing to give them up.

¹⁷ Lawrence Chung, "Taiwan gets tough over fake news blamed on Beijing 'disrupting its democracy,'" *South China Morning Post*, July 27, 2019, <https://www.scmp.com/news/china/politics/article/3020261/taiwan-gets-tough-over-fake-news-blamed-beijing-disrupting-its>.

¹⁸ Aaron Tu, Lin Ching-chuan and William Hetherington, "PRC funding of campaigns probed," *Taipei Times*, October 23, 2018, <http://www.taipeitimes.com/News/front/archives/2018/10/23/2003702864>.

¹⁹ Keoni Everington, "Taiwan's first fact-checking center launches to battle fake news," *Taiwan News*, August 2, 2018, <https://www.taiwannews.com.tw/en/news/3497482>.

²⁰ Matthew Strong, "Taiwan Investigation Bureau to look at election funding from China," *Taiwan News*, July 6, 2019, <https://www.taiwannews.com.tw/en/news/3739698>.

²¹ Lisa Wang, "Social media firms vow to fight misinformation," *Taipei Times*, June 22, 2019, <http://www.taipeitimes.com/News/front/archives/2019/06/22/2003717366>.

President Tsai expressed sympathy with the protesters early on and has benefited politically from taking a strong pro-democracy stance. On June 9, the first day that hundreds of thousands of Hong Kong citizens filled the streets to protest a bill that would allow extraditions to mainland China and other governments that Hong Kong does not currently have an extradition treaty with, President Tsai tweeted:

We stand with all freedom-loving people of #HongKong. In their faces, we see the longing for freedom, & are reminded that #Taiwan's hard-earned democracy must be guarded & renewed by every generation. As long as I'm President, "one country, two systems" will never be an option.

Kaohsiung Mayor Han Kuo-yu, who later became the KMT's presidential candidate, initially referred to the Hong Kong protests as a parade and said he knew nothing about them. Realizing that he had blundered and ran the risk of losing supporters, Han stated at a rally that "one country, two systems" could only be implemented in Taiwan "over my dead body." The perception that Han is close to China has spooked some people in Taiwan who worry that if Han were elected president, he might be beholden to Beijing in ways similar to Carrie Lam, Hong Kong's Chief Executive.

Demonstrations in Taiwan have been held to show solidarity with the Hong Kong protesters. A rally on June 16 in Taipei that drew an estimated 10,000 participants was followed a week later by a much larger gathering of hundreds of thousands of citizens protesting the "Red Media" in Taiwan. There have also been joint events held in Taipei where youth from Hong Kong and Taiwan shared stories and strengthened their bonds.²²

If the Hong Kong protests peter out in the coming months and there is a negotiated solution between the demonstrators and the Hong Kong government, the impact on Taiwan's election will probably be marginal. However, if the protests continue, anxiety in Taiwan will persist, and that could play to the advantage of Tsai Ing-wen and the DPP. In the event that Beijing decides it must send in paramilitary forces or even worse, the People's Liberation Army (PLA), to suppress the protests, the impact on Taiwan's politics would likely be deep and enduring, including the adoption of a more cautious posture toward China by the KMT.

Longer-term Prognosis for Cross-Strait Relations

Cross-Strait relations are not, in my view, heading inexorably toward a crisis. If Tsai Ing-wen wins re-election, she is not likely to take radical pro-independence measures that could back Xi Jinping into a corner and provoke a military response. China may adopt tougher measures against Taiwan but will not likely abandon its policy of pursuing "peaceful development" across the Strait. Chinese confidence will be bolstered if the KMT wins a majority in the Legislative Yuan, resulting in political gridlock. Even if the DPP retains control of the legislature, however,

²² Chris Horton, "Hong Kong and Taiwan are Bonding Over China," *The Atlantic*, July 5, 2019, <https://www.theatlantic.com/international/archive/2019/07/china-bonds-between-hong-kong-and-taiwan-are-growing/593347/>.

the cost/benefit calculus of an anaconda strategy is more favorable to China than going to war. US policy could be a factor enhancing cross-Straits stability or could add a layer of volatility.

A victory by Mayor Han Kuo-yu would likely be followed by an improvement in cross-Straits relations for at least several years, especially if the KMT wrests control of the legislature away from the DPP. However, worries among the majority of Taiwan's citizens about getting too close to Beijing would likely constrain Han from launching cross-Straits political talks or taking other measures that could provoke domestic controversy and weaken him politically.

A "tipping point" might come in 5-10 years if Xi Jinping loses patience, perhaps under growing domestic pressure to achieve concrete progress toward reunification of the motherland. The shift in the cross-Straits military balance in China's favor and an assessment that the PLA could prevail against the US in a Taiwan conflict could lead Xi to believe that there was a window of opportunity to resolve the Taiwan problem.

Policy Recommendations for the US Congress

1. **Assist Taiwan in its efforts to counter Chinese interference in its elections, and more broadly in Taiwan's politics and society.** US officials have stated that the Trump administration is helping Taipei to counter Chinese meddling. Congress should hold hearings and call US officials to testify and provide details about US efforts in this regard. Congress should encourage the US to share information with Taiwan and provide techniques to identify and counter Chinese cyber threats, and to trace illicit funding from the PRC to Taiwan's political candidates.
2. **Regulate social media companies to notify users when they are interacting with social media accounts that are suspected to be foreign state actors.** Social media companies should also be encouraged to create easy ways for users to report suspected fake news and to more proactively remove false information from their platforms.
3. **Urge the Trump administration to bolster US economic ties with Taiwan.** Taiwan's economic prosperity is an inextricable component of its national security. The US should launch negotiations aimed at signing a bilateral investment agreement and a free trade agreement. It should also encourage its allies to negotiate economic agreements with Taiwan.
4. **Expand the mission of the US Department of State's Global Engagement Center (GEC) to include working with governments and civil society organizations from like-minded countries to counter CCP influence operations.**²³ The GEC was created under Section 1287 of the FY17 NDAA (amended by the FY19 NDAA) "to direct, lead, synchronize, integrate, and coordinate efforts of the Federal Government to recognize, understand, expose, and counter foreign state and foreign non-state propaganda and disinformation efforts aimed at undermining or influencing the policies, security, or

²³ This policy recommendation has been put forward by Russell Hsiao, executive director of the Global Taiwan Institute. See his testimony to the USCC, <https://www.uscc.gov/sites/default/files/Hsiao%20-Written%20statement.pdf>.

stability of the United States and its allies and partner nations.”²⁴ Taiwan would be a natural partner in this mission, alongside US allies and other like-minded countries.

5. **Pass the bipartisan bill, *Countering the Chinese Government and Communist Party’s Political Influence Operations Act***, which was reintroduced by US Senators Marco Rubio (R-FL) and Catherine Cortez Masto (D-NV) in February. The legislation seeks to counter China’s political influence worldwide. The bill calls for the US Secretary of State and the Director of National Intelligence (DNI) to create a taskforce to report on “China’s disinformation, press manipulation, economic coercion and influence operations in the United States and certain allies and partners who are impacted by China’s influence operations.” Taiwan should be included as one of the United States’ partners.
6. **Pass the Taiwan Assurance Act of 2019, which reaffirms US commitments to Taiwan, including the implementation of the Taiwan Relations Act.** The US House of Representatives passed the resolution in May by a voice vote of 414 in favor, zero against, and 17 abstentions.

²⁴ Global Engagement Center, <https://www.state.gov/bureaus-offices/under-secretary-for-public-diplomacy-and-public-affairs/global-engagement-center/>.

**OPENING STATEMENT OF SYARU SHIRLEY LIN, LECTURER, POLITICS,
UNIVERSITY OF VIRGINIA; ADJUNCT ASSOCIATE PROFESSOR, GLOBAL
POLITICAL ECONOMY, CHINESE UNIVERSITY OF HONG KONG**

VICE CHAIRMAN CLEVELAND: Thank you. Dr. Lin?

DR. LIN: I want to thank the Commission and the staff for an opportunity to address the critical issue of China's relations with Taiwan and Hong Kong where I have spent the last 13 weeks.

Today, more than ever, the fate of Hong Kong and Taiwan are tied together, and the gap between them and Beijing has never been wider. My comments will focus on the dilemmas that China proposes for Taiwan and for Hong Kong, and the implications for the United States.

First, Taiwan is caught in what I call the high-income trap with slower growth, stagnating wages, demographic decline, high youth unemployment and widening inequalities.

These structural issues are hard to resolve for any high-income economies, just like for Japan, and for Taiwan they are further complicated by a debate over whether China presents a way out of this trap.

Many Taiwanese believe that relying on China is a viable solution, given the size and potential of that market. But others worry that further expanding economic ties with China will compromise Taiwan's distinctive identity and values including democracy and freedom.

The previous Ma Ying-jeou government tried to stimulate growth by integrating Taiwan more closely with China. However, over-dependence on China actually failed to produce higher growth and led to greater inequality and a serious political backlash which led to the election of President Tsai Ing-wen.

Since then, 2016, the Tsai administration has been trying to economically diversify away from China. Yet cross-strait interdependence has deepened, and trade and investment have continued to rise. Cross-strait investment has fallen, but not dramatically.

The dilemma is intensified as Beijing has offered sweeter carrots and brandishes bigger sticks in order to increase support for unification. Incentives include allowing Taiwanese to live and work in China with the same treatment as Chinese citizens. And in response, roughly half a million Taiwanese, mostly young people, went to work in China last year, forming a brain drain.

On the other hand, Beijing has used restrictions on tourism as a coercive tool since Tsai came into office, reducing Chinese tourists by an estimated 80 percent by the end of this year. This is in addition to applying sharp power through friendly media and civil society organizations to influence Taiwanese domestic politics which Dr. Glaser just now talked about.

To reduce what she regards as excessive reliance on China, President Tsai has initiated the New Southbound Policy, which encourages Taiwanese trade and investment with 18 Australasian countries. This policy has shown positive early results with increased trade, inbound investments and people-to-people exchange.

Taiwan's estimated growth of two percent this year actually will be the highest among high income economies in Asia and unemployment is at a 19-year low.

Taipei's incentives to lure Taiwanese businesses back to Taiwan have also been more successful than expected. The diversification policies have been assisted by the rising costs of manufacturing in China and the increased tariffs the United States has imposed on Chinese exports.

In four months, Taiwanese will choose between a populist Kuomintang candidate who sees China as the solution to Taiwan's high-income trap and a technocratic Democratic

Progressive Party incumbent who prioritizes diversification away from China to strengthen Taiwan.

Many Taiwanese fear that re-electing President Tsai next year will be detrimental to relations with China and to Taiwan's economic prospects. Others believe that electing Han Kuo-yu will risk Taiwan's security and threaten Taiwan's identity.

Hong Kong faces a similar China dilemma with important implications for Taiwan. As a resident of Hong Kong since 1992, I have seen the city's distinctive identity steadily being eroded. Although Hong Kong has thrived with China's economic rise, the city's high-income trap is much worse than Taiwan's in terms of inequality and unaffordability.

But like Taiwan's protests against deeper economic integration with China in 2014, the recent protests in Hong Kong are beyond economics and are focused on defending core values such as freedom and democracy.

Effective solutions must provide ways for Hong Kongers to have a greater voice in the future of their city. It is an international financial center for the world and for China, but more importantly, it is home to seven million people who have only a limited role in its governance.

In both places, surveys show that there is dwindling support for Beijing's preferred political outcomes. Moreover, the parallels between Hong Kong and Taiwan are growing. Many Hong Kongers see democratic Taiwan as a model for their future. And many Taiwanese fear that they are doomed to resemble today's Hong Kong.

The majority of Taiwanese have supported the protests in Hong Kong since they began in June. Beijing's insistence on reunification has become completely unacceptable for Taiwan under the one country, two systems.

Half a million young Taiwanese will cast their votes for the first time in 2020 and few call themselves Chinese. Their votes could have a significant impact on the outcome of the election.

Finally, what does this mean for the United States? Taiwan is a litmus test for American ability to uphold free markets and democratic institutions against China's presentation of alternative systems.

The United States should help Taiwanese defend the values of democracy and social justice that have become important parts of their identity and help Taiwan overcome the challenges of the high-income trap so that China does not appear the sole solution.

To that end, the United States must increase its appeal as a trade and investment partner for Taiwanese who may otherwise feel that they have no choice but to work more closely with China.

Hong Kong is also a canary in the coal mine. It suggests China's inability to accept diversity of values within its borders. The United States must continue to closely monitor the situation, as required by the Hong Kong Policy Act. But if any sanctions are applied, they should be carefully targeted so as not to add to the hardship already faced by ordinary Hong Kong people.

Finally, the United States must demonstrate the attractiveness of market economies and democratic institutions. Having taught in Charlottesville, Beijing, Hong Kong and Taipei, all in the last 18 months, and engaged in non-profit and entrepreneurship, I believe that the United States should encourage more educational and professional exchanges with both places, especially with the younger generation, to further this end.

In conclusion, Hong Kong's autonomy is being diluted every day, and Taiwan's democracy is threatened not only by its own shortcomings but also by Chinese efforts to

undermine it.

How well the United States responds to the challenges facing Taiwan and Hong Kong will be an indicator of America's commitment to exercise leadership in defending shared values. Thank you.

**PREPARED STATEMENT OF SYARU SHIRLEY LIN, LECTURER, POLITICS,
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**Opening Statement of Syaru Shirley Lin
Lecturer, University of Virginia and
Adjunct Associate Professor, Chinese University of Hong Kong**

**The United States-China Economic and Security Review Commission
September 4, 2019**

I want to thank the Commission and the staff for an opportunity to address the critical issue of China's relations with Taiwan and Hong Kong. Today, more than ever, the fates of Hong Kong and Taiwan are tied together and the gap between them and Beijing has never been wider. My comments will focus on the dilemmas that China poses for Taiwan and for Hong Kong and the implications for the United States.

Taiwan is caught in what I call the “high-income trap” with slower growth, stagnating wages, demographic decline, high youth unemployment and widening inequalities. These structural issues are hard to resolve for any high-income economies, and for Taiwan, they are further complicated by a debate over whether China presents a way out of the trap. Many Taiwanese believe that relying on China is a viable solution, given the size and potential of the market. But others worry that further expanding economic ties with China will compromise Taiwan's distinctive identity and values including democracy and freedom.

The previous Ma Ying-jeou government tried to stimulate growth by integrating Taiwan more closely with China. Yet over-dependence on China actually failed to produce higher growth and led to greater inequality and a serious political backlash. Since 2016, the Tsai Ing-wen administration has been trying to economically diversify away from China. Yet cross-strait interdependence has deepened, and trade and investment have continued to rise. Cross-strait investment has fallen, but not dramatically.

The dilemma is intensified as Beijing offers sweeter carrots and brandishes bigger sticks in order to increase support for unification. Incentives include allowing Taiwanese to live and work in China with the same treatment as Chinese citizens. In response, roughly half a million Taiwanese went to work in China last year, forming a brain drain. On the other hand, Beijing has used restrictions on tourism as a coercive tool since Tsai came into office, reducing Chinese tourists by an estimated 80% by the end of 2019. This is in addition to applying sharp power through friendly media and civil society organizations to influence Taiwanese domestic politics.

To reduce what she regards as excess reliance on China, President Tsai has initiated the New Southbound policy, which encourages Taiwanese trade and investment with 18 Australasian countries. This policy has shown positive early results with increased trade, inbound investments and people-to-people exchange. Taiwan's estimated growth of 2% this year will be the highest among high income economies in Asia and unemployment is at a 19-year low. Taipei's incentives to lure Taiwanese businesses back to Taiwan have also been more successful than expected. Such diversification policies have been assisted by the rising costs of manufacturing in China and the increased tariffs the United States has imposed on Chinese exports.

In four months, Taiwanese will choose between a populist Kuomintang candidate who sees China as the solution to Taiwan's high-income trap and a technocratic Democratic Progressive

Party incumbent who prioritizes diversification away from China to strengthen Taiwan. Many Taiwanese fear that re-electing President Tsai next year will be detrimental to relations with China and to Taiwan's economic prospects. Others believe that electing Han Kuo-yu will risk Taiwan's security and threaten Taiwanese identity.

Hong Kong faces a similar China dilemma, with important implications for Taiwan. As a resident of Hong Kong since 1992, I have seen the city's distinctive identity steadily being eroded. Although Hong Kong has thrived with China's economic rise, the city's high-income trap is worse than Taiwan's in terms of inequality and unaffordability. But like Taiwan's protests against deeper economic integration with China in 2014, the recent protests in Hong Kong are beyond economics and are focused on defending core values such as freedom and democracy. Effective solutions must provide ways for Hong Kongers to have a greater voice in the future of their city. It is an international financial center for China and the world, but most importantly, home to seven million people who have only a limited role in its governance.

In both places, surveys show that there is dwindling support for Beijing's preferred political outcomes. Moreover, the perceived parallels between Hong Kong and Taiwan are growing. Many Hong Kongers see democratic Taiwan as a model for their future. And many Taiwanese fear that they are doomed to resemble today's Hong Kong. The majority of Taiwanese have supported the protests in Hong Kong since they began in June. Beijing's insistence on reunification under One Country Two Systems has become completely unacceptable for Taiwanese. Half a million young Taiwanese will cast their ballots vote for the first time in 2020 and few identify themselves as exclusively "Chinese." Their votes could have a significant impact on the outcome of the election.

Finally, what does this mean for the United States? Taiwan is a litmus test of American ability to uphold free markets and democratic institutions against China's presentation of alternative systems. The United States should help Taiwanese defend the values of democracy and social justice that have become important parts of their identity, and help Taiwan overcome the challenges of the high-income trap so that China does not appear the sole solution. To that end, the United States must increase its appeal as a trade and investment partner for Taiwanese who may otherwise feel that they have no choice but to work more closely with China.

Hong Kong is also a canary in the coal mine. It suggests China's inability to accept diversity of values within its borders. The United States must continue to closely monitor the situation, as required by the Hong Kong Policy Act. But if any sanctions are applied, they should be carefully targeted so as not to add to the hardships already faced by ordinary Hong Kong people.

Finally, the United States must demonstrate the attractiveness of market economies and democratic institutions. Having taught in Charlottesville, Beijing, Hong Kong and Taipei, I believe that the United States should encourage more educational and professional exchanges with both Hong Kong and Taiwan, especially with the younger generations, to further this end.

In conclusion, Hong Kong's autonomy is being diluted every day, and Taiwan's democracy is threatened not only by its own shortcomings but also by Chinese efforts to undermine it. How well the United States responds to the challenges facing Taiwan and Hong Kong will be an indicator of America's commitment to exercise leadership in defending shared values.

**OPENING STATEMENT OF VICTORIA TIN-BOR HUI, ASSOCIATE PROFESSOR,
UNIVERSITY OF NOTRE DAME DEPARTMENT OF POLITICAL SCIENCE**

VICE CHAIRMAN CLEVELAND: Thank you very much, Dr. Lin. Dr. Hui?

DR. HUI: Thank you. Thank you so much for giving a voice to Hong Kong. I was born in Hong Kong, I grew up in Hong Kong, so the Hong Kong situation is both academic and personal.

So China watchers have been raising the issue of China reckoning in U.S.-China relations, and Americans suddenly have woken up to China's increasingly aggressive trade and security policies.

And I think if international observers had paid more attention to Beijing-Hong Kong relations over the years, then an earlier Hong Kong reckoning could have led to an earlier China reckoning.

Beijing has completely broken the promise of Hong Kong people ruling Hong Kong with a high degree of autonomy under the one country, two systems model, and written in black and white in the Sino-British Joint Declaration and the 1990 Basic Law.

Now, many people argue that all is still well in Hong Kong so long as Beijing has not rolled out tanks into the streets of Hong Kong in Tiananmen-like fashion. And this morning, my friend, Victor Shih, testified that China's approach to Hong Kong has remained soft and moderate.

I disagree. I think we should not define violence narrowly just by Beijing rolling out the PLA. I think this will also distract from how Beijing has controlled Hong Kong through non-military but still very heavy handed and violent means.

So in order to quell the protest, Beijing has deployed the Hong Kong police without rolling out the Chinese troops. They've also used the Hong Kong government to take draconian measures without formally declaring emergency. And they have wielded less visible whole-of-society white terror without creating bad optics.

The U.S. Congress and the U.S. government should broaden monitoring efforts from Chinese troop deployment to the daily repressive measures already applied in Hong Kong.

So the protest started with the call to withdraw the extradition bill which would have required Hong Kong to turn over accused offenders to Mainland China. The chief executive, Carrie Lam, suspended the bill on June 15. She refused for two and a half months to withdraw the bill until early this morning. This concession is too little too late.

So for two and a half months, in refusing to address protesters' demands, the authorities have relied on Hong Kong's police to repress the escalating protests. And this policy has corrupted what used to be Asia's finest police into just another mainland force.

When I was a little girl, every time we went out, my mom would tell me if you ever get separated from mommy, just go ask a police auntie or police uncle, and he or she will help you. That was the level of trust. What happens today, the police will just randomly beat up people, as we have seen across global TV.

And it is not even obvious who the police really answer to today. When the Chief Secretary, Matthew Cheung, Carrie Lam's second in command, apologized about the police actions, he was publicly rebuked by the Police Inspectors' Association.

And to make it even clearer that it's just Beijing ruling from behind the scenes, the Central Government's Hong Kong and Macau Affairs Office, in a rare press conference, has said we should relentlessly crack down on violent criminal acts without mercy, and we firmly support

Hong Kong police and judicial authorities in doing their job.

And Beijing has additionally stepped up the white terror campaign. So the written testimony chronicles many, many repressive measures up to September 2nd. The rest of my oral testimony will only highlight a few key points.

So the first point is a very bloody crackdown led by the Hong Kong police. The police have several tools in their tool kit. The first one is to restrict the freedom to protest by refusing to issue a no-objection notice, essentially a permit. This technically renders many protests unlawful.

And then second, the police have arrested more than 1,000 and 100 people since June, charging many with not just unlawful assembly but also very serious crimes such as rioting, assaulting the police, and possessing weapons. And some of those weapons include, for example, laser pens and also first aid workers in possession of scissors.

Third, the police routinely hit protestors with batons, and they also fire tear gas, pepper spray, beanbags, rubber bullets, and sponge grenades. The first Bloody Sunday happened on August 11th, and then more bloody arrests have taken place since.

The UN Human Rights Office and Amnesty International have accused the Hong Kong police of using crowd control weapons in ways that are prohibited by international standards.

But what is not really visible to reporters and bystanders alike is even more disturbing. Many of the detained have been denied access to lawyers for many hours. They are also stopped from contacting their families for a long time. And some of them were also so brutally beaten in detention centers that they came out with broken bones and also head injuries.

Now, we don't really know what goes on inside police stations, so it really striking to see that a lot of people are doctors and nurses. They have repeatedly staged sit-ins with a slogan, Hong Kong police attempt to murder Hong Kong citizens. And news recounted how one detainee's wrists, an x-ray showed it was connected only by skin. There were no bones and tendons in full pieces.

Medical workers have also complained about inhumane rules and procedures. The ambulances are not allowed access to the wounded at protest sites without police approval. And the police arrest the suspected protesters at hospitals so that the injured are fearful of seeking medical treatment. The medical staff are also restricted from calling family members on patients they have.

Even more alarming, police officers are also credibly suspected of colluding with criminal gangs who have assaulted both reporters and protesters. And this very biased enforcement of the law, and complicity with lawless attacks on protesters, has turned Hong Kong into a police state, even a mafia state.

And the second point is that Hong Kong has taken emergency measures without declaring emergency since September 30th. Now, August 31st is a very important date, because it was the fifth anniversary of a Beijing decision to deny universal suffrage that has sparked the Umbrella Movement of 2014.

And so the day before, the police arrested very well-known legislators and activists as a preemptive move to suppress protest turnout. And to further intimidate the public, the police, for the first time, imposed a total ban on a peaceful march organized by the Civil Human Rights Front on August 31st.

The police then took very severe measures against those who dared to protest. They deployed water cannons with blue dye for the first time, leading some people to liken the Hong Kong situation with the Apartheid in South Africa.

The police also stormed into the Prince Edward metro station with batons and pepper spray. The early horrifying scenes were caught on live streams and videos. The police then later ordered reporters to leave the station. And the medical staff were also not allowed to rescue people for two and a half hours. The police acted more violently that night than any notorious gangsters ever did before.

So nowadays, many pro-government voices have been advocating the imposition of emergency to put an end to the escalating protests.

However, if the police are already taking away citizens' rights to protest, arbitrarily arresting democratically elected law-makers and activists, indiscriminately beating up passengers inside train stations, banning reporters from covering police abuses, denying medical workers access to the wounded, arresting social workers who mediate between the police and protesters, and breaking the bones of the arrested, then the Hong Kong government has effectively adopted emergency measures even if it has not formally declared emergency.

And then the third point is a widening white terror to punish middle class professionals. The protests have enjoyed very extensive societal support. One million people marched on June 9, 2 million on June 16, and another 1.7 million on August 18.

Many professional groups have organized their own separate protests, medical staff, social workers, journalists, civil servants, lawyers, airline crews, teachers, accountants, surveyors, architects, financial sector staff, and many more.

While the police cannot lock up everyone, but Beijing has dramatically raised the cost of supporting the protests. So earlier in this morning's panels, there's been a lot of talk about how China has been using trade in order to kind of achieve its own national security objectives.

This is what they have done. So Cathay Pacific in particular is Hong Kong's first airlines. Beijing has forced it to choose between its China business and its employees' rights to protest, and banning crew members who protested. This pressure has led to the resignation of the CEO and the sacking of pilots and ground staff.

And then the big four accounting firms in Hong Kong are also pressed to identify employees who placed an advertisement in the pro-democracy Apple Daily. Teachers are also targeted. There's been talk that the teachers should really, only those who are patriotic to the motherland should become teachers. Others should be fired. And TVB, Hong Kong's main TV station, has fired over 20 staff for protest comments.

The extent of Beijing's erosion of Hong Kong's economy is nicely captured by one social media meme, Hong Kong's police, Hong Kong's airlines, Hong Kong's television stations no longer belong to Hong Kong people, because the Hong Kong government does not belong to Hong Kong people.

And yet, this combination of bloody crackdown and white terror has only stiffened Hong Kong people's resolve to defend their freedoms that they have grown up with. They see the struggle as the last stand.

This is because they are fast losing even the most basic form of freedom, the freedom from fear, of getting beaten by police officers and gangsters alike, and the fear of getting fired for simply saying go Hong Kongers. Hong Kong (foreign language spoken).

So we don't really know how the protest will unfold. What the determined Hong Kong people have achieved so far is to fully expose the lie that Beijing has kept its promises to Hong Kong.

If there's anything left to the one country, two systems model in Hong Kong, it is the people of Hong Kong themselves. It is the will to continue to keep defending their freedom at

huge personal cost, so the world's democracies should stand with them.

Hong Kong protesters have called on the U.S. Congress to pass the Hong Kong Human Rights and Democracy Act. Protesters have called for international condemnation of police abuses and for closer monitoring of the last visible white terror.

Hong Kong people have also called for closer international monitoring of their rights to protest. They should not have their heads and their limbs broken under arrest.

Hong Kong women have also called for protection of their dignity. They should not be subjected to strip search and sexual assault by the police.

And Hong Kong's medical staff have called for international humanitarian assistance. They should not be denied access to the injured. And they should not themselves be arrested just for possessing scissors.

And Hong Kong's social workers have called for attention to similar humanitarian concerns. They should not be arrested for providing social service to protesters.

Thank you so much.

**PREPARED STATEMENT OF VICTORIA TIN-BOR HUI, ASSOCIATE PROFESSOR,
UNIVERSITY OF NOTRE DAME DEPARTMENT OF POLITICAL SCIENCE**

September 4, 2019

Victoria Tin-bor Hui

Associate Professor in Political Science, University of Notre Dame

**Testimony before the U.S.-China Economic and Security Review Commission
“U.S.-China Relations in 2019: A Year in Review”**

The Hong Kong Reckoning

Since last year, China watchers have raised the idea of the “[China reckoning](#)” in U.S.-China relations. Analysts have pointed to Beijing’s “[sharp power](#)” infiltration into the domestic politics of the U.S. and other countries; its coercion to force international firms to toe the party line; and its increasingly aggressive gray-zone operations in the Western Pacific.

If international observers had paid more attention to Beijing’s erosion of Hong Kong’s autonomy over the years, an earlier “Hong Kong reckoning” could have led to an earlier “China reckoning.”

Beijing has broken the promise of “Hong Kong people ruling Hong Kong” with a “high degree of autonomy” under the “one country, two systems” model – written in black and white in the 1984 Sino-British Joint Declaration (filed with the United Nations) and the 1990 Basic Law (the mini-constitution for Hong Kong). For two decades since the handover in 1997, Beijing has encroached on Hong Kong’s freedoms and the rule of law while reaping the benefits of the city’s special international status.

International [scholars](#) and policy-makers had until recently taken for granted that all was well in Hong Kong so long as Beijing did not roll out tanks into the streets of Hong Kong in Tiananmen-like fashion. In recent weeks, the prospect of Beijing crushing the Hong Kong protests by rolling out [Chinese troops](#) has made headlines.

This angle, however, distracts from how Beijing has long chipped away at Hong Kong’s autonomy with less visible, nonmilitary, whole-of-society repression akin to the “sharp power” deployed elsewhere.

In order to quell the current protests, Beijing has deployed the Hong Kong police and local thugs without rolling out Chinese troops, used the Hong Kong government to take draconian emergency measures without formally declaring [emergency](#), and wielded white terror without creating bad optics. The U.S. Congress and the U.S. Government should broaden monitoring efforts from Chinese troop deployment to the daily, less visible repressive measures to intimidate Hong Kong.

The Hong Kong government, if it were accountable to the people, could have avoided the escalating crisis. Protestors have 5 demands: withdrawing the extradition bill which would have required Hong Kong to turn over accused offenders to mainland criminal justice; ordering an

independent commission to investigate police abuses; taking back the characterization of the protests as “riots”; dropping the excessive charges leveled against the arrested; and reopening discussions of democratic reform as promised in the Basic Law.

The Chief Executive Carrie Lam “suspended” the extradition bill in June. But she has stubbornly refused to formally withdraw the bill as demanded by [73%](#) of respondents in a representative survey. When a [Reuters correspondent](#) asked Lam if she had the [autonomy to withdraw the bill](#), she had no answer. In a leaked audio, she told business leaders that “[If I have a choice](#), the first thing [I would do] is to quit.” So she apparently does not even have the autonomy to quit her job.

Deprived of the option of easing tensions by addressing protestors’ top demands, the authorities have increasingly relied on Hong Kong’s own police force. This policy has only corrupted what used to be [Asia’s finest](#) police into “[just another mainland force](#)” that now arbitrarily beats up and arrests protestors and passersby. Police abuses have, in turn, galvanized [79%](#) of the respondents in the same survey to call for an independent inquiry.

Yet, the Carrie Lam government seems to have lost command of the police. In a closed-door meeting, she ruled out an independent investigation because “[colleagues of the police force were very much opposed to it](#).” When the Chief Secretary Matthew Cheung, her second in command, apologized that “the police’s handling [of gangster violence in Yuen Long on July 21] fell short of residents’ expectations,” he was publicly rebuked by the [Police Inspectors’ Association](#). One anonymous [statement](#) read: “Matthew Cheung, why do you deserve to represent the police force? If you want to apologize, you should resign. If you don’t step down or apologize to the whole force, you will be a sworn enemy of the police!”

As if that weren’t enough to show that it is Beijing officials rather than Carrie Lam’s administration that is really ruling Hong Kong, the central government’s Hong Kong and Macao Affairs Office has held three rare press conferences to comment on the protests. Spokesman Yang Guang said: “We should relentlessly crack down on... violent criminal acts without mercy, and we firmly support Hong Kong police and judicial authorities in bringing the criminals to justice as soon as possible.”

With Beijing’s blessings, the Hong Kong police have resorted to an increasingly [bloody](#) crackdown that “[evokes memories of Tiananmen era](#)” without the tanks; they have practiced emergency measures before formally declaring emergency. Recent [news reports](#) highlight that, since the government cannot accept protestors’ demands, the plan is to “arrest as many as possible” “until there is nobody left” ([「拉得幾多得幾多」](#), [「拉到無人為止」](#)). Beijing has additionally stepped up a white terror campaign to silence the larger society.

This testimony chronicles such repressive measures up to September 2.

A Bloody Crackdown by the Hong Kong Police and Local Thugs

On June 12, when protestors surrounded the Legislative Council to prevent it from deliberating on the extradition bill, the police were already [criticized](#) by local and international observers

alike for beating unthreatening protestors with batons and firing excessive rounds of rubber bullets, pepper spray, beanbags, and tear gas.

After Beijing's first press conference on Hong Kong on July 29, the Hong Kong police began to take more draconian actions.

The first tactic has been to restrict the freedom to protest by refusing to issue a “no-objection notice” – essentially, a permit – to organizers. Such refusals were rare for two decades, but the police have repeatedly used this card in the last two months. The police denied a permit for a planned protest in Yuen Long on July 26 and then showed up in force to subdue the “unlawful assembly.” In subsequent applications, the police allowed rallies at parks but denied marches, rendering spillovers to the streets as illegal.

Then, in response to “unlawful assemblies,” police officers have routinely hit protestors with batons and fired tear gas, pepper spray, beanbags, rubber bullets, and even sponge grenades.

Increasingly lethal police operations have resulted in bloodier and bloodier crackdown. On the first “[bloody Sunday](#)” on [August 11](#), officers disguised as protestors [beat](#) up the arrested. [One](#) protester had his face pushed into a pool of his own [blood](#). A woman was [shot in the eye](#) by a [rubber bullet](#), permanently blinding her right pupil. At the Taikoo metro station, protestors were fired at with pepper spray at [close range](#) and chased down the escalator with batons.

Police spokespersons have insisted that the crowd control weapons are not deadly. However, the [UN Human Rights Office](#) and [Amnesty International](#) have accused the Hong Kong police of using them in ways that are prohibited by international standards. The [New York Times](#) has documented how the police have fired some of the 1,800 rounds of tear gas from high above at high velocity, at head level, and at close range, producing “blunt force trauma” from canisters among suspected protestors.

With many cases of police abuses in the streets caught on livestream, the police have also turned their ire toward journalists, directly firing tear gas at them on July 27 and August 3–4.

What is not visible to reporters and bystanders is even more disturbing. Fifty-four of the arrested on August 11 were taken to San Uk Ling, the farthest possible detention center close to the border. [Lawyers](#) who made their way to the remote location were denied access for [12 hours](#). The detained disclosed later that they were stopped from even [contacting families](#). Most of all, some of them were so [brutally beaten](#) that they came out of detention with severe injuries. A young man, in particular, emerged with [brain bleeding](#) that he did not have before detention – the moment of his arrest was caught on film when an officer put a sharpened rod into his backpack. When pressed by reporters, police spokesmen admitted that 30 detainees from August 11 were hospitalized, with 6 suffering from [bone fractures](#). At least 7 detainees from August 25 were hospitalized for [head injuries](#). However, without closed circuit TV (see a [separate case](#)), the police insist that they have always used only the necessary amount of force to restrain the arrested.

It is thus noteworthy that doctors and nurses have protested with the slogan “[Hong Kong police attempt to murder Hong Kong citizens](#).” A [nurse](#) anonymously recounted how one detainee’s wrist was so broken that x-ray showed that it was connected only by skin. The medical sector has also complained about [inhumane rules and procedures](#): that ambulances are not allowed to treat the wounded at protest sites without police approval, that the police arrest suspected protestors at hospitals so that the injured are fearful of seeking medical treatment, and that medical staff are restricted from calling families on patients’ behalf.

Other forms of treatment are no less appalling. Some of the detained complained of being given [salty toilet water](#) for drinking. Several women disclosed that they were strip-searched, a practice normally reserved for drug addicts. [Three underaged students](#) have been put in juvenile centers rather than released on bail to families.

With more than [1,100 people](#) arrested so far, the police are charging them with more serious crimes such as rioting, assaulting the police and possessing weapons in addition to the lesser one of “unlawful assembly.” Rioting is an unlawful assembly of three or more people where any person “commits a breach of the peace” and it carries a maximum sentence of 10 years.

Most alarming, police forces are credibly suspected of [collusion with criminal gangs](#) who have assaulted both reporters and protesters. In a July 21 incident, hundreds of suspected triads dressed in white shirts indiscriminately beat locals with wooden sticks and metal rods at the Yuen Long train station. The police [did not show up](#) until after the gangsters had left, and senior officers were filmed speaking with the men in white shirts prior to the attack. [Zachary Wong](#), a local district councilor, has received death threats for speaking to the media about police-gangster collusion. A month later, only [2 were charged of rioting](#). As the police can be counted on to look the other way, there have been more cases of thug attacks: in Tsuen Wan on August 5, in North Point on August 5 and 11, in Wan Chai on August 18, and Tseung Kwan O on August 20. On August 29, thugs beat up [Max Chung](#), who organized a protest against the Yuen Long gangsters, and [Jimmy Sham](#), convener of the Civil Human Rights Front which has organized various massive peaceful protests.

This biased enforcement of the law and complicity with lawless attacks on protestors has turned Hong Kong into a police state, even a mafia state.

Emergency Measures Without Declaring Emergency since August 30

Until August 30, the bloody crackdown targeted at [700](#) to [1000 core protesters](#) (though the police have been so indiscriminate that the arrested include a pilot, medical volunteers, social workers, NGO observers, and passersby). Since August 30, the police have extended its sweep.

The authorities were particularly worried about [August 31](#), the fifth anniversary of a Beijing decision to stifle universal suffrage that had sparked the Umbrella Movement of 2014.

The day before on August 30, the police arrested Joshua Wong and Agnes Chow (as well as Ivan Lam who was arrested absentia) of the Demosisto party; legislators Jeremy Tam of the Civic Party, Nok-hin Au of the Democratic Party, and Chung-tai Cheng of the Civic Passion; district

councilor Rick Hui; Andy Chan of the pro-independence Nationalist Party; and former student union leader Althea Suen. One legislator is charged with assaulting the police for using a loud hailer at a high volume that hurt officers' ears; another is charged with obstructing police operation by mediating between the police and protestors. This wave of arrests involves better known activists but not core protestors, so it is widely seen as a preemptive move to suppress protest turnouts the next day.

Late on August 30, an off-duty officer endured [bone-deep wounds](#) after he was stabbed by three masked men. The attack was attributed to violent rioters. Netizens found it curious that while the attack happened at 23:21pm, a pro-government newspaper the *Oriental Daily* published the story only [20 min. later](#) at 23:41pm.

To further intimidate the public, the police for the first time imposed a total [ban](#) on a peaceful march organized by the Civil Human Rights Front on August 31. This did dampen participation in an “illegal assembly,” so that tens of thousands rather than millions took part. Yet, some were [first-time protestors](#) outraged by the police ban.

The police took even more draconian measures against daring protestors on August 31. They deployed water cannons with blue dye for the first time, leading analysts to draw analogy with martial law under the [apartheid regime](#) in South Africa.

When some officers dressed up as protestors were identified in Causeway Bay, uniformed police surrounded and held up reporters so that no photos or live streams could be taken.

The police stormed into the Prince Edward metro stations with batons and pepper spray. Many people were hit on their heads. Sixty-three people were arrested from the incident. The early horrifying scenes were caught on [live streams](#) and [videos](#). The police later [ordered reporters to leave](#) the station. Medical staff were not [allowed in](#) for 2.5 hours. On that night, the police acted more violently than even gangsters in Yuen Long on July 21.

Pro-government voices have been advocating the imposition of emergency to put an end to the escalating protests. However, if the Hong Kong police are already taking away citizens' right to protest, arbitrarily arresting democratically elected law-makers and activists, indiscriminately beating up passengers inside train stations and train cars, banning reporters from covering police abuses, denying medical workers access to the wounded, breaking the bones of the arrested in detention centers and more, then the Hong Kong government has effectively adopted emergency measures even if it has not formally declared emergency.

A White Terror

Less bloody but no less repressive is a widening white terror. International media have extensively covered how Beijing has used [Facebook, Twitter, and YouTube](#) to spread disinformation about the Hong Kong protests. There should be more attention to how Beijing also is seeking to punish dissenters among moderate, [middle-class professionals](#).

The protests have enjoyed extensive societal support. One million marched on June 9, 2 million on June 16, and 1.7 million on August 18. Many professional groups have organized protests one after another: medical staff, social workers, journalists, civil servants, lawyers, airlines crew, teachers, accountants, surveyors, architects, financial sector staff, and many more. While Beijing cannot order individuals to toe the party line, it can [raise the costs](#) of sympathizing and participating for common people:

- Beijing, in particular, forced Cathay Pacific Airways to [choose](#) between its China business and its employees. It was told on August 9 to ban crew members who supported the protests in general and the strike on August 5. The pressure led to the resignation of the CEO Rupert Hogg and his deputy Paul Loo Kar-pui, and the sacking of pilots and ground staff. Among the 20 or so already fired, some merely shared social media posts. Rebecca Sy, the former chairwoman of Dragon Airlines Flight Attendants' Association, was fired on August 23 for pro-protest contents on her social media. The airlines subsequently instructed its employees to [blow the whistle](#) on one another.
- The big four accounting firms in Hong Kong are pressed to identify employees who placed an [advertisement](#) in the pro-democracy Apple Daily newspaper in support of protests on August 16. Mainland Chinese internet users have warned them against "[becoming the next Cathay Pacific](#)."
- Hong Kong's tycoons and big firms have been placing front-paged advertisements in local newspapers to publicly pledge their support for the Hong Kong police. Even U.K.-headquartered banks [HSBC and Standard Chartered](#) PLC have followed the pack.
- The [Airport Authority](#) fired two pro-protest managers on August 5.
- The Hong Kong [railway MTR Corporation](#) was criticized for letting protestors to arrive at and leave protest sites at will. It has suspended service to stations near protest routes since August 24.
- The police have complained about uncooperative [medical staff](#) and disclosed their personal information on pro-regime platforms.
- Officers of various [university student unions](#) have received death threats.
- [Priests](#), who have led prayer and hymn service at protest sites, have received death threats.
- [Teachers](#) are targeted by China's *People Daily* for polluting young minds. Pro-Beijing voices in Hong Kong are agitating for recruitment based on patriotism.
- [TVB](#) has fired over 20 staff for pro-protest posts or post-it notes.
- [Radio Television Hong Kong](#) was surrounded by a pro-Beijing rally on August 24.

One [social media meme](#) has this message: HK's television stations, railway corporations, airlines, and police no longer belong to Hong Kong people because the Hong Kong government does not belong to Hong Kong people.

Beijing is expected to further tighten control over all branches and all levels of government as it did in the aftermath of the 2014 Umbrella Movement. At the time, its efforts to rein in Hong Kong already went far beyond charging movement leaders of "inciting nuisance" and sentencing them up to 16 months in jail. Beijing handpicked the Chief Executive and filled top positions with loyalists in the civil service, law enforcement, judicial institutions, and university councils. To curb the power of the Legislative Council, the Chief Executive banned some opposition candidates from running for office and disqualified others after they had been elected. To further

undercut the courts' lingering independence, the Standing Committee of the National People's Congress took the unusual step of issuing a binding interpretation of local oath-taking requirements while a case to remove legislators who had disrespectfully stated their oath was still pending. And to dominate the city's 18 district councils, Beijing's Liaison Office intensified support for its loyalist candidates.

Hong Kong's Last Stand

Just as the post-Umbrella repression did not extinguish dissent, the current combination of bloody crackdown and whole-of-society white terror will only stiffen Hong Kong people's resolve to defend the freedoms that they have grown up with.

If the authorities have tried to isolate the thousand or so core protestors from the broader society, the blanket repression has only united them.

If anything, the lessons from the Umbrella Movement and the harshness of the current clampdown have convinced Hong Kong people that this struggle is the "last stand" with "no retreat." They are fast losing even the basic freedom from fear – the fear of getting beaten by the police in train stations and the fear of getting fired for simply saying "Go, Hongkongers (香港人加油)!"

What the intensifying suppression has achieved is to fuel escalation. Some protestors believe that escalation necessarily means countering police brutality with their own violence. At the same time, some protestors understand that the best counter to the police's intensifying bloody arrests is to focus on nonviolent methods. The more repressive the police become, the more necessary it is to avoid their hard blows. One of the more prominent protest slogans is: "it is you [Carrie Lam] who taught us that peaceful marches are ineffective." But nonviolence does not have to mean only peaceful rallies and marches. Concentration of protestors is vulnerable to police and thug violence. There are more and more calls for dispersed actions that do not require the police's no-objection permit. Students and workers have staged another general strike on September 2 and 3. Going on strike may not get one arrested, but could still get one fired. Consumer boycott is another method that is not just less vulnerable to physical arrests and attacks, but also conducive to job creation. Hong Kong people are developing apps that facilitate targeted boycott of pro-Beijing businesses and targeted support of pro-democracy entities, and platforms that connect pro-democracy employers with pro-democracy employees. There are further calls to shout protest slogans out of the window at 10pm every night so that the voices of dissent can echo through every neighborhood.

Stand with Hong Kong

At the moment, we do not know how the protests will unfold. What the determined Hong Kong people have achieved so far is to expose the lie that Beijing has kept its promises to Hong Kong. Beijing has completely violated "one country, two systems" with or without rolling out Chinese troops, with or without formally declaring emergency. Beijing has reduced "Hong Kong people ruling Hong Kong" into "Beijing appointees ruling Hong Kong." Beijing has even taken away the last thread of freedom – freedom from fear.

If there is anything left to “one country, two systems,” it is the people of Hong Kong – it is their will to keep defending what they have grown up with.

Hong Kong people stand for universal values, democracy and human rights. As Hong Kong people make their last stand, the world’s democracies should stand with them.

Hong Kong protesters have called for the US Congress to pass the Hong Kong Human Rights and Democracy Act as quickly as possible.

Protestors have called for international condemnation of police abuses, and for closer monitoring of the not always visible white terror.

Hong Kong people have called for closer international monitoring of the right to protest, the right to have access to lawyers and families, and the right not to have your bones broken in detention.

Hong Kong women have called for investigation into abuses of their dignity – they should not be subject to strip search and even sexual harassment during arrest.

Hong Kong medical staff have called for international humanitarian assistance. They want to fulfil their professional duty to provide emergency care at protest sites without police approval and in-hospital care without the police arresting their patients. They do not want to be arrested for simply possessing [scissors and saline](#) – these are tools and not “weapons.”

Beijing has accused the U.S. and other governments of meddling in China’s internal affairs and fomenting the protests in Hong Kong. Beijing wants to blame “black hands.” Chinese leaders should understand that this movement has massive popular support.

If foreign governments are paying attention, it is Hong Kong people who have been crying out for support. They have won the attention of international media with their determined protests. They have filed many “We the People” petitions. They have crowd-sourced funding to place full-paged advertisements in major international newspapers.

Chinese officials should also remember that it was Deng Xiaoping who in the mid-1980s lobbied western capitals and invited them to grant Hong Kong its special status on the basis of the promised high degree of autonomy.

Beijing should also understand that it is its own policy – the threat of using the PLA and the actual deployment of Hong Kong police and thuggish violence – that has stirred up the world’s “Hong Kong reckoning.”

Beijing’s best response is to stand with Hong Kong. Carrie Lam said that Beijing cares about its “[international profile](#)” and doesn’t want to forsake all the efforts of building up China as a responsible power. The “Hong Kong reckoning” has magnified the “China reckoning” in the U.S. and the rest of the world. The best strategy to reverse the current bipartisan consensus and global consensus on China’s bullish behaviors is for Beijing to honor its promises to Hong Kong

as outlined in the Hong Kong Basic Law and the Sino-British treaty. Standing with Hong Kong is the real win-win. Let the Hong Kong government withdraw the extradition bill, open independent investigation into police abuses, drop rioting charges, and deliver the promise of universal suffrage as stipulated in the Basic Law.

PANEL III QUESTION AND ANSWER

VICE CHAIRMAN CLEVELAND: Thank you, compelling testimony. Chairman Bartholomew?

CHAIRMAN BARTHOLOMEW: Thank you, thank you very much for all of your testimony. I have a couple of different questions. It seems really generationally, both in Taiwan and in Hong Kong, the young people are growing up with an identity different than Mainland Chinese identity.

I'm curious with Taiwan when we talk about the brain drain. These are young people who have grown up used to Taiwan's freedoms. How are they dealing with the restrictions on speech and all of these things in China? Is it changing their sense of identity? Is it changing their sense of the rights that they should have?

DR. LIN: I guess I'll take that first. So for young people in Hong Kong and Taiwan, I've been writing about the similarity which, at the beginning, very few people identify with the trend I was marking. But it's now very, very clear.

Because the support for, over 70 percent of Taiwanese support the protests in Hong Kong. Relative to other generations, it's much higher. So that's the first thing. There's a generation that understands each other and want freedom, and wants individual expression, both in terms of economic and political rights.

In terms of Taiwan, so I think let's take a moment back and look at it from Beijing's point of view. It's an utter disappointment. For the last 30 years, since Taiwan democratized, Taiwan is a land of pollsters. There are polls every day, all the time. And so there's unending proof of what I'm saying.

But most of the polls will show you that for 30 years there has been a declining, as people who came from China, of course, died and the generation changed, the polls show basically more and more people say they are Taiwanese and Taiwanese and Chinese. And that number has moved to a majority of the people say they are only Taiwanese. Don't call them anything else but that. So that's first.

Second, for young people, in many of the individual polls this year for young people, that number is zero, zero percent of young Taiwanese and zero percent of Hong Kongers, actually in Hong Kong's case the pollsters will say anybody under 29, zero percent in most of the polls say they are Chinese. So how do you govern or unify a place that actually has nobody who thinks that they are Chinese?

So to come back to this point about the 30-year trend is that, in the last four years, there has been remarkable improvement. And this is, I think, why it has emboldened Beijing to take certain measures this year, even before the Hong Kong protest, that has led to more of a backlash in Taiwan.

And that is two things. One is for the last four years, I think Xi Jinping's led this sweeter carrots and bigger sticks campaign that actually has led to a four percentage increase in Taiwanese who say let's have unification eventually.

Now, eventually means something quite different than immediately. It doesn't mean really let's rule under the way of one country, two systems, or Beijing's CCP rule. But somehow that's an improvement. So everybody, I think was quite optimistic in Beijing that there was improvement, finally, after 30 years of going the other way.

But in the last 13 weeks with Hong Kong's protest, this has all come back. And in mid-year, this year, the polls snapped back right to original.

So basically, there is a low single digit number of people in all of Taiwan who claim they are Chinese, and low single digit, actually less than two percent, for a decade now of people who support unification. So this trend is much more focused on young people who think on the other side of the extreme.

CHAIRMAN BARTHOLOMEW: So I have more questions, but go ahead.

VICE CHAIRMAN CLEVELAND: I was just going to ask on that point. How do you think Beijing reads that polling data in terms of less than ten percent supporting unification?

DR. LIN: Well, supporting unification, less than two percent, it's one point whatever percent. And it's very disappointing. But I would just say to compliment my colleagues in Beijing, they know the polls better than I do, to the decimal. So it is not that they don't see, and it is not a failure of intelligence. But I think it's a failure to comprehend.

Seeing the same number as all of we do here, all the Commissioners see the same papers we do, but I think we all draw different conclusions based on the same data. And so for the last 30 years, Beijing has decided that with all of the data they will actually coerce more. And yet, it has come to the point where I think Hong Kong today is the ultimate litmus test for what they think.

Because let me just put a moment of focus on Hong Kong. Hong Kong situation is not like Taiwan. Taiwan has democratized 30 years ago, and the number has been steady and gradual. However, Hong Kong actually was more and more patriotic from the handover until 2008.

Since 2008, everything started to change the other way. And in the last few years, it's dramatically changed. So the young people do not believe that they are Chinese, and young people do not support the one country, two systems. The confidence level is at an all-time low, since 2014, the Umbrella Movement. And I think maybe Victoria can say a few words about what has happened in Hong Kong.

DR. HUI: Yes, so then the way that the Beijing understands the situation in Hong Kong, Hong Kong's youth is that while they blame it mostly on the teachers. They believe that is teachers who have been basically polluting the young minds, and therefore the way to go is to impose patriotic education.

They have tried that, so Joshua Wong actually was the guy who started to rebel against the terms to impose patriotic education when he was only 14 in 2012. And that got shelved. But then over the time, essentially more and more loyalists have been employed.

And now with this current young generation, so many of them are willing to even die. When asked, you know, do you know that when you are arrested and charged for rioting, you could risk ten years in jail? And they were, like, we know. And we are willing to sacrifice our lives to defend Hong Kong's freedoms, to defend what we have grown up with.

And so more and more of these people, and also just a few days ago, Beijing's People's Daily, in particular, said that the Hong Kong Teachers' Alliance, Teachers' Union, they are so, I guess, you know, because they want democracy, they support democracy, therefore there should be a lot more patriotic education that a lot of the teachers should be screened. So this is a very scary move. Even though we don't see any violence.

MS. GLASER: If I could just add one brief point, I think there's almost a silver lining in having Beijing not completely lose hope in unification with Taiwan. Because so far we've seen Xi Jinping's foreign policy in so many areas really change in a much more assertive direction.

When it comes to Taiwan, we've seen a change in tactics. We really haven't seen a change in the overall strategy. And they continue to believe that economic integration might

bring them to the goal of political unification of some kind.

If the Chinese believe that that approach has been a complete failure, I mean, I think that's the day that we have to worry that they might decide to use force. So the fact that they try these other tactics, like 31 measures and other incentives to people in Taiwan, they might see a little bit of a spike in some of the polls, not such a bad thing from my perspective.

DR. LIN: I apologize, I actually didn't come to the heart of the question which is what does a young person do. So this is the heart of, basically, my research, Taiwan's dilemma, Hong Kong's dilemma.

Every day there are young people who think to themselves, should I go to the protest? If I do, and a picture is taken of me, will I be able to work in a bank one day? And the answer is many of the older generation will tell them no, you will not ever be able to work in a mainstream institution.

And so the fear is there, yet, you see all these people going on the street. They feel they're risking their lives, because their future is basically China or nothing.

And I think this is the same situation in Taiwan. But in Taiwan's case, it's much more of the most educated people, I would say, that actually have this dilemma.

So you are talking about people who are really thinking about this as a compromise, and that is a very big dilemma. If you are a PhD student in Taiwan, you really have no hope of going to teach in California.

It's more likely, because your English is not so good and it's more likely that you also have a degree from a local university, that you will go to Xiamen University to teach. And Xiamen University offers you three times what you will get as a professor which there is no vacancy anyway in Taiwan.

And so the dilemma is every day, all the time for everybody in the working class, middle class, and among intellectuals.

DR. HUI: So I want to add to that. I think that Dr. Glaser has a very good point, that we want to also give Beijing some hope. Essentially, people are rebelling against Beijing's increasing encroachment into Hong Kong's autonomy.

As I said, that essentially now they are defending the last thread of freedom, freedom from fear, why can't Beijing really just be nice and soft. Because if they can stop encroaching on Hong Kong, then they have reaped so much benefit from Hong Kong's special status.

And this is also, so Dr. Lin also said that this trend in Hong Kong has changed a lot. Early on, when Hong Kong people have faith in one country, two systems, people were actually really okay.

It's really because of Beijing's encroachment, increasing encroachment over time that has really driven the young people to the wall. So relax, Hong Kong people not asking for independence. Hong Kong people basically are happy to keep everything the way that they are.

This is actually Beijing that's been changing the status quo. So if Beijing would just step back, then that is the hope for them to, you know, to keep Hong Kong as part -- people are much happier.

VICE CHAIRMAN CLEVELAND: Beijing, step back, okay. Commissioner Lewis?

COMMISSIONER LEWIS: Thank you all very much. There's obviously great courage exhibited by the people in Hong Kong. I would like to ask a question.

When Hong Kong was turned back to China for 50 years, what is the expectation of the people in Hong Kong, what will occur after the 50 years are up? That's number one. And number two, there's a Taiwan presidential candidate, Terry Gou, who owns or is a major

shareholder of Foxconn with represents about 70,000 people in China making apple products.

Has anything happened to disturb that relationship now, and will the people who work for Foxconn be able to either move to Taiwan or can Taiwanese people be trained to do the work the people are doing in China?

DR. HUI: For about 50 years, for the one county, two systems, so in 1984 when the UK and China issued the Sino-British Joint Declaration, Hong Kong people were completely excluded. We were actually the most important people, but our future was being negotiated away.

But at the same time though, it is important to also keep in mind that for that older generation, for the first generation of democrats in Hong Kong, because you have no choice, at the same time that the Joint Declaration, and then later on the basic law, really writes down, in black and white, all these very liberal guarantees of all kinds of freedoms.

And also in the 1980s, Beijing leaders, at the time, would travel around the world. Now today, they complain about foreign interference, but in the 1980s, they traveled around the world to tell the world that, well, you know, Hong Kong is going to really keep its special status.

And you guys should treat Hong Kong as a special place. And so this is why, in reaction to that statement, U.S. were issued the Hong Kong Policy Act. So the promises were there.

And then today, because over time that, I mean, some people would say that, well, you guys were kind of stupid. Why would you accept Beijing's promises then? But one thing is there was no choice.

And two, you really wanted, in the way you want to believe that everything is going to be fine, but everything has turned out to really gone down south. And again, at this point, there's really not even the freedom from fear.

And for these young people, 2047, they will still be in their adulthood. So for them, this is really the last stand they are fighting for, the future. And this is why that they are all not going to give up.

MS. GLASER: In answer to your question about Terry Gou, the founder of Foxconn, so, you know, we will know by September 17th whether he's running for president. That's the deadline for filing in Taiwan.

There's, obviously, growing signs that he may run. The vast majority of his operations remains in mainland China. There is some discussion now of him moving some of those operations to India.

There has been some talk about this plant in Wisconsin, which, I gather, is not going to hire as many workers as he originally said he was going to hire, and my guess is that, you know, even if he by chance were to win the election in Taiwan that those operations, the vast majority of them, would stay in mainland China.

Even -- there are five major semiconductor companies in Taiwan. Four out of the five, Foxconn being the outlier, have brought some of their operations back to Taiwan.

But it's only a small portion of those operations. So I think many people are skeptical that Taiwan could really accommodate the entire set of factories, the operations that they do.

And I don't think it's so much because Taiwan people aren't skilled. You may have some labor shortages. Taiwan certainly faces demographic problems, going forward.

But there's also the issues of shortages of land and water and electricity, and the government in Taiwan is doing a lot to address these.

But I saw a statistic this morning in something I read that forecast that based on the companies that are likely to bring a portion of their operations back to Taiwan this will increase

the jobs by about 40,000, which is really a drop in the bucket.

If you brought all of Foxconn's operations back, my guess it that that might be impossible for Taiwan to absorb. I don't know that they have that much land to accommodate them.

But, importantly, I have not heard Terry Gou say anything about having the intention to pull all of his operations out of mainland China and I'd be surprised if he did.

COMMISSIONER LEWIS: Does he still have the access to be able to go to China today?

MS. GLASER: Yes.

DR. LIN: Maybe I could add to both of my distinguished panelists here. I think that there is something very important about Terry Gou and 2047 and that is this is -- in the next, I think, few months, the United States will have to provide leadership in a key moment in East Asia.

What happens in Hong Kong, I think, is very important because 2047 is an excellent question. It was always meant to be some kind of hope. Some people, I would say, thought 2047 could be an extension, not an expiration.

All such hope have been dashed. So there is, number one. And what do you do in a place where property rights is everything? How do you buy property which also doesn't have land use right -- it's only lease hold -- that doesn't extend beyond maybe in 10 years? We don't know actually what the real expiration is. Dilution of values and autonomy is happening every minute every day.

And so for property rights, what does that mean? I think that is quite important, and Terry Gou is an important character because let us not forecast whether he will run in the next few days but I actually in my previous life as a venture capitalist we co-invested in SMIC in Shanghai in semiconductors.

So he is a very interesting character because he has done everything you think that is the furthest away from being a Taiwanese president.

He made China stronger. He went to Wisconsin, made investments and said that it was a Chinese investment, and the next thing you know is he is trying to be Taiwanese president.

But, of course, I often say to people when they ask, because people think I know him and I know the private sector, and they ask a very philosophical question -- what is in it for him?

Well, what could be a better job for a billionaire but to be Taiwanese president? What could somebody from Beijing want more than that?

So I said he is the smartest man. He now wants the best job vis-a-vis people who are very powerful.

But I think one thing I want to say about Terry Gou and young people is there is an unusual pull, actually, among people who think that he could bring economic dynamism to Taiwan.

So it goes back to my point. Taiwan is an economic trap just like Hong Kong with socioeconomic problems that are not resolvable, and people have illusion that this high-income economy can certainly turn out jobs.

As Bonnie says, Terry has no intention -- has never said he will bring anything back to Taiwan. So to the third point that I want to address is on a economic level can the return to Taiwan be possible?

Most businesses, no. The returning to Taiwan of \$16 billion year to date due to tax incentives and other incentives is because of the tariff war right now that is leading to especially the IT sector being really unaffordable also in coastal cities in China but the tariff war making it

very uneconomical commercially unviable to export from China anymore. So businesses are coming back.

But that is not the business Terry is in.

COMMISSIONER LEWIS: Thank you very much. I just want to express my own personal admiration for what's going on in Taiwan and Hong Kong. Thank you.

VICE CHAIRMAN CLEVELAND: Commissioner McDevitt.

COMMISSIONER MCDEVITT: Thank you. Terrific presentations, and I am going to ask you now to venture into the realm of opinion.

I am trying to think through if we were the standing committee or the politburo here, and we have heard all of these things that have made the idea of one country/two systems seem an impossible dream for Taiwan, what might we do?

How -- what kind of a different formulation might Beijing come up with to make reunification more attractive? In other words, saying that the one country/two system process or formulation has outlived its usefulness.

Okay, time to jump ship and come up with a new idea. What might that idea be?

MS. GLASER: That's a great question so I'll start and then my other panelists, I think, will have their opinions as well.

When Xi Jinping gave his speech on January 2nd, the one thing that really struck me as new is he was offering Taiwan the opportunity to sit down and talk about and collectively decide what their version of the one country/two systems would be.

That they haven't given Hong Kong that offer, right, so that -- it didn't resonate in Taiwan. We understand why. But if you talk to people on the mainland they will tell you that was a carrot. They felt that Xi Jinping was reaching out, and, you know, could he go further? Absolutely. That is my view.

2011, I remember when Wang Yi, who was head of the Taiwan Affairs office at that time was at CSIS and he said China remains open to a different version, a different formulation for unification and it doesn't have to be one -- it doesn't even have to be the 1992 consensus to have a basis for talks.

And we, basically, heard the same thing from a senior Chinese official earlier this year in a private setting that I was -- that I was at.

So when the Taipei Mayor Ko-wen Je said, you know, both sides of the strait are sort of part of one family, that was good enough to have the Shanghai-Taipei talks. Wouldn't be good enough if he was president.

But it shows you that there is potentially some flexibility that ultimately what China wants is this notion that the two sides of the strait belong to something together.

It's not Taiwan being part of the PRC. It is both sides of the strait belonging to one China.

So I've always believed that that door is still open with Xi Jinping. We may have closed a little bit. I mean, he is tougher. He's talking more about one country/two systems.

But let's remember he inherited that as well. So the two sides of the strait part of one family. There's people who have talked about one country two governments or different things like that.

The important part to them to is the one something. And so I just -- I would not rule out that there could be some flexibility to formulate this in a different way.

But what Taiwan would be able to do under that formulation itself, that where it would have autonomy, that's something that has to be negotiated.

You will remember that Jiang Zemin told Taiwan that it could have its own military, and Xi Jinping has not repeated that.

So what else are they going to take back from what they offered and how much of that offer was ever real. We don't know.

DR. LIN: I guess I am not so optimistic. In the original one country/two system as put out by Ye Jianying and Deng Xiaoping, of course, Taiwan was supposed to have its own army and we have never been back to that formulation.

So I think where we are today is so far away from the sort of -- the ideal sense of a -- one country/two system, let me just say, was the ideal, and if Hong Kong were to work out, it was the best example of the CCP rule and a peaceful rising China.

So I think that Hong Kong is really, really at the lynchpin and, as I said in my remarks, it's a litmus test for China, just like Taiwan is a litmus test for the United States leadership.

There are different tests right now for all the major powers and I think I want to be a little bit more philosophical because I think legalistically I don't see where this is going.

But on a philosophical level, I have said this in Beijing often to different groups and people who can make their voices heard is that China has to accept multiple identities and different values.

It is a vast land with many cultures, many languages, many religions, many people who have different aspirations and values.

And the one thing I think that is really hard to do even when individuals in China understand it is the right thing to do is that the Chinese government believes that money can solve everything and it simply cannot.

Today's protests, when people say the Hong Kong protests -- the Taiwanese protests against this service trade agreement is all about the money, I tell them no, because if it is it would have been solved already, and that is the issue.

Throwing money at problems only takes care of things temporarily. But the deep-seated difference, as I said in my remarks, is a difference of value -- core values and different systems that I think eventually if people have to choose they will have to say is there a difference. There is a very big difference, and to come back to the original question if you go live and work in China with national treatment do you end up going back to Taiwan and voting for the party that advocates unification?

The result in the last 30 years is no. So it has been unsuccessful no matter how many incentives they throw, and so I think Beijing is trying to find a better way as well.

That is the only silver lining -- that with a president for life maybe he will find a better way and be courageous to implement it because nobody else in the past has been courageous enough to say, let's take the soft approach and be inclusive.

And the word is inclusive to want to go for values young people care about -- freedom, justice, equality, environmental sustainability -- that Hong Kong and Taiwanese young people care much more than their parents do and is at odds with some of the identity that Beijing wants a Chinese person to uphold.

DR. HUI: Thank you.

The one country/two systems model in theory could work. The reason it has failed is because of practice -- all these practices by Beijing.

So when you look at these young people, what kind of young people -- you know, the youngest person who's been arrested is 12 years old and a lot of them are teenagers.

The first question I ask my students when they come back on the first day of class is what

did you do in your summer. Did you go have internship, go have fun, go on vacation, go play basketball and all that.

Hong Kong young people are the same. Why would anyone want to risk going to jail for 10 years or getting beaten so hard that you have brain bleeding or you have broken bones. Why would Hong Kong's young people do that?

It's because they've been pushed to the wall -- that they feel that they have no future and this is why they are resisting. And repression has only generated even more and more fierce resistance.

And if I were -- if the Politburo would listen to me I would say please go back to the Sino-British Joint Declaration. Please go back to the basic law. Honor these promises.

If you honor your promises to Hong Kong, Taiwan would look at it, oh, okay, so it's not too bad. The rest of the world would also then look at, okay, China is signing all these agreements and with the WTO, all these agreements, and they actually if they can honor their agreements, their promises to the Hong Kong people, the rest of the world would also then treat China differently.

And so Hong Kong really is a test case for Beijing's behaviors around the world.

VICE CHAIRMAN CLEVELAND: Commissioner Wessel?

COMMISSIONER WESSEL: Thank you all, and I think we all stand in awe and deeply admire what the people are doing in both countries. So we are appreciative.

Let me turn to a question, though, and Bonnie, you talked about two bills that you thought might be important. There's been no discussion about the arms sales. There's been no real discussion about administration policy or other than the two bills, Bonnie, what else Congress might do.

We are a U.S.-China Commission. What advice would you give to the U.S. to be able to be helpful to both the Taiwanese people and the Hong Kong people?

And whoever wants to respond.

MS. GLASER: Well, one of the things that I emphasized is digging into the question of what the U.S. is doing and can do to work with Taiwan to prevent Chinese interference in their political system, their social system, and their media.

I know that Assistant Secretary of Defense Randy Schriver has said publicly that we are doing things to work with -- with Taiwan to prevent interference. I don't know the extent of that and I don't know whether the U.S. is doing all that it can do.

My concern is that if we have a close election in Taiwan in January and you get a substantial number of Taiwan citizens who think that the outcome of the election was illegitimate, we will have a crisis in Taiwan's democracy and that is something that -- let's not -- let's not wait until it happens and this could be more likely if we have a third candidate that jumps into the race. Any one candidate is going to get a plurality; not going to win a majority and this really just could be a major crisis for Taiwan.

So identifying what is being done where money is flowing. I think they have pretty good law enforcement capabilities. But whenever I talk to senior people in Taiwan about this problem they say that understandably, because of their history of martial law, they don't want to take measures in Taiwan to crack down in a nondemocratic way.

So their answer so far seems to be greater transparency and that may not be enough. And so I just -- I hope that we can do enough to work with them so that we can prevent any major degree of interference that ends up being decisive in the outcome of those --

COMMISSIONER WESSEL: Just as a quick question there so that we can get to the

others, do our, you know, social media companies play a huge role there? Is it Chinese or is it Taiwanese? So the Facebook, Twitter, et cetera, is that something that we can do that will make a difference?

MS. GLASER: There are two very big social media companies in Taiwan. One is Facebook, used primarily by the younger people, and then something called the Line that is used more by older people.

COMMISSIONER WESSEL: And is that a Taiwanese platform?

MS. GLASER: It's Japanese.

COMMISSIONER WESSEL: Japanese. Okay.

MS. GLASER: It's Japanese. Yes. Now, obviously, they use WeChat --

COMMISSIONER WESSEL: Right. Right. I understand. Okay.

MS. GLASER: -- and, you know, Chinese assistance. But when it comes to social media, those are the two major companies. I know that recently Facebook has agreed to remove some fake accounts and Twitter as well.

But in Taiwan just tracking the number of postings and pages, there's one very good report that was done -- a journalist report -- about how on the day that the KMT, then candidate for mayor, Han Kuo-yu, said that he was going to run for mayor there was this page that was created on Facebook, not by him but by people who were essentially from mainland China and the argument that's made in that article with, I would say, more than circumstantial evidence but perhaps not enough that's absolutely decisive, is that a lot of the Han wave, what they called it, was the creating his image that brought him to power in Kaohsiung that may have been due to support from China and that's really worrisome.

So those are the two media companies that are particularly influential.

COMMISSIONER WESSEL: Dr. Lin?

DR. LIN: Yes. This is such a good question. I am trying to see how I can answer in a very short time.

First of all, I agree with everything Bonnie said. I think the problem of a democracy is that it's very hard to deal with nondemocratic organizations, institutions that are coming into your system and I think we know that best in the United States.

So Taiwan is facing unbelievable cyber warfare and this is going to -- this has been a big issue already in November 2018 in the mid-term election for mayors in Taiwan and some people attribute that, and Bonnie has written about it extensively in her testimony.

But I think that a corollary to this is trying to make sure that Taiwanese election is fair. It is also very important to look like the United States is not intervening and this also goes to Hong Kong.

A big part of the allegation by Beijing for both Taiwan and Hong Kong is the Brits and the Americans are behind everything.

While that's very nice to blame it on other people, but there is some truth to that in some ways and I think we need to avoid looking like we prefer any candidate.

So as my remarks show, I believe that the very big difference, of course, I didn't talk about between the Western liberal order, of course, is the focus on process as oppose to outcome.

And I think that if we can uphold a fair process so that Hong Kongers and Taiwanese can have a -- can have a role in their future that is very important.

But on Taiwan one more thing I want to say is the current administration's arms sales, since you talked about it -- and this morning nobody talked about it -- I think it's very important to not make Taiwanese or Hong Kongers feel like they are a pawn in somebody else's game, and

this is one thing that I think is very important too for Hong Kongers.

A lot of people say to the -- the young people in Taiwan and Hong Kong, you're just being played by American -- by the American government. And one of the signs, of course, is when arms sales go forward and then they go backward, people say, you see, this is just sort of for the United States to get something for the tariff war.

And I think that too as this morning's second panel talked about, separate the security from -- to not basically link issues is very important to make sure that the Taiwanese can defend themselves and that they are -- and to themselves.

And the second point is on Hong Kong. I think that the Congress should do everything they can to make sure that the Joint Declaration is adhered to -- that autonomy is not eroded and there are many, many things happening right now and I believe that if the U.S. -- the legislators can do everything -- if they can do anything they can, everything they can to hold China to it, this is very important.

But the one thing I want to say is I believe execution will be very difficult because many of the things being considered -- for example, financial sanction requires us in the United States to have the ability to find out who's doing what and to actually -- to hold people accountable, which is nearly impossible because most people do not have assets in their own name. And so I think that the practicality is very important, otherwise we are just legislating for the sake of looking like we are trying to uphold democratic institutions when there is no impact.

DR. HUI: However, Beijing likes to say that, you know, it warns the U.S. against meddling in its own internal affairs. The interesting thing is that Beijing and Hong Kong governments are very responsive to U.S. actions.

So why Carrie Lam for two and a half months refused to completely withdraw the bill but did so only early this morning? I suspect that it has much to do with today's hearing that you convened.

And then at the same time that why Carrie Lam -- and then at the same time why Carrie Lam, when she announced the suspension of the bill, it also should have something to do with the fact that Pelosi a week earlier was saying that she was going to use a fast track way to push through the Hong Kong Human Rights and Democracy Act.

And also this morning Professor Victor Shih highlights, China has benefitted so much from Hong Kong's special status. They really, really care about how the rest of the world think.

And so international actions and the Congress can really take a lot of actions to help Hong Kong people push through the Hong Kong Human Rights and Democracy Act as quickly as possible.

Imposing sanctions may be difficult. But what is really interesting is that even the talk of it has already convinced some of the -- some of these Hong Kong -- pro-Beijing politicians in Hong Kong to sell their assets in Hong Kong. They are blaming the U.S. They worry that their assets will be seized by the U.S. government.

So there is actually some kind of deterrence effect, and then at the same time when it comes to the administration, I was very frustrated when President Trump said early on that, well, first, President Xi Jinping has been responding to the protests in a very responsible way, and then later on he agreed that the protests were riots and then he connected the Hong Kong protests or, you know, the non-use of violence and connecting that to the trade deal.

Hong Kong should not be treated as just a bargaining chip because if you use Hong Kong as just a bargaining chip, then if there is a trade deal then Hong Kong could be sacrificed.

Hong Kong people, as also Dr. Lin was saying earlier, Hong Kong people stand for

universal values. They stand for democracy and freedom. They should be supported just because of its -- it's a matter of principle.

And so and also at the same time this is also good for the world. Hong Kong is an international city. Whatever happens in Hong Kong affects not just the U.S. but the rest of the world.

MS. GLASER: If I could just jump in very briefly on the arms sale question. Of course, I agree the United States shouldn't use Taiwan as a -- as a pawn.

I don't see any evidence of linkage between arms sales to Taiwan and the U.S.-China trade talks. I think selling arms to Taiwan is not putting a thumb on the scale of any particular candidate or should not be seen as weighing in on the side of anyone.

This administration came in with a commitment to normalizing the process of arms sales to Taiwan. I think that is long overdue.

There have been four arms sales made and I don't think that we should be connecting the issue of arms sales requests, approvals, that process with the political schedule in Taiwan.

And so I personally am glad to see that there has been some progress made towards that normalization.

COMMISSIONER FIEDLER: Thank you.

Let me -- I disagree with you on the role of the United States in influencing Carrie Lam to withdraw the extradition bill. I think it had much more to do with the millions of people turning out on the street consistently and refusing to go back home.

I also think it's not over and that the next issue is a much more difficult one of universal suffrage because there will be no permanent change or change between now and the end of the 50 years unless there's been universal suffrage.

That had been falsely promised and dangled and withdrawn over the years and I suspect a very dangerous thing for Beijing to do for itself -- to offer universal suffrage to Chinese people nearby.

So that we may be entering a phase in the protests that are even more difficult and dangerous than have been up to this point because somewhat experienced in this country with protests and organizing, having spent my entire life doing it, the universal suffrage questions is not as easily -- by Xi Jinping, and whether young folks -- I -- my gut is that they are not going to be satisfied and perhaps should not be satisfied until they get universal suffrage.

So and I actually don't believe that the United States has a great deal of influence here, especially influence that exceeds the people of Hong Kong themselves at the moment.

DR. HUI: Thank you. I absolutely agree with you that the Hong Kong people's courage and their persistence, despite all the police brutality they continue to pour into the street, is very important.

What I wanted to say is that U.S. actions matter. Don't think that it's -- you know, whatever you do is not going to be important, and so this is -- and also at the same time I think that the world is paying attention to what is going on in Hong Kong only because Hong Kong people have persisted.

And I earlier also said that the only thing that has actually preserved one country-two systems today is the determination of Hong Kong people -- their insistence that they are going to continue to keep fighting.

So I agree with you absolutely that Hong Kong people are going to continue fighting, and there are also efforts that Hong Kong people, because the police have become so brutal, they are actually also taking less risky methods. For example, they are developing apps to arrange --

target the boycotts of these pro-Beijing businesses and also provide targeted support of pro-democracy businesses.

And then people are also arranging that -- they are getting together to yell out protest slogans at 10 p.m. every night so that you have echoes of dissent going through all the neighborhoods.

And then at the same time I also want to say that, yes, the last part about the last demand to reopen the discussions of universal suffrage is going to be very difficult.

But at the same time, if I were to advise the Politburo, Beijing has done such a good job at instilling patriotism among mainland Chinese.

So so many mainland Chinese they actually don't agree with Hong Kong people. They think the Hong Kong people -- basically, you guys are too spoiled.

They don't really care about, you know, their own -- having democracy in China. If that's the case, then the Politburo should be rather sure that while, okay, you don't really have to make Hong Kong safe for China because they have already done a very good job at insulating Hong Kong from the rest of China.

COMMISSIONER FIEDLER: My question really is am I correct in thinking that universal suffrage is going to be the next big issue on the street of Hong Kong?

DR. LIN: Absolutely. So I think, as Victoria has said, the compromise came too late too little. That's a headline today --

COMMISSIONER FIEDLER: Yeah.

DR. LIN: -- in all the Hong Kong newspapers in Chinese and in English. Basically, I think today in this panel we didn't even talk about the fugitive law, and that's the case in point -- extradition law. Sorry.

And that's the case in point. It's irrelevant now. People have gone beyond it. They realize the one country-two system is under threat and that's where it's going to head and I fully agree with you.

Whether there are people who are involved with these young people or not, they truly from the bottom of their heart want a different future for themselves.

COMMISSIONER FIEDLER: Thank you very much.

Jim?

COMMISSIONER TALENT: Thanks to the three of you. What's happening in Hong Kong is magnificent. I hope it works. But whether it does or doesn't it gives everybody hope who believes in freedom.

So my question is about Taiwan and you talked about polls in Taiwan. When I look at the relationship between Taiwan and the mainland, how far out on a limb Beijing is on this, I guess my question is do you think the people of Taiwan are going to be willing if they have to do the equivalent of what's happening in Hong Kong now, and that would be, to me, a scenario like there's a confrontation. It begins to escalate, and the mainland threatens, look, if you don't do X we are going to attack. And it's going to be missiles; it's going to be hitting you. So do you think they are willing to say, well, okay. You may be able to destroy us but we are not going to give up, which is what they are doing in Hong Kong now, right.

And one of the reasons I ask is because I think that kind of willingness is the kind of thing that would lead the rest of the world, maybe led by the United States, to say no. If you attack them we are going to help.

So is there any way of knowing what they would do under those circumstances?

DR. LIN: I think Bonnie would have a lot to say about this. I am going to start, briefly,

and let her take it from here.

But I think we are seeing it. In four months the Taiwanese people will choose and many of them believe they are choosing against all odds. So there are two sides of the story for the presidential and, very importantly, legislative election. It is not just about the president. The legislators will turn over at the same time next year, and this is very important because if either party were to gain the executive and legislative control this will be very important for the next four years and for the future of the region's stability and what kind of future we are looking at.

And I think that a lot of people are saying if you were to vote for the incumbent, President Tsai, we will see war. And as we know it already, the Taiwan Strait this year you've had more PLA Navy ever than ever before.

So I think, number one, it's already happening every day. So unlike Hong Kong where it is part of China and one country-two system is a system, Taiwan actually has always lived on the edge and every day they say to their selves we are facing a test and our choice is going to mean what we mean.

And I think a lot of people, as I said, believe that if you vote for President Tsai, Taiwan's economic future will be cut off and, more importantly, the security may also be risked, even though the other side says you will be risking Taiwan's security if you vote for the KMT.

Actually, a lot of the -- I think the KMT campaign focuses on you'll be risking security because China for sure will be looking more closely at using force if the DPP were to come into power.

COMMISSIONER TALENT: So if I understand you correctly, you're saying the election is going to -- the results of the election are going to tell us a lot about the answer to my question?

DR. LIN: Well, usually, if you look at 1995 and 1996, before the election there will be more action. So let's hope that that is not the case.

I think that this is very, very important for Beijing and so the test that we are talking about in Hong Kong -- in Hong Kong, as Victoria and I are both saying, the Hong Kongers were -- I wouldn't say happy but they were taking it one day at a time. Most of them were first generation, second generation Chinese. So it's very different. Where Taiwanese, basically, were cut off for decades from China.

So the Hong Kongers' sense of being a Hong Konger is very much based on civic values only developed in the last few years after the handover whereas Taiwan has a much longer history.

So Taiwanese have lived with the choice almost every day, every election they go to -- and there's so many elections. Every election they believe they are showing the world we make a choice despite the fact that it could hurt us in some people's sense.

And so that's the one thing I wanted to say. And the second is in terms of this fight -- the struggle, as Xi Jinping said this week at the Central Party School, the struggle -- I think for the Taiwanese it's a bit different.

They've already done it. In 2014, the same year as the Umbrella Movement, Taiwan started in March with the Sunflower Movement where students boycotted going to school for more than three weeks and occupied the parliament in order to reverse the ratification of a China service trade agreement.

So they have already done it, shown the world, and on that point I'll give it to Bonnie.

MS. GLASER: I think it's a really excellent question. It's really a question that is in two parts. You know, one is what is determination of people in Taiwan to defend themselves and then what is the perception in mainland China of Taiwan's determination to defend itself.

There's really a third piece about what the U.S. perception is as well because if we are going to come to their aid we need to know that.

So I am not -- I wish that I had data points. I wish I had something that I could look at that would tell me the determination of people in Taiwan to defend themselves.

They live under the -- a very serious threat from mainland China that has only grown over the last couple of decades. And yet, the amount of information about that in the media is virtually nil. It's not really much part of their education. I am glad to see now the military is opening up bases. Like, once a year they invite the public in to interact with the military.

But whether KMT or DPP, any ruling party in Taiwan sort of wanted to keep that threat on the side, not talk to the people about it, not a good idea, in my view. Their recruitment is improving for the all-volunteer force but the demographic challenges are going to make it very difficult for them to build a very capable military.

Right now, their conscription is down to -- they have four months service. The people who come in -- what do you learn in four months? I've talked to young people in Taiwan. They learn how to take apart and put back together a gun and they are very proud of it, and I think they learn how to shoot it.

So I guess I think that the trend lines are that as more -- you get more younger people in Taiwan that they too will feel like the people of Hong Kong, that they really value their freedoms -- that they've never known anything else and I'd like to believe that they would be determined to fight for them.

But I think Taiwan is very different from Hong Kong. Its circumstances are very different and, I mean, I am not certain. I want -- I want the U.S. and Taiwan to do enough so that the PRC believes that Taiwan is determined to defend itself.

And a growing problem that we have, given China's growing anti-access and area denial capabilities, is that that figure people used to throw around years ago if they hold out for two weeks the United States will be there is long, long gone and the figure that I hear some people discuss today is about three months, and I don't know how reliable that figure is.

So we need Taiwan to be determined to defend itself and whatever we can do for them in peacetime to help bolster that and the PRC's perception of it I think is incredibly important.

VICE CHAIRMAN CLEVELAND: I have a couple of questions. But let me start by saying that I think -- Carolyn and I were emailing over the weekend about the nature of the protests and what has been so impressive to me is how innovative they are and how when the police deploy a specific tactic against the demonstrators they modify what they are doing and come back in a new form that has been truly impressive in its scale and certainly the commitment to freedom and democracy.

And I've said, you know, when you watched students at the -- the protestors at the airport and then the Metro was shut down and streams of cars showed up to pick up the students, it was reminiscent of the efforts made when there was a boycott of the bus system in the South in our early history. So it is innovative in one way and very reminiscent of some historical struggles for democracy and freedom.

So I applaud the courage of everybody who is speaking out. I also share the view that the United States taking a very public posture in support of what is happening is crucial to democracy.

I also believe that it's important to stick to the law in some way and the basic law memorial. It includes language that's very specific about the citizens of Hong Kong being in a position to take legal action against their officials if they -- if their rights are violated.

So my first question is, is there any effort underway to take that legal action. Because it's one thing for the United States to sanction Carrie Lam. It's another thing for the citizens of Taiwan to take legal action when their rights are breached.

And then the second part of -- same sort of issue in terms of legal, I noticed yesterday Agnes Chow won her case in the courts and may or may not have the opportunity to run for Legco. That seemed to me a faint glimmer of hope in terms of the sanctity of the judiciary system in Hong Kong. So I am curious whether or not you feel the courts may mitigate some of the damage done by the 1,117 and counting arrests. So what role with the courts play and will it be independent. So those are my two questions.

DR. HUI: The last question first is that of using the courts. Because a lot of these arrests are still in the early stage and they haven't really -- and essentially they are still just trying to stand in line to wait for the hearing.

And already that we have massive lawyers. Lawyers have staged these silent marches and even prosecutors have come out speaking against police actions, especially the massive sweep -- the massive arrests on August 30th.

And the problem, of course, is that Beijing has appointed all these loyalists. So the secretary for justice is one of those loyalists and she, for months before the bill was suspended kept saying that, oh, all the -- all these lawyers and the legal sector they don't -- you guys, you know, despite the facts that these are experts. You guys just don't understand the extradition bill. This is fine. It's all going to be great. And then, of course, as soon as the bill was suspended then they turnaround.

So the problem is that essentially Hong Kong has really been ruled by Beijing loyalists for all this time. And so a lot of the -- so the DOJ and the secretary for justice -- the Department of Justice, there are a lot of people who would do Beijing's bidding.

And then at the same time the courts have also been backed by more pro-Beijing loyalists as well. So this is why that early on when the governments asked for retrial of some of these young people, originally they were just given community service and then later on the court said that no, these people have to be locked up.

So these are the real concerns we have. The hope that we can have is that lawyers, prosecutors, a lot of these people are willing to even sacrifice their job in order to stand up to speak for justice. So this is very important.

And another thing I want to say is that when it comes to Agnes Chow's case, as she calls it, this is a Punic victory in a sense that the judge ruled in her favor only on this technicality that she was never even asked to defend herself.

And so if next time these election officials who are just -- if they just ask these people, you know, what exactly do you stand for -- do you really pledge your support to the basic law. But if you guys ask for self-determination autonomy that is tantamount to independence. So then we don't trust you. Then next time they may still be disqualified.

And another thing is I -- thank you so much for, you know, giving so much attention to what is going on in Hong Kong. All the experience of, you know, people when the -- train service and also the bus service they got cancelled that you have these massive middle class people with their own cars which go pick up these protestors. This just goes to show how massive the popular support is behind the protestors.

At the same time, though, I am hoping that, you know, they are also going to become even more creative in the face of police brutality because we are talking about not just 10 years in jail -- that these people -- some of these people probably will never recover from their brain

bleeding and also broken bones and everything.

And so they have to do things that can avoid police brutality so, for example, using targeted boycott against pro-Beijing businesses and targeted support of pro-democracy businesses.

And at the same time these pro-democracy employers and pro-democracy young people there are also these efforts -- platforms to bring them together.

So, essentially, if there are ways to establish essentially an alternative economy then the protests can continue. And yes, Hong Kong people are not going to give up the last amount of -- demands today -- getting genuine universal suffrage -- because they really understand why Carrie Lam basically is really just a puppet. She has no autonomy to even quit the job. And so the only crux of the issue is that Hong Kong people do not really have their own government.

DR. LIN: I would just add to that. I think the -- Commissioner Cleveland, you're absolutely right. The big test of Hong Kong's autonomy is going to be at the judicial level.

Hong Kong has an incredibly sophisticated and very deep bench in terms of the legal profession and many have come out to say, I think, very fair statements and to be just and to stand on the side of the Hong Kong people.

But whether this will erase the fact that so many localists or young people who've been elected have been disqualified in the past few years, I think this is a chance if you all go on the optimistic side, again, for a Hong Kong government -- SAR government -- to show that they have autonomy, that they are not intervening in the judicial proceedings and for Beijing also to let it go forward in a justice way.

But in the last few years, the judicial branch is where you see actually an erosion of autonomy. And so I am very much hoping with Agnes Chow's case. But as Victoria says, it's really not a victory as much as something long overdue and very technical.

But I think that if Beijing and the Hong Kong government were to be interested in conciliation and as all of you have pointed out, universal suffrage is going to be very difficult. But at least the first step is that the court, the judges can provide some just ruling for the more than 1,000 rioters who've been arrested.

I live five minutes from the start of the protests. Every weekend that's what I live in. I live in Causeway Bay, and there are children, families, going to these protests and people providing First Aid who are being arrested, and they've been -- their passports have been taken.

They cannot leave and I think that many of them are just in the early stage, and so many of them have been using the same lawyer that the lawyer doesn't have time to take on new cases. So we have a real big issue that's unfolding in front of you in the next few weeks.

VICE CHAIRMAN CLEVELAND: Commissioner Kamphausen?

COMMISSIONER KAMPHAUSEN: Thank you very much. I am sorry that I missed your oral testimony due to other business. But I've read your testimonies and very much appreciate all that you've laid out.

I just have one question for Ms. Glaser -- Bonnie. You talk about -- you note the event of March 31st and perhaps you discussed it in your oral testimony.

But I'd invite you to maybe speculate a little bit on this event, perhaps informed by the fact that I was in Taiwan not long thereafter and had some private discussions with leaders.

It occurred to me, and I am asking actually for your comment and feedback, that this might be a -- if not an inflection point at least a new -- the beginning of a new phase in PRC coercive efforts vis-a-vis Taiwan in the military space.

The unique features of it, the almost public taunting of Taiwan's ability to respond, and

you note the president's statement and responses to what the Taiwan air force will do in the future.

But the initiative is completely with Beijing and the variations of how they could undertake similar types of actions in the future put Taiwan completely on the defensive unless they find an opportunity to change the dynamic, and that really brings into consideration concerns for the U.S. and how to manage risk escalation.

So first, I invite your comment -- is this a new development or is it incremental? And then what are some potential responses we might consider?

MS. GLASER: Great question. I recently had somebody ask me whether Taiwan was more concerned about the bombers and fighters that have been circumventing the island or this particular episode on March 31st and on the one hand the circumventing activities of the -- and naval activities too are becoming more persistent and more sort of routine, and the events that we are talking about here are so far one off. We don't know whether this is going to become part of the new normal.

I've talked -- I remember being at a meeting in New York where Taiwan affairs office representatives were as well as scholars from China and there were different theories in the room put forward as to what had triggered that particular action.

The fact that that crossing of the middle -- and it took place, as you know, in sort of the southern part of the midline so it wasn't the shortest part. But it hadn't happened in 20 years. And yet there was no agreement on the Chinese side as to what exactly had triggered that kind of response.

And so it led me to believe that this was almost planned on the Chinese side -- that they were just looking for perhaps anything that they can retroactively blame it on.

But they are, as you say, doing new things. They are being more creative and that is the most provocative thing we have seen in the military space.

But you can look at other things that they are doing. Pressure on, of course, multinational companies that we have seen like the change that they demanded in the name of airlines on their websites was something they had not done before.

I wonder if they have gone out to different parts of their system and said come up with ways we can use coercion more effectively against Taiwan.

So I am worried about that, and if we look specifically at that March 31st episode, we know, of course, that Taiwan scrambled -- they intercepted the fighters. If that does become a more common event then the risk increases of some kind of accident in the Taiwan Strait that we certainly don't want to see.

But the toughest part of your question then is what do we -- what do we do about it. Certainly, one thing we can do is to privately communicate to the Chinese how dangerous that is and I think that there are times when we tell the Chinese something that they are doing that is really beyond the bounds and beyond the pale that we do not want to see -- that it is just too dangerous.

And, you know, Taiwan can find ways to communicate that as well. I understand that the U.S. recently -- I believe it was just two months ago -- had an aircraft that flew along the midline of the Strait. It was not a fighter. I think it was a tanker. We can send signals as well like that -- that we are willing to defend Taiwan, of course, and we can find various ways of doing that.

But if the Chinese are determined to use coercive ways and more creative ways than they have in the past, it's going to pose a lot of challenges to Taiwan and to the United States.

But thank you for the question.

COMMISSIONER MCDEVITT: Bonnie, I have a quick follow-up. Do you know if Taiwan launched fighters to go check out the Russians who are flying around the island? Or Shirley, you may know.

MS. GLASER: I'll be there next week. I'll ask.

[Laughter.]

MS. GLASER: I have not -- I have not had the opportunity to ask. But it is quite notable that the Chinese side said nothing in reaction to the fact that the --

COMMISSIONER MCDEVITT: That doesn't -- that doesn't surprise me. But I just wanted to know what Taipei did.

MS. GLASER: I am not even sure exactly how close they flew. But interesting that the Russians just like -- of course, after that we saw them fly over Dokdo as part of --

COMMISSIONER MCDEVITT: Yeah. That was just crummy navigation.

[Laughter.]

MS. GLASER: Okay. And if you believe that I've got something else I can sell you.

VICE CHAIRMAN CLEVELAND: Chairman Bartholomew?

CHAIRMAN BARTHOLOMEW: Thank you. Again, and I want to associate myself with Robin's comments. It's really been extraordinary to watch not only the courage of the people of Hong Kong but the brilliance and the creativity of the young people who are -- who are changing tactics in a leaderless peaceful organization.

They are changing tactics and taking care of each other and even people who are not protesting. I think it's a real -- it's an inspiration, frankly, around the world, which is probably one of the things that Beijing doesn't like.

I am not asking for an answer on this, but since Mike said, you know, if we are -- if we are the standing committee, I think one of the issues that the standing committee really needs to be thinking about is what happens after you take over a place where the population opposes you, right. I mean, it is not just leading up to it and doing it, but what do you do as what would essentially be an occupying force in Taiwan and in Hong Kong, and I hope that they are thinking down the road because I think that it would be very messy and I don't think that they would achieve the outcomes that they want in doing this.

But the other point I wanted to make is we have had this whole hearing and we really haven't talked about foreign interference. So Beijing ridiculously accuses us of being the black hands behind what's going on and meanwhile on college campuses around the world Chinese mainland inspired -- I use that word -- protestors are protesting against people who are supporting Hong Kong, sometimes violently, and it's very ironic, of course, that they are exercising free speech rights in doing that that they want to deprive the people of Hong Kong of.

So there's so many issues embedded in all of this. There's economics and there's security and there's all of these freedom issues. It's a complicated situation but part of it is quite simple, which is, you know, the people the fighting for values that we hold dear in this country and believe they are universal values and universal human rights and, you know, we should continue to stand with them.

DR. LIN: Could I say something to that? That's very important for both places because actually Taiwanese have experienced that for three decades already. Any time you hold a speech, first, no flag; second, no name; third, no title. All these rules apply to Taiwanese around the world.

And so the courage that they exhibit to do what they do and to stand for the candidate they stand for and to continue to stay -- I will work in China but I believe in democracy and

freedom and I will go home when I am done with this assignment -- I think it's incredible.

And today with what's happening in Hong Kong, the pressure is on all over the world. There are students, and I would say this as a teacher -- I've had students in Hong Kong for the last 10 years.

Basically, half my class are from mainland China. Half are from Hong Kong. They used to coexist peacefully. The last five years have been very difficult. Three years ago we had a fight in class -- fist fight -- a physical fight, and I think the intolerance of people who don't let others speak, I would say, like you said, absolutely right. When people are accusing others of intervening, we should think first: who is actually intervening.

And the biggest manifestation actually of this is what Bonnie had said actually -- more so than physical, which is actually quite limited. If you think about people around the world who could be fighting each other on the street, in Prague and New York, it's very limited. The real issue is online now. I think for the new generation online bullying by Chinese netizens is now not even being paid for.

People actually feel that they need to defend Chinese patriotic values and really curtail other people's rights, and so anybody who speaks up for a Hong Kong protestor must be a pro-independence-ista. And likewise, Taiwanese have had this issue for many decades. But, of course, in Taiwan's case, if you were to do anything you'll be taken away in terms of monetary incentives, opportunities to work, and to go to China.

VICE CHAIRMAN CLEVELAND: So on that note, I think I will quote my former boss and say -- and embellish, I think we are out of time. We are 15 minutes, and we have a business meeting.

COMMISSIONER LEWIS: I'd like to ask you for your assessment of what I asked the earlier panel, which Jim called the \$64,000 question. What do you think of the willingness of the PRC to use force with Taiwan?

VICE CHAIRMAN CLEVELAND: One word.

MS. GLASER: They are not there yet. If they have to it's a last resort. It's an option they would exercise. But I believe Xi Jinping has an enormous amount on his plate. I don't think they've given up on peaceful unification. That could happen someday. But I personally don't think that we are very close to that.

COMMISSIONER LEWIS: Thank you.

DR. LIN: I agree with Bonnie. I think it sounds better than actually done and I think it's important for the domestic audience in China that this message continues to be said by some people in Beijing. But actually the likelihood of it, in my assessment, is low.

VICE CHAIRMAN CLEVELAND: So back to wrapping up --

COMMISSIONER LEWIS: Thank you very much.

VICE CHAIRMAN CLEVELAND: -- I think I will finish on the note that Senator McConnell said recently, which is I think it's -- if you didn't come away with this impression, we stand with Hong Kong and Taiwan.

The Commission is adjourned for the year in terms of hearings. Is that right? And the next meeting that we will have we will be rolling out the annual report.

So thank you very much. Your testimony was compelling.

(Whereupon, the above-entitled matter went off the record at 3:30 p.m.)