

CHINA'S NEW LEADERSHIP AND IMPLICATIONS FOR THE UNITED STATES

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

ONE HUNDRED THIRTEENTH CONGRESS
FIRST SESSION

THURSDAY, FEBRUARY 7, 2013

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COMMISSION

WASHINGTON: 2013

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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).

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

February 13, 2013

The Honorable Patrick J. Leahy
President Pro Tempore of the Senate, Washington, D.C. 20510
The Honorable John A. Boehner
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR LEAHY AND SPEAKER BOEHNER:

We are pleased to notify you of the Commission's February 7, 2013 public hearing on "*China's New Leadership and Implications for the United States.*" The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, section 635(a)) provides the basis for this hearing.

At the hearing, the Commissioners received testimony from the following witnesses: Christopher K. Johnson, Senior Advisor and Freeman Chair in China Studies, Center for Strategic and International Studies; Dr. Cheng Li, Director of Research and Senior Fellow, John L. Thornton China Center, Brookings Institution; Dr. Eswar Prasad, Senior Professor of Trade Policy, Cornell University; Nicholas Borst, Research Associate and China Program Manager, Peterson Institute for International Economics; Dr. James Mulvenon, Vice-President, Intelligence Division, Defense Group, Inc.; Roy D. Kamphausen, Senior Advisor for Political and Security Affairs, National Bureau of Asian Research; LtGen Wallace 'Chip' Gregson, Jr. (USMC, ret.), Senior Director, China and the Pacific, Center for the National Interest; Dr. David M. Lampton, Professor and Director of China Studies, Johns Hopkins University, School of Advanced International Studies; and Dr. Michael Auslin, Resident Scholar and Director of Japan Studies, American Enterprise Institute. In 2012, the Chinese Communist Party's 18th Party Congress ushered in a new generation of political leaders, raising questions over what China's priorities will be over the next decade. This hearing examined impacts of China's recent leadership transition through the lenses of China's domestic policies, its economy, and its military. Additionally, the hearing included a discussion on the United States' evolving policy towards Asia.

We note that prepared statements for the hearing, the hearing transcript, and supporting documents submitted by the witnesses will soon be available on the Commission's website at 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 other issues enumerated in its statutory mandate, in its 2013 Annual Report that will be submitted to Congress in November 2013. Should you have any questions regarding this hearing or any other issue related to China, please do not hesitate to have your staff contact our Congressional Liaison, Reed Eckhold, at (202) 624-1496 or via email at reckhold@uscc.gov.

Sincerely yours,



Hon. William A. Reinsch
Chairman



Hon. Dennis C. Shea
Vice Chairman

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CHINA'S NEW LEADERSHIP AND IMPLICATIONS FOR THE UNITED STATES

THURSDAY, FEBRUARY 7, 2013

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION*Washington, D.C.*

The Commission met in Room 2212 Rayburn House Office Building, Washington, D.C. at 9:00 a.m., Chairman William A. Reinsch and Vice Chairman Dennis C. Shea (Hearing Co-Chairs), presiding.

**OPENING STATEMENT OF CHAIRMAN WILLIAM A. REINSCH
HEARING CO-CHAIR**

CHAIRMAN REINSCH: Good morning, everybody. Welcome to the first hearing of the U.S.-China Commission's 2013 Annual Report cycle. Let me begin by welcoming the two new Commissioners, Katherine Tobin, who is right there, and Senator Jim Talent, who is right behind me, who have joined the Commission this year. I'm sure you'll be hearing from them later on in the question period.

Today we're going to examine the changes in China's political, economic, and security landscape following the Party Congress last November. We'll also discuss U.S. policy toward the region in light of the changes that occurred then. We have assembled a strong set of witnesses to address different aspects of China's leadership transition, and I want to thank them for their participation in the hearing.

Last fall, the Chinese Communist Party's 18th Party Congress ushered in the "Fifth Generation" of political leaders. We'll begin today by assessing who was selected for the Politburo Standing Committee, who was not selected, and what these decisions suggest about the Party's policy, directions, and priorities.

Although Xi Jinping and Li Keqiang's appointments were long anticipated, other outcomes surprised outside observers. We look forward to hearing our witnesses' testimony today about how these officials' backgrounds, loyalties, patronage networks, and other factors may have affected the transition. More importantly, we're hoping to gain insight about what the new leadership team means for China's governance over the coming decade.

The second panel will assess the prospect for economic reform under China's new leaders. We know already that Xi and Li face internal and external challenges. Inside China, they must overcome growing economic

inequality and other structural imbalances along with endemic corruption and entrenched local interests that will resist reforms. Their central dilemma is the likelihood that any meaningful reforms will undercut Party control.

In addition, the global economy heavily affects China's economic performance. Our witnesses today will provide insight into how China's new leadership will attempt to meet these challenges, or whether the status quo will prevail as China's leaders seek to maintain their 7.5 percent economic growth target as well as the Party's position in power. This panel will lay the foundation for forthcoming Commission hearings on China's economy and its financial sector.

Let me now yield to the co-Chair of today's hearing, Vice Chairman Shea, for his opening statement, and then I'll introduce the first panel.

**PREPARED STATEMENT OF CHAIRMAN WILLIAM A. REINSCH
HEARING CO-CHAIR**

Welcome to the first hearing of the U.S.-China Commission's 2013 Annual Report cycle. Today we will examine the changes in China's political, economic, and security landscape following the Party Congress last November. We'll also discuss U.S. policy toward the region in light of these changes. We have assembled a strong set of witnesses to address different aspects of China's leadership transition, and I'd like to thank them for their participation in this hearing.

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Thank you.

**OPENING STATEMENT OF VICE CHAIRMAN DENNIS C. SHEA
HEARING CO-CHAIR**

VICE CHAIRMAN SHEA: Well, thank you, Chairman Reinsch, and thank you again to our witnesses for joining us.

Our first afternoon panel will address the military leadership transition that--like the broader political transition--held a few surprises. Chief among these was the clean break in the chairmanship of the Central Military Commission from Hu Jintao to Xi Jinping. This represents a clear deviation from the pattern set by Jiang Zemin, who held on to the chairmanship following the transfer of power to Hu Jintao a decade ago.

Xi has already begun to consolidate his power over the military: he has managed a wave of high-level promotions and urged the People's Liberation Army to maintain "combat readiness." His personal linkages to the military have been said to help cement his authority as head of China's armed forces.

I look forward to a discussion with our witnesses about what we can expect from the PLA under Xi and the other new top military leaders. We're hoping, in particular, to gain insight about what these personnel changes mean for China's security policies over the coming decade.

We'll conclude today's hearing with a panel on policy implications of these transitions for the United States. By now, the broad outlines of the U.S. "rebalancing" to Asia are well-known. We're interested in our witnesses' views on how sound the policy is and how well it's been implemented so far. We have made it a priority to invite panelists with different perspectives on the issue, and we anticipate a fulsome discussion on the policy's strengths and weaknesses. We have asked panelists to consider the Chinese response to the rebalancing, as well as regional responses.

Finally, a couple of housekeeping items before we begin. I'd like to offer our sincere appreciation to Representative J. Randy Forbes and the House Armed Services Committee and their staff for helping us secure this room today. As always, I'd like to remind witnesses to keep remarks to seven minutes so that we have ample time for our question-and-answer session. I too would like to join the Chairman in welcoming our new members, Katherine Tobin and Senator Talent. I'd also like to welcome Reed Eckhold, who is our new congressional liaison, and Kimberly Hsu, our security expert, who helped set up this meeting, who's a later arrival but a recent one as well.

So with that, I'll yield back my time to Chairman Reinsch.

**PREPARED STATEMENT OF VICE CHAIRMAN DENNIS C. SHEA
HEARING CO-CHAIR**

Thank you, Chairman Reinsch, and thank you again to our witnesses for joining us. Our first afternoon panel will address the military leadership transition that—like the broader political transition—held a few surprises. Chief among these was the clean break in the chairmanship of the Central Military Commission from Hu Jintao to Xi Jinping. This represents a clear deviation from the pattern set by Jiang Zemin, who held on to the chairmanship following the transfer of power to Hu Jintao a decade ago. Xi has already begun to consolidate his power over the military: he has managed a wave of high-level promotions and urged the People’s Liberation Army to maintain “combat readiness.” His personal linkages to the military have been said to help cement his authority as head of China’s armed forces. I look forward to a discussion with our witnesses about what we can expect from the PLA under Xi and the other new top military leaders. We’re hoping in particular to gain insight about what these personnel changes mean for China’s security policies over the coming decade.

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PANEL I INTRODUCTION BY CHAIRMAN REINSCH

CHAIRMAN REINSCH: Thank you.

The first panel features two distinguished China leadership analysts. Chris Johnson is currently the Freeman Chair in China Studies at CSIS. Prior to that, he was a senior China analyst at the CIA. I can say that apparently.

[Laughter.]

CHAIRMAN REINSCH: With experience advising policymakers on a variety of China issues, including national leadership transitions.

Dr. Cheng Li is the Director of Research at the Thornton China Center at the Brookings Institution. He's also Director of the National Committee on U.S.-China Relations. Dr. Li testified before this Commission during the last major leadership transition so we're looking forward to his insights this time around. I'm sure he got everything right last time so we're going to wait with great interest what you're going to tell us this time.

Thanks to both of you for being here. Mr. Johnson, let's begin with you, and then we'll go to Dr. Li, and then we'll have questions.

**OPENING STATEMENT OF CHRISTOPHER K. JOHNSON
SENIOR ADVISOR AND FREEMAN CHAIR IN CHINA STUDIES
CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES (CSIS)**

MR. JOHNSON: Thank you very much, Mr. Chairman, and let me just start off by thanking the Commissioners for the opportunity to come down and address them on this very important topic. In the interest of time, we'll just dive right in.

I'd like to start by giving a broad overview of my assessment of the process and political outcomes that we've just been through with the 18th Party Congress last fall and then seek to provide some very quick thoughts and kind of broad strokes about what it all may mean for the new leadership team's approach to key policy matters.

In terms of the political process and its outcomes, I'd like to focus my opening remarks this morning on what I believe to be three key and closely related misconceptions about the transition that are part of the broad sweep of analysis and commentary that has followed the Party Congress. I think, first and foremost, and in some ways most significant, is the notion that's been out there in the sort of analytic churn of the return of former President Jiang Zemin in the process, or the idea that he dramatically reinserted himself in the political process to shape the new leadership lineup.

This narrative also posits that through his meddling, Jiang somehow altered the rules of the political game in a way that runs counter to the broad trend toward greater institutionalization of the succession process that we've seen developing in recent years, and that, in turn, these actions by Jiang made the process at least more unwieldy as the leadership struggled to form a consensus on the new lineup, if not inherently more unstable.

But in my assessment, the reality of the situation is that a careful analysis of the eight years since Jiang left formal office makes abundantly clear that he never really left the political stage. His strong influence was manifest in the last several years in several ways, but particularly in the personnel sphere, in shaping the leadership lineups that came when he formally retired at the 16th Party Congress in 2002, following again, the 17th Party Congress, and then again here recently at the 18th Party Congress in the fall.

So with that in mind, his strong hand in shaping the new leadership team should therefore come as no surprise in a system that tends to value personal power and has few hard and fast rules governing the political process.

A second key misreading of the Party Congress results is the idea that Xi Jinping likely will be as constrained when it comes to setting his own policy agenda as Hu Jintao was when the latter took power at the last transition a decade ago.

This is because in this line of thinking, Xi is surrounded by Politburo Standing Committee colleagues that he did not choose, and that

he's also hemmed in by not just one but now two retired Party General Secretaries, Jiang Zemin and also Hu Jintao, the departing Party Secretary and President, both of whose interests must be accommodated as Xi thinks about how he's going to take on the policy and personnel challenges that he faces going into the future.

Both of these statements are true as simple matters of fact, but in my own assessment, based on the broad context of what we saw with the Party Congress, they probably lack broader explanatory power.

This is because whatever Xi's differences may be with his mostly Jiang Zemin-backed new Politburo Standing Committee colleagues, there presumably is far less policy daylight among this group than if more Hu allies, the people who did not make the Politburo Standing Committee, who I assume Dr. Li will go into in great detail, were appointed to the top ranks.

Secondly, the other key Party and personnel developments at the Congress certainly appear consistent with a sort of broad desire among the top leadership to fully empower Xi Jinping given the challenges that the leadership is facing in the economics sphere, in the political process sphere, and in the foreign policy sphere as well.

There is also, for reasons we can go into in the question and answer period, I think ample reason to believe that Xi will be far less constrained than Hu Jintao was when it comes to the meddling of retired predecessors from behind the scenes.

And the final misconception I'd like to discuss is this idea that the new Politburo Standing Committee leadership is innately conservative and therefore allergic to any type of reform whatsoever. In my estimation, this conjecture is sort of overstated, if not completely wrongheaded. While it is true that the new top leadership is definitely more conservative in orientation than if some of the more reform candidates who did not make the list were chosen, these people are not by their sort of intrinsic nature opposed to all types of reform. In fact, most of them have served in their past capacities in some of the most reform-oriented provinces in China, where economic experimentation is part of the job.

So I think, moreover, a lot of the new Politburo Standing Committee's members, five of the seven, will actually be retiring in five years' time if the Party continues to hold to the informal age restrictions that they've been following in the last several Congresses. So, in many ways, these five individuals, this is their last time in office so they have less constraint than they might if they were potentially worried about having to seek another five-year term.

So what does this all mean? In broad strokes, I think it means that the new leadership team is (a) more stable than a lot of the analysis has predicted and (b) more able to take on some of the challenges that they are facing in terms of the key economic difficulties, primarily in the economic sphere that they are facing, than their predecessor leadership.

There's a broad recognition within the top leadership that the last decade under Hu Jintao in a lot of ways was a lost decade for the Party's

ability to move the system forward, and they're trying to empower the new leadership to allow them to be able to make some change.

The key question then is what kind of changes might they make? I think the new leadership has been signaling very strongly so far that they do intend to engage in some kind of economic reform program. Exactly what that's going to look like is going to be the subject of debate probably between now and the Party Plenum that we expect in the fall, which should roll out whatever reform program they're able to unveil.

The key question in my mind is not so much the willingness of the top leaders in this regard, but rather has the Party's Leninist system become so sclerotic in its orientation and captured by key vested interests within the system that despite the leadership's good intentions, are they unable to move the process forward?

Very quickly, on foreign policy, the picture is much less clear in terms of the signs we've been seeing. We've certainly been seeing some very nationalistic and hard-line rhetoric coming out of Xi Jinping and some of his colleagues, although it's important to note that a lot of the language he's been using is kind of standard language. He's just framing it in a slightly different way.

But he's still in the process of consolidating power, and so it's hard to know whether these initial statements and signals that he's been sending reflect the policy orientation of foreign policy that we expect the new leadership to adopt or whether this is just about proving his bona fides going forward.

And I see I'm just about out of time, so I'll stop there and look forward to your questions.

**PREPARED STATEMENT OF CHRISTOPHER K. JOHNSON
SENIOR ADVISOR AND FREEMAN CHAIR IN CHINA STUDIES
CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES (CSIS)**

February 7, 2013

**Testimony Before the U.S.-China Economic and Security Review Commission
Hearing on “China’s New Leadership and Implications for the United States”**

Christopher K. Johnson

Senior Adviser and Freeman Chair in China Studies

The Center for Strategic and International Studies

Interpreting the Transition: Three Misconceptions and their Implications

At the close of the First Plenum of the 18th Central Committee on November 15, 2012, the Chinese Communist Party (CCP) unveiled its new, slimmed-down Politburo Standing Committee (PBSC) to the world. With the new leadership lineup no longer a mystery, the attention of party insiders in Beijing and foreign China watchers turned quickly to dissecting the results of the 18th Party Congress in an effort to interpret their broader meaning. Among such analyses, three common misperceptions about the transition process and its outcome have substantial ramifications for understanding the political and policy implications as the new leadership team begins the necessary work of consolidating power and framing the outlines of its governing approach.

1) The “Return” of Jiang Zemin. With at least five—and arguably six—of the new PBSC members having political ties to former President Jiang Zemin, many observers were stunned by the seemingly strong influence in shaping the new leadership lineup wielded by a leader who notionally had been formally retired for nearly a decade. This in turn has spawned ominous warnings about a dangerous return to elder-mediated politics¹ (老人政治) as the outcome of the Party Congress clearly called into question entrenched assumptions about the incremental institutionalization of the Chinese political system. The new PBSC configuration is a poignant reminder of one of the eternal verities of Chinese politics—personalities matter. Of course, this is a truism in almost any political system. Still, the importance of personal relationships in Chinese culture—and of personal networks in Chinese politics—means that in China, more so than in other polities, the rule of thumb is people first, then policy. China’s authoritarian system, despite some modest tweaks to make the process appear more regularized and predictable, remains a largely informal and highly-personalized affair.

¹ Jeremy Page, “Chinese Party Elders Step Back In,” *The Wall Street Journal*, September 6, 2012, at <http://online.wsj.com/article/SB10000872396390444301704577631932672679296.html>

This reality has been easy to lose sight of under the fairly monochrome management of the outgoing leadership cohort and their obsessively consensus-driven style of decisionmaking under the stewardship of President Hu Jintao. Their approach intentionally masked Jiang's continuing behind-the-scenes role. Still, there was ample evidence throughout Hu's tenure that Jiang never really left. Jiang remained number two in the official party hierarchy after stepping down as party chief in 2002. More importantly, he retained that status after retiring from his last official post as chairman of the Central Military Commission in 2004. Interpreted by many analysts as merely an honorific recognition of his status as a retired CCP general secretary, in hindsight, it is clear this status instead reflected his continuing influence as the "core" of the third generation Chinese leadership and thus its representative in elite decisionmaking.

Moreover, Jiang's guiding hand was especially apparent in shaping the senior personnel lineups at both the 16th and 17th Party Congresses in 2002 and 2007, respectively. In conjunction with his departure as sitting party chief, Jiang expanded the size of the PBSC at the 16th Party Congress from the previous seven seats to nine to accommodate additional members of his leadership circle.² But the true measure of his victory at that conclave was the simultaneous stacking of the full Politburo with his associates. Jiang further consolidated his position at the 17th Party Congress by placing Xi Jinping in the pole position to replace Hu and by tightening his grip on several of the Party's key levers of power. Putting his supporters firmly in control of the CCP's key investigative organs at the 2007 Congress, for example, sent an unmistakable signal that he had fully recovered following the purge of then Shanghai party chief Chen Liangyu—a clear attack on Jiang's powerbase—only a year before.³

Jiang repeated this performance in the runup to the 18th Party Congress. His early support for former Politburo member Bo Xilai risked putting him on his back foot in the succession sweepstakes as Bo became engulfed in scandal and accusations that his family members were involved in the death of a foreign national. But Jiang seized on the equally lurid scandal surrounding the death of the son of former CCP General Office Director Ling Jihua in a car crash—while driving a Ferrari, no less—to come roaring back. He reportedly criticized Ling for seeking to cover-up the crash and even held back a key investigative report for several months to maximize its political impact.⁴ Jiang's adroit manipulation of the incident was a political masterstroke on the eve of the leadership handover, in what had become his signature move ahead of the last several Party Congresses.

Against this backdrop, Jiang's influence over the personnel outcomes at the 18th Party Congress was no surprise. In fact, the rise of several of the proteges Jiang placed on the full Politburo at the 16th Party Congress to the PBSC this time around speaks volumes about the farsightedness of his gameplan in arranging the Politburo deck chairs in 2002. His heavy hand in crafting the new lineup should therefore be viewed as what passes for "normal" in a process governed by very few formal rules. As such, it would be misleading to conclude that Jiang's role signified a

² Joseph Fewsmith, "The Sixteenth National Party Congress: The Succession that didn't Happen," *The China Quarterly*, No. 173 (March 2003): 3-16

³ Joseph Fewsmith, "The 17th Party Congress: Informal Politics and Formal Institutions," *China Leadership Monitor*, No. 23 (Winter 2008)

⁴ "How Crash Cover-Up Threatens Career of Hu's Top Aide," *South China Morning Post*, September 3, 2012, at <http://www.scmp.com/news/china/article/1028489/how-crash-cover-threatens-career-hus-top-aide>

fundamental change to the CCP's way of doing business, or that the process had somehow become more unwieldy or intrinsically unstable as a result.

2) Xi Constrained. A second—and interrelated—misreading of the Party Congress outcome is the notion that Xi Jinping likely will be as constrained when it comes to setting his own agenda as Hu Jintao was when the latter took power at the last transition a decade ago. This is because, so the thinking goes, Xi is surrounded by PBSC colleagues he did not choose. He also is hemmed in by not just one, but two retired general secretaries—Hu and Jiang—whose interests must be accommodated. Both of these statements are true as matters of fact, but they probably lack broader explanatory power.

In fact, if there is any lesson we should take from the still unfolding transition, it is that past precedent may not be the best predictor of future developments or performance. Whatever Xi's differences with his mostly Jiang-backed PBSC colleagues, there presumably is far less policy daylight among them than had more Hu allies been appointed to the Party's top ranks. The key personnel developments at the Party Congress—trimming two seats from the PBSC, downgrading the party's security czar, and making Xi party boss and commander-in-chief in one fell swoop—certainly appear consistent with such a seeming desire to fully empower Xi. The meaningfulness of these changes is amplified still more if viewed through the prism of personal political power instead of misguided notions of institutionalization.

Although it is unclear whether Xi will face the same kind of substantial meddling from his retired predecessors that seemingly plagued Hu's tenure, early indications would suggest otherwise. The CCP's late January announcement that, at his own request, Jiang Zemin would now be grouped with other retired leaders in the Party's official pecking order⁵ sends an important signal about his willingness to give Xi sufficient breathing room. Likewise, Hu Jintao may lack the inclination—or, more importantly, sufficient authority—to intervene in meaningful ways. Having never been designated the official “core” of his generation's leadership cohort⁶, Hu probably lacks adequate justification to weigh in from behind the scenes. Moreover, even though several of his proteges were elected to the full Politburo at the 18th Party Congress, Hu's lack of a working majority on the PBSC limits his influence. So, while Xi must be appropriately deferential to both Hu and Jiang and mindful of their interests, he probably will be less hamstrung by such considerations than Hu.

This is not to suggest that Xi is entirely unfettered, or that the transition process and its results are, or will be, free from consequences, intended or otherwise. By promoting the oldest members of the previous full Politburo (save the one female contender, Liu Yandong) to the new Standing Committee, for example, five of the seven current members will again face retirement at the next five-yearly Congress in 2017 if the leadership maintains the current informal age restrictions governing service on the Politburo.⁷ Based on the natural cycling of the Chinese political process, this would mean that Xi and his colleagues, after roughly a year of settling in, would have at most two to three years to make progress before the political horse trading will begin

⁵ Yang Jingjie, “Jiang Zemin Requested that he be Moved Down in Official Ranking,” *Global Times*, January 24, 2013, at <http://www.globaltimes.cn/content/757887.shtml>

⁶ Alice Miller, “The New Party Politburo Leadership,” *China Leadership Monitor*, No. 40, January 14, 2013, at <http://www.hoover.org/publications/china-leadership-monitor/article/137951>

⁷ Joseph Fewsmith, “The 18th Party Congress: Testing the Limits of Institutionalization,” *China Leadership Monitor*, No. 40, January 14, 2013, at <http://www.hoover.org/publications/china-leadership-monitor/article/137941>

again in earnest. Still, the implications of this type of constraint are very different than those associated with activist elders or a too-finely-balanced PBSC. Xi will have to decide, and probably fairly early on in his tenure, to either abide by the traditional timelines described above, or, if he concludes he has sufficient room, to attempt a political breakout of some sort. The point is that it will be Xi's own calculus, and not exogenous factors, that fundamentally shape the path he ultimately chooses.

3) The “Conservative” New PBSC Lineup. The suggestion that the new PBSC is innately conservative—and thus allergic to any type of reform⁸—also seems overstated, if not wrongheaded. Among the common criticisms, new PBSC member Zhang Dejiang is derided for being educated in North Korea⁹ and accused of being merely a shill for the state sector of the economy, while his colleague Zhang Gaoli is described as “part of the problem” for presiding over a massive fixed investment bubble as party chief of Tianjin municipality.¹⁰ Even Yu Zhengsheng has been mysteriously branded as an orthodox figure. Such critiques ignore these leaders' broader experience—stints as party chief in Zhejiang and Guangdong Provinces in the case of Zhang Dejiang and in the Shenzhen Special Economic Zone for Zhang Gaoli—in some of the country's most dynamic regions known for practicing economic experimentation. Similarly, Yu's strong connections to the family of Deng Xiaoping¹¹ alone would seem to call into question characterizing him as an antireform hack.

Of course, the new lineup is undoubtedly less reformist in orientation than if it included the likes of former Guangdong party chief Wang Yang and former CCP Organization Department Director Li Yuanchao, who both were relegated to seats on the full Politburo. But, as part of their political dealmaking, senior leaders appear to have deliberately traded wider representation of the broad spectrum of views within the Party's ranks for greater unity within the PBSC. If Xi and Li Keqiang are able to agree on the basic contours of a revitalized reform program, the Zhangs and Yu, as well as remaining PBSC members Liu Yunshan and Wang Qishan, are unlikely to stand in the way.¹²

Implications for Domestic Policy

During his first public remarks as the newly-minted CCP General Secretary, Xi Jinping won plaudits—from both domestic and foreign audiences—for speaking candidly about the many challenges facing the CCP, and for deliberately avoiding the kind of ideologically-laced rhetoric that has featured so prominently in the speeches of his predecessors. Many observers have suggested this approach underscores Xi's innate confidence as a leader whose “princeling” status as the child of one of the regime's founding fathers imbues him with a born-to-rule leadership

⁸ See, for example, Naomi Rovnick, “The Triumph of Conservative Hardliners in China's Power Transition,” *The Atlantic*, November 15, 2012, at <http://www.theatlantic.com/international/archive/2012/11/the-triumph-of-conservative-hardliners-in-chinas-power-transition/265273/>

⁹ Peter Ford, “Who are China's next leaders? – Zhang Dejiang,” *Christian Science Monitor*, November 15, 2012, at <http://www.csmonitor.com/World/Asia-Pacific/2012/1114/Who-are-China-s-next-leaders/Zhang-Dejiang>

¹⁰ Tom Holland, “Zhang Gaoli's Tianjin economic model promises disaster for China,” *South China Morning Post*, November 6, 2012, at <http://www.scmp.com/business/article/1075766/zhang-gaolis-tianjin-economic-model-promises-disaster-china>

¹¹ “Red Nobility: Yu Zhengsheng navigates China's Factional Politics,” *Want China Times*, June 22, 2012, at <http://www.wantchinatimes.com/news-subclass-cnt.aspx?id=20120622000110&cid=1601>

¹² Barry Naughton, “Signaling Change: New Leaders begin the Search for Economic Reform, China Leadership Monitor, No. 40, January 14, 2013, at <http://www.hoover.org/publications/china-leadership-monitor/article/137931>

style. With the new leadership lineup no longer a mystery, the new favorite parlor game in Beijing and among foreign China watchers is to speculate on whether Xi will embrace reform to tackle the laundry list of mounting problems that are steadily eroding the CCP's legitimacy with the Chinese populace.

Xi and the rest of his so-called "fifth generation" leadership cohort have taken the helm as China swiftly approaches another critical inflection point in its political, social, and economic development path. The fifth generation's formative experiences with the chaos of the Cultural Revolution and its members' often unremarkable rise as good stewards deeply invested in the current system have led some analysts to prematurely dismiss them as merely another caretaker leadership. But the risk of assuming absolute policy continuity during the fifth generation's presumed decade-long tenure is actually far greater than that of contemplating the prospect of some sort of discontinuous change. The reality is that China's rapid rise on the world stage and the stresses of more than three decades of "reform and opening up" probably leave the new lineup less room to simply muddle through. Whether they choose to reform or to retrench, the implications for China, the United States, and the rest of the world will be profound.

In terms of broad domestic priorities, the new leadership must go beyond merely acknowledging the need for a new wave of economic reform and take concrete steps to implement it. Li Keqiang signaled his intent as the future steward of China's economy last February by personally endorsing a World Bank study, the China 2030 report¹³, highlighting the need for important changes such as taming sprawling state firms and further liberalization in the financial sector. The CCP's fundamental domestic strategic benchmark—its prediction that China will become a "moderately well-off society" (小康社会) by 2020—was revalidated at the 18th Party Congress¹⁴ and will expire late in the new leaders' tenure. They should take full advantage of the press of its approach, as well as their mandate to craft the successor policy guideline, to press ahead with essential change. This probably can best be facilitated by a two-step process of several years of economic consolidation, during which the leadership tackles the distortions to the economy wrought by its policy response to the global financial crisis and the unfinished business of the current Five-Year Plan, followed by a new wave of economic experimentation that sets the country on a firm course toward advancing China to the next stage of economic development.

Xi Jinping sent an important signal regarding the leadership's prevailing mindset after its first few months in office with his repeated references to "crossing the river by feeling the stones" in remarks delivered on the margins of a Politburo "study session" held on New Year's Eve to discuss deepening China's reform in the year ahead.¹⁵ Xi's careful comments underscore several realities. They suggest a lack of a solid consensus within the leadership over exactly how to

¹³ "China 2030: Building a Modern, Harmonious, and Creative High-Income Society," The World Bank and the Development Research Center of the State Council, People's Republic of China, February 27, 2012, at http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2012/02/28/000356161_20120228001303/Rendored/PDF/671790WPOP127500China020300complete.pdf

¹⁴ "Full Text of Hu Jintao's report at the 18th Party Congress," Xinhua, November 17, 2012, at http://news.xinhuanet.com/english/special/18cpcnc/2012-11/17/c_131981259.htm

¹⁵ "Greater political courage and wisdom to deepen reform; Moving toward reform and opening up under the guidelines of the 18th Party Congress 以更大的政治勇气和智慧深化改革 朝着十八大指引的改革开放方向前进," People's Daily Online, January 2, 2013, at http://paper.people.com.cn/rmrb/html/2013-01/02/nw.D110000renmrb_20130102_3-01.htm?utm

tackle the many challenges they are facing. They also are an implicit acknowledgement that Xi knows he needs more time to continue consolidating power and to formulate whatever reform program the leadership is likely to roll out in the coming months (or even years).

Still, both Xi¹⁶ and Li Keqiang¹⁷ in their early speeches seem to be acknowledging that the approach under the administration of Hu Jintao and outgoing Premier Wen Jiabao, in which the substantial structural impediments to more fundamental reform were left largely unaddressed, cannot provide lasting solutions to the current challenges. There seems, in other words, a growing recognition that the principal hindrance to reform is not a revanchist band of neoleftists akin to those who supported the social leveling battle cry of disgraced Politburo member Bo Xilai. Instead, it is the inertia generated by powerful vested interests that distort the outcome of the existing reforms to their benefit and block more sweeping policies that would threaten their privileged position.

The rekindled reform debate has tended to focus on two such interests in particular—local officials and state-owned enterprises (SOEs)—and the seemingly nefarious nexus between them. There is a broad consensus that local officialdom has contributed markedly to worsening social tensions through the maintenance of a fiscal system that, in the wake of tax reforms, incentivizes them to live off land seizures and corrupt relationships with land developers and speculators. This practice was further entrenched in the wake of the government’s four trillion yuan stimulus program in response to the 2008-09 global financial crisis, whereby local governments and the SOEs collaborated in taking massive capital injections from the state banks and directing them into infrastructure and real estate projects of often questionable necessity. Of course, one cannot then expect the local governments or the SOEs to willingly accept reforms that might challenge their current role as the channel of choice for the government to pump money into the economy. Instead, the Party will have to dramatically strengthen central control over the reform agenda and its implementation to ensure that it is not high jacked by these vested interests.

Along these lines, the new leadership seems to understand that it must address the center’s weak control over the provinces. Deceased paramount leader Deng Xiaoping’s decentralization policies were a necessary evil to promote experimentation and to overcome resistance from his orthodox rivals then in command of much of the central bureaucracy. But the pendulum has swung too far, as evidenced by the revelations surrounding the fall of Bo Xilai. Bo’s transgressions may have represented an extreme case, but the collusion between provincial party bosses and the security chiefs and local interests that serve and support them certainly is not unique. These relationships allow regional party barons to evade—and in some cases to defy—central directives, hamstringing Beijing’s ability to ensure smooth policy implementation. Add to this the tremendous latitude granted to provincial authorities in executing Beijing’s mandate to safeguard social stability, and the lack of accountability can have profound consequences. Xi and his cohort are well-versed in these issues, having each spent substantial time during their careers working in varied provincial administrations. Using that experience to craft approaches that

¹⁶ Hu Jian, “Xi Jinping tours Guangdong, a veritable record: Write the “China dream” by advancing reform and opening 习近平考察广东纪实：在改革开放前沿起笔“中国梦”。” *Nanfang Daily*, December 13, 2012, at <http://news.sohu.com/20121213/n360279611.shtml>

¹⁷ “Reform is like a boat beating against the current; if you don’t move forward you will slip backward 改革如逆水行舟不进则退,” November 23, 2012, Xinhua News Agency, at http://whb.news365.com.cn/yw/201211/t20121123_796468.html.

reassert the center's dominance will be critical to ensuring that any new policy directions they chart out will be meaningfully pursued.

In what is likely to pass for political reform in the first five years of the Xi-Li administration, there is a parallel discussion within party circles concerning the need to advance the rule of law. Here again the Bo scandal seems central to the argument. The CCP has expelled Bo from its ranks and is moving toward orchestrating his final legal disposition through a formal trial that, just like those of Bo's wife and his erstwhile security chief, will undoubtedly be touted by the Party as underscoring that all people are equal before the law. But some opinion makers in the Party elite clearly aren't buying it. Their frustration is perhaps best reflected in the series of editorials on the case published ahead of the Party Congress by Hu Shuli of the reformist-leaning financial news outlet Caixin.¹⁸ In essence, they argue that, in its management of the Bo affair, the leadership has chosen the path of expediency rooted in a desire to avoid soul-searching that might threaten its efforts to rebuild the public facade of unity tarnished after a year where tales of intraparty squabbles repeatedly spilled out into the public space. As such, the CCP is squandering an opportunity to show that the rule of law in China "must be more than just a slogan."

Xi has touched on both of these issues in the way he is orchestrating the rollout of the CCP's still unfolding anticorruption campaign. In his remarks during the late January Second Plenum of the party's anticorruption watchdog, the Central Discipline Inspection Commission (CDIC), he called for strict adherence to party discipline and absolute compliance with "the decisions of the Central Committee."¹⁹ Underscoring the message to errant local officials, a sternly worded commentary in the official media noted that some officials "pretend to be in agreement with the decisions of the Central Committee but are actually at odds." Directly referencing the Bo Xilai affair, it continued that still others "say whatever they like to say and do whatever they want to do," adding categorically that the CCP will never "tolerate any 'private clubs' that go their own way."²⁰ In the same speech before the CDIC, Xi alluded to the rule of law by suggesting that the power of Party barons should be "restricted by a cage of regulations." Signaling that the crackdown may be moving into a new phase, Xi also noted that guidelines calling for thrift and straightforward policy approaches adopted at a Politburo meeting soon after the new leadership took office are just "the first step" in the Party's efforts to improve its performance and reputation with the Chinese public.

Implications for Foreign Policy

With such a full plate at home, Xi and the new leadership team will struggle to find the wherewithal to also manage foreign policy. But, once Xi collects the last of his formal titles, the presidency, in the spring, he will not have a choice. China's relationships with many of its regional neighbors remain strained amid continuing controversies over territorial disputes. In particular, the maritime disputes on China's periphery, already a source of tensions between Beijing and its neighbors, may become further aggravated under the new leadership.

¹⁸ See, for example, Hu Shuli, "The Dark Heart of the Bo Xilai Case," Caixin, October 10, 2012, at <http://english.caixin.com/2012-10-10/100445554.html>

¹⁹ "XI Jinping vows 'power within cage of regulations,'" January 22, 2013, Xinhua News Agency, at http://news.xinhuanet.com/english/china/2013-01/22/c_132120363.htm

²⁰ Wang Xiaopeng, "Commentary: CCP will not tolerate defiance of discipline," January 25, 2013, Xinhua News Agency at http://news.xinhuanet.com/english/china/2013-01/25/c_132125878.htm

In the East China Sea, Chinese marine and fishery surveillance vessels and aircraft are challenging Japan's administrative control over disputed islets (called Senkaku by Japan and Diaoyu by China) and their adjacent waters, increasing the potential for a clash that could escalate, and in some scenarios, draw in the United States. Friction over territorial disputes in the South China Sea may also intensify, especially if Beijing seeks to interfere with oil and gas exploration and development activities conducted by rival claimants Vietnam and the Philippines. Several members of ASEAN, along with the US, continue to push for a Code of Conduct for the South China Sea that holds promise for reducing the risk of conflict, but Beijing is resisting, preferring instead to manage the disputes bilaterally.²¹ Beijing's emerging gameplan of exploiting these quarrels to alter the status quo and to create new facts on the ground is an acute challenge for the United States and its allies in the region. Indications that Xi fully endorses this strategy—such as his sweeping statement in a late January inaugural foreign policy address to the Politburo that “No foreign country should ever presume that we will bargain over our core national interests”²²—suggest the intensity of this challenge is unlikely to diminish under his rule.

Xi's tough comments speak to the broader issue of how the new leadership team intends to manage China's “assertiveness debate,” or the dispute over how aggressively China should project its resurgent power and influence on the global stage to defend its “core interests.” Hu Jintao struggled to stay on top of the debate during his tenure, having to remind the CCP elite on several occasions that the regime continues to abide by deceased paramount leader Deng Xiaoping's so-called “bide and hide” (韬光养晦) dictum, under which China adopts a low-key foreign policy approach and never takes the lead. The regime also artificially suppressed the debate as part of its campaign to maintain stability and avoid controversy through the succession period. Now that the transition is nearly complete, the debate is likely—if it hasn't already—to come quickly back to the fore, especially amid continuing uncertainties in the global economy and a perception among many regime constituencies that the United States is more aggressively seeking to frustrate China's rise through its “pivot” to Asia.

Implications for the United States

Xi also will have to quickly define his approach to managing China's most important bilateral relationship, that with the United States. The rare convergence of a U.S. presidential election cycle and China's a once-in-a-decade leadership transition left both leaderships struggling to sustain momentum in the face of powerful forces drawing their respective gazes inward. One consequence of the ensuing drift in the bilateral relationship was the emergence of growing concerns about “strategic distrust” between Beijing and Washington, or the deepening suspicion of each country's long-term intentions toward the other.

Xi is likely to confront a dilemma between following his own inclinations and managing the emerging sentiments of the Chinese elite and the broader Chinese public. Xi has far more familiarity, and therefore comfort, with the United States than Hu Jintao did when taking on the

²¹ Christopher K. Johnson and Bonnie S. Glaser, “Critical Questions for 2013: Regional Issues,” January 25, 2013, CSIS.org, at <http://csis.org/publication/critical-questions-2013-regional-issues>

²² Chris Buckley, “China leader affirms policy on islands,” January 29, 2013, *The New York Times*, at http://www.nytimes.com/2013/01/30/world/asia/incoming-chinese-leader-will-not-to-bargain-on-disputed-territory.html?_r=0

mantle of steward of the bilateral relationship, and there is every indication that he genuinely supports healthy bilateral ties with America. But it is equally clear that Chinese suspicions of U.S. intentions, especially in the aftermath of the U.S. strategic rebalancing to Asia, are hardening. Successfully walking the fine line between instinct and political necessity may well define whether Xi can achieve his own stated goal of “building a new type of great power relationship” with Washington.

In the economic and trade relationship, Xi already has signaled his support for the notion that the strong economic interdependence between the United States and China offers the best hope for finding, in the words of Secretary of State Hillary Clinton, “a new answer to the old question of what happens when an established power and a rising power meet.” During his visit Washington last February, Xi stated on several occasions that U.S.-China economic and trade ties should serve as the “ballast” for and “propeller” of the overall bilateral relationship. Instead, however, the economic relationship appears to be emerging as a new trouble spot. Recent squabbles such as a regulatory dispute over auditing procedures for Chinese companies listed in the United States, the escalating debate in Washington over Chinese investment here, and growing frustration in the U.S. business community with Chinese economic espionage are just a few of the economic challenges that risk souring the bilateral atmosphere as the new leadership team settles in.

The challenges in the security dimension of the relationship are no less vexing. A major task for the United States this year is how to respond to China’s increasing predilection to bully its neighbors through the use of white-hulled maritime vessels rather than naval warships, or via the employment of crafty economic coercion tactics. In addition to maritime disputes, North Korean provocations, such as a third nuclear test or an attack on South Korea, could prove a near-term test of the outlines of bilateral cooperation and of Chinese foreign policy under the new leadership. America’s continuing pivot to Asia, which China fears is an umbrella for a new US-led coalition of nations to contain Chinese influence, will undoubtedly remain an irritant complicating U.S.-China ties.

Xi and his colleagues are more cosmopolitan—and more confident—than their predecessors. As such, they probably are less likely to defer to the United States on areas of discord, and they can be expected to negotiate stubbornly in all of these areas of bilateral friction. Fixing these problems won’t be easy, but it is an essential task for the new Chinese leadership and for the second Obama administration going into 2013. It will take bold leadership from senior officials on both sides to ensure that, again in the words of Secretary Clinton, “there is reason to hope that over the coming years, we can in fact chart a path that avoids conflict and builds on the areas where our interests align.”

**OPENING STATEMENT OF DR. CHENG LI
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DR. LI: Well, first, I want to thank the Commission for the invitation. I'm honored to speak to your distinguished Commissioners and also speak along with Chris Johnson, one of America's leading analysts on China.

The topic of China's political succession is extremely important, not only for the future of China, but also for the future of U.S.-China relations. In Beijing, perhaps even more than in Washington D.C., personnel is policy. To assess China's future trajectory therefore requires examining various aspects of this leadership change from the overall process and the means of selection to the resulting factional balance of power.

Misperceptions or narrow-minded judgments of the capacity, constraints, and intentions of the top CCP leaders risk rendering our policies towards China ineffective. Like many other things happening in China, the Chinese leadership change is a paradox of hope and fear, a paradox of persisting problems and promising potential.

In the next six minutes or so, I will present what I believe is a balanced assessment of these problems and promises. Let me start with the negative aspects of assessment and then end with a more positive assessment.

I will use four "un" words, namely, "uncompleted," "unbalanced," "unpopular," "unsafe," to characterize the top leadership format at the 18th Party Congress. Remember these are negative aspects. I have positive as well.

[Laughter.]

DR. LI: In terms of being uncompleted, this leadership transition was expected to be a generational change of the top leadership from the so-called "fourth generation" to "fifth generation" leaders. However, Xi Jinping and Li Keqiang were the youngest members of the Politburo Standing Committee five years ago. They are still the youngest members of the Politburo Standing Committee five years later. Five new members of 18th Party Politburo Standing Committee, as my colleague just mentioned, will retire. Actually, they are roughly only three to five years younger than Hu Jintao and Wen Jiabao who just stepped down.

In a sense, this was merely a leadership change from the "fourth generation" to "fourth-and-a-half generation." Probably a good metaphor is what iPhone 4S is to iPhone 4 and iPhone 5. It's not completed. Now, it also means that the new round of vicious infighting for seats of the Politburo Standing Committee will begin much earlier than expected. It has perhaps already begun. I just got the phone call from Reuters to talk about who will serve on the next Standing Committee. This is a constant game.

Now, my second "un" word is "unbalanced." The biggest surprise

and potentially the most consequential development is the factional imbalance that has emerged in the Politburo Standing Committee. Although the CCP monopolizes power in China, the Party leadership is not monolithic. There are two main political coalitions within the CCP leadership. Namely, the Jiang camp and the Hu camp have been competing for power, influence, and control over policy initiatives since the later 1990s.

Prior to the announcement of the composition of the new guard, many analysts both in China and abroad believed that the new leadership would continue to maintain the roughly equal balance of power between these two coalitions. Yet in the end, the Jiang camp won a landslide victory by obtaining six of the seven seats on the Politburo Standing Committee, leaving only one leader in the Hu camp. Li Keqiang, the premier designate, was able to keep a seat on this premier decision-making body.

The third word is "unpopular." None of the seven leaders is famous for political reform. And, also, more importantly, the princelings dominate the leadership body. Four out of these seven top leaders are princelings, and this is actually an unprecedented high percentage in CCP history, and it's double that of the last Party Congress.

At this time, the Chinese public is very critical about the fact that the big families and princelings control power and financial resources. This really resonated very, very poorly among the Chinese public.

The above factors--the uncompleted nature of the generational transition of power, the unbalanced factional composition, and the unpopular concentration of power by princelings--all come together to generate a sense that the political environment is unsafe. This is the last "un" word I use. Now, for example, if the two coalitions cannot cut a deal, the defeated faction potentially could come back or could reach out to the public for support, therefore causing a serious political crisis and also concern about social stability.

Despite these above negative aspects, there are at the same time some important positive trends in Chinese elite politics. In spite of all the problems in the formation of this new leadership prior to the 18th Party Congress, we should not forget or overlook the fact that this political succession was overall another orderly, peaceful and institutionalized transition of power. That was quite a remarkable achievement.

Let me highlight the three main positive developments and trends in terms of the politics: one is political institutionalization, second is the new team's capacity, and the third is Xi Jinping's mandate.

Very quickly, institutionalization. Some institutional mechanisms have been enduring and effective. The leadership change at the 18th Party Congress primarily followed the rules and norms regarding age limits. As expected, 71 percent of the Politburo Standing Committee, 70 percent of military members of the CMC, and 70 percent of the incoming executive committee of the State Council are newcomers.

And, also, membership in other top leadership bodies, like the Central Committee, the Discipline Commission, Secretariat, all have very

high turnover rates, much higher than the turnover rate of the membership of the U.S. Congress.

Chris also mentioned Hu Jintao stepping down, which is a remarkable achievement in terms of the CMC chair. By surrendering the post of Commanding Chief to Xi, Hu Jintao strengthened not only the norm of institutionalized and undivided political succession, but also the relationship among the Party, State and Army.

The second point of the leadership team: they are not political reformers, but they are all very capable economic administrators. You can be politically conservative, but economically very liberal, and these four princelings are very experienced. They have decades' long experience running coastal cities. In particular, Wang Qishan is known as a very capable financial administrator.

So I think that, in spite of or because of their weaknesses and liabilities in terms of fundamental political reform, the new leaders will likely pursue bolder and more aggressive economic reform to lift public confidence. This is an area where we will see some very important developments, particularly pleasing China's middle class in financial liberalization.

And finally, Xi Jinping's mandate. Because of time concerns, I don't want to go too far, but in the past two or three months since he became Party Chief, he already has made some important moves. For example, his remarkable speech on the 30th anniversary of the Constitution Amendment. In his remarks, he emphasized the supreme power of the Constitution, which is imperative in bringing about rule of law in China. He said this should not be lip service. It should be implemented in a real manner, and a few weeks after that he ended the so-called "laogai" system, which is the illegal and unlawful policy allowing forced labor camps. So that came to an end.

And there are some other important developments, but because of time constraints, I am unable to discuss them.

Let me also mention that the left-wing intellectuals or ultra-nationalists also applaud Xi Jinping for some of his remarks: a tough stance on Taiwan, on East China Sea issues, particularly tensions with Japan, and also that he still praises the Mao era. That has also caused serious concern. But at the same time, liberal intellectuals also applaud Xi Jinping for some of his liberal policies. So it's a honeymoon period. Sooner or later, one group will probably be disappointed. The people in China talk about how Xi Jinping may become China's Chiang Ching-kuo, the son of Chiang Kai-shek, who is also conservative, also a princeling. Yet all of a sudden he opened up the political process in Taiwan in late 1980s. Chiang Ching-kuo provides a good metaphor because Gorbachev is considered as a failure in China, but Chiang Ching-kuo was still more or less considered a success. So the question is whether he will become China's Chiang Ching-kuo. I think we will have the answer within the next few years.

Thank you very much.

**PREPARED STATEMENT OF DR. CHENG LI
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China's Political Transition:

A Balanced Assessment of its Problems and Promises

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[Written testimony prepared for the U.S.-China Economic and Security Review Commission's public hearing "China's New Leadership and Implications for the United States" held in the Rayburn House Office Building, Room 2118, Washington, DC on Thursday, February 7, 2013.]

Seldom in history has the attention of the world been so closely focused on political succession in the People's Republic of China (PRC) as it was during the 18th National Congress of the Chinese Communist Party (CCP) held last fall. The international community's strong interest in the event should not be surprising for four main reasons. First, this is the first CCP leadership transition taking place at a time when China has fully emerged as a global economic powerhouse. In China, as elsewhere in the world, new leadership often means new policies. The policies—be they monetary, trade, industrial, environmental, or energy related— of the incoming top leaders in China have the potential to make a major impact on the global economy.

Second, the significance of the leadership change in China goes well beyond the economic realm. As the PRC now carries more weight on the world stage, the Chinese government's handling of domestic political issues, from human rights and religious freedom to ethnic tensions and media censorship, is increasingly in the international spotlight. Foreign commentary and criticism, especially that which originates in the United States, is often interpreted in China as a US-led conspiracy to curtail China's rise. The Chinese leadership has therefore tended to adopt a nationalistic foreign policy toward the United States, other Western countries, and some neighboring countries with which it has territorial disputes. Whether China's new leadership will become more militant and confrontational in its foreign policy has become a central concern in the Asia-Pacific region, especially in the wake of recent tensions with Japan.

Third, there were several scandals and political crises on the eve of the 18th Party Congress last year, most notably the dramatic downfall of Bo Xilai, who was the former Party chief of Chongqing and a rising star in the top ranks of the CCP. These events exposed the deep flaws of China's political system. Although the CCP has been guilty of political repression and has made

grave mistakes during its long rule, senior Party leaders have generally not been known for gangland-style murders. But now Bo's wife has been convicted of having plotted the murder of a British business associate while Bo's former lieutenant, the police chief of Chongqing, has also been found guilty of abusing his power. The public is left wondering: What expectations of impunity moved Bo to engage in the misdeeds, including obstruction of justice, alleged on his long charge sheet? The astonishingly great amount of bribery in the case of the Bo family and also in the cases of other national and local leaders—e.g., recent cases involving former top officials in the Railways Ministry taking bribes totaling several billion U.S. dollars—has vividly portrayed to the world the unprecedented scale of official corruption. These scandals have profoundly undermined the legitimacy of CCP rule, thus constituting an overwhelming challenge for the new leadership. The sense of political uncertainty—and fear of disruptive social uprising in the world's most populous country—is on the rise.

Finally, the importance of this once-in-a-decade generational transition of power is also reflected in the scale and scope of the leadership change. The three most important leadership bodies in the Party, government, and the military—namely, the Politburo Standing Committee (PSC), the State Council, and the Central Military Commission (CMC)—are all expected to undergo a membership turnover of about 70 percent, mainly due to the age requirement for retirement. The principal figures responsible for the country's political and ideological affairs, economic and financial administration, foreign policy, public security, and military operations will now consist largely of newcomers. In Beijing, perhaps even more than in Washington, personnel *is* policy. To understand politics in China therefore requires examining various aspects of this leadership change, from the overall process and means of selection to the resulting factional balance of power.

As China's new leaders have now been unveiled, we can begin to answer some important questions: Are there clear winners and losers? What are the main characteristics of the new leadership? In what ways do the newcomers differ from their predecessors? Will the formation of the new leadership provide insights into the inner workings of the Party and the potential friction between factions? What does this leadership succession tell us about the prospects and challenges for China's political institutionalization, including the degree of political nepotism and patron-client ties? Can the identities of newly promoted leaders help us understand where China is headed in terms of economic policy, sociopolitical development, and foreign relations?

Empirically well-grounded, conceptually rigorous, and analytically balanced assessments about this political succession are very valuable to the United States. Misperceptions of China's new leadership or narrow-minded judgment of the capacity, constraints, and intentions of top CCP leaders risk rendering our policies toward China ineffective. Like many other things happening in China, the Chinese leadership change is a paradox of fear and hope—a paradox of persisting problems and promising potential— for China, the United States, and the world.

Fear rears its head because the pluralistic thinking that is growing in China makes consensus building among the elite very difficult. Ideological disputes among the leaders apparently have become too divisive to reconcile. Controversy about personnel appointments, especially regarding the membership in the PSC, the top ruling body in the country, has become

viciously contentious, causing serious concerns about elite cohesion and leadership unity. Much-needed political reforms may be delayed because leaders known for their advocacy for democratic change have failed to obtain seats on the PSC. Additionally, the imperative for public support may lead some political leaders to derive their popularity from a strong endorsement of Chinese militarism in foreign policies.

There is also hope. Compared to their predecessors, the newly promoted leaders are collectively more diverse in terms of their professional and political backgrounds, more weathered and adaptable due to their formative experiences during the Cultural Revolution, more experienced in economic administration, especially in running coastal cities, and more cosmopolitan in their worldviews and policy choices. The concentration of power enjoyed by Xi Jinping and his camp in the PSC may give him the sense of having a mandate to reduce the policy deadlock that often resulted from the bureaucratic infighting that characterized the Hu era. The Xi leadership may carry out bolder economic reform policies, including promoting the private sector and financial liberalization.

Negative Aspects of the Assessment

In his assessments of the Chinese economy over the past few years, Premier Wen Jiabao candidly used the four “un” words (“unstable, unbalanced, uncoordinated, and unsustainable”) to describe the challenging economic situation that the country confronts. In the same vein, one may adopt a different set of four “un” words—namely, “uncompleted, unbalanced, unpopular, and unsafe”—to characterize the top leadership formed at the 18th Party Congress and to explain why this leadership lineup has not lifted the nation’s spirits. These four descriptors of the new leadership are examined below.

Uncompleted

This leadership transition was expected to be a generational change of the top Chinese leadership—from the so-called fourth generation of leaders who were primarily born in the 1940s and completed their college education prior to the Cultural Revolution to the fifth generation of leaders who were by and large born in the 1950s and lived their formative years during the Cultural Revolution. Ironically, however, Xi Jinping and Li Keqiang were the youngest members of the Politburo Standing Committee that was formed at the 17th Party Congress over five years ago, and they are still the youngest members of the PSC that was selected at the 18th Party Congress five years later. Xi and Li are the only two leaders in the new PSC who were born in the 1950s. The average age of the 18th PSC is 63.4, which is older than the average age (62.3) of the 17th PSC. Five new members of the 18th PSC are roughly 3–5 years younger than outgoing top leaders Hu Jintao and Wen Jiabao.

In a sense, this was merely a leadership change from the fourth generation to the “fourth and a half” generation (a good metaphor would be the iPhone4S, not a full-fledged change but a transition between the iPhone4 and iPhone5). The incomplete nature of this leadership transition reveals the intensity of the power struggle at the top. It also reflects the strong desire for many senior leaders to stay in power—even if their victory came at the expense of the Party’s ability to present to the country a fresh new leadership team for the next decade.

Due to age limits, five of the seven members of the PSC will retire at the 19th Party Congress that will take place less than five years from now. This implies lengthy, constant, and excessive competition in the top leadership ranks. Apparently, the new round of vicious fighting for seats of the PSC will begin much earlier than expected. It has perhaps already begun.

Unbalanced

The biggest surprise and potentially the most consequential development, however, is the factional imbalance that has emerged in the PSC. Although the CCP monopolizes power in China, the Party leadership is not monolithic. Two main political coalitions within the CPC leadership have been competing for power, influence, and control over policy initiatives since the late 1990s. This bifurcation—a dynamic structure of “one Party, two coalitions”—has created something approximating a mechanism of checks and balances in the decision-making process.

One of the two intra-Party camps in China is the “elitist coalition,” which emerged in the Jiang Zemin era. This coalition was previously headed by Jiang, and is currently led by new Party chief Xi Jinping. The core group of the elitist coalition consists mainly of princelings: leaders who come from families of either veteran revolutionaries or high-ranking officials (both Jiang and Xi are princelings). The other is the “populist coalition,” which was led by President Hu Jintao prior to the 18th Party Congress and is now headed by his protégé Li Keqiang. The core group of the populist coalition is the so-called *tuanpai*: leaders who advanced their political career primarily by way of the Chinese Communist Youth League, as did both Hu and Li.

Prior to the announcement of the composition of the new guard, many analysts both in China and abroad believed that the new leadership would continue to maintain the roughly equal balance of power between these two coalitions. Yet in the end, the Jiang camp won a landslide victory by obtaining six of the seven seats on the PSC while only one leader in the Hu camp—Li Keqiang, the premier designate—was able to keep a seat on this supreme decision-making body.

The factional balance of power now appears to be broken at the top. There were three eligible candidates (all of whom both served on the previous Politburo and met the age requirement) who failed to be elevated to the PSC at the 18th Party Congress—all were *tuanpai* leaders. These include the only woman candidate, State Councilor Liu Yandong, and two rising stars, former Guangdong Party chief Wang Yang and former head of the CCP Organization Department Li Yuanchao. All three, especially Wang and Li, are regarded as staunch advocates of political reform. This outcome is particularly startling when one considers the fact that Hu Jintao and his ally Wen Jiabao decisively expelled Bo Xilai, a notoriously ambitious princeling, from the Party on the charge of criminal conduct in early 2012.

What has caused this profound change in the power equation is not entirely clear, but two incidents may have played important roles. The first was the now well-known Ferrari crash that occurred in Beijing in March 2012, which killed the driver, who was the son of heavyweight *tuanpai* leader Ling Jihua, then director of the CCP General Office and Hu Jintao’s chief of staff. Ling was removed from his very powerful post a few months later due to the speculated cover-up of the incident and other “dirty tricks” he allegedly played in order to obtain a seat on the PSC.

This episode severely damaged the authority and credibility that Hu Jintao wields within the leadership.

The second incident was the accusation that Premier Wen Jiabao's family is corrupt, as reported in the *New York Times* in October 2012. This accusation, though not verified, has effectively undermined the premier's reputation and his potentially strong support for the PSC membership of *tuanshipai* leaders (such as Wang Yang and Li Yuanchao) who are like-minded with Wen in terms of calling for political reforms in China. Wen was forced to fall largely silent during the most crucial period of the leadership succession.

Unpopular

The exclusion of Wang Yang and Li Yuanchao from the new PSC could greatly damage the CCP leadership's efforts to obtain public support. Both Wang and Li are popular among the Chinese public. During his tenure as Party chief of Guangdong, Wang Yang frequently used the phrase "thought emancipation" to urge local officials to break free of ideological and political taboos. His input regarding the political experiments of local elections, his support for a more open media, and his liberal approach to handling the villagers' protests in Wukan in the fall of 2011, all earned him a well-deserved reputation as a down-to-earth and forward-looking leader.

As for Li, an instrumental voice supporting the rule of law, governmental accountability, and intra-Party democracy, he has many supporters, especially among liberal intellectuals. He has also played a crucial role in recruiting foreign-educated returnees and promoting college graduates who work as village cadres. The latter represents one of the largest volunteer movements in present-day China.

In contrast, none of the seven members of the PSC has been known, at least until now, for advocating for political reforms. What is even more troubling is the fact that princelings have dominated the pivotal power ranks. In fact, the number of princelings in both the top civilian and military leadership bodies is unprecedentedly high, including four of the seven PSC members (57 percent) and four of the eleven CMC members (36 percent). In both organizations, the percentage of princelings is double that of the previous congress.

It has been widely noted that large numbers of prominent Party leaders and families have used their political power to convert state assets into their own private wealth. The unprecedentedly strong presence of princelings in the new PSC is likely to reinforce public resentment of how power and wealth continue to converge in China. The public is also resentful of the fact that a large number of senior leaders' family members possess great wealth and often live, work, or study in the United States and other Western countries.

In several recent speeches since becoming Party chief, Xi Jinping claimed that his administration's top priority is to increase fairness and equality and to crack down on corruption. The Chinese public generally hears these words with skepticism. What the public sees is that princelings dominate the country's highest levels of power and the families of some of the top leaders control the most lucrative businesses in the country. As a result, the credibility of the new leadership as a whole will likely be significantly undermined.

Unsafe

The above factors—the uncompleted nature of the generational transition of power, the unbalanced factional composition, and the unpopular concentration of power by princelings—all come together to generate a sense that the political environment is unsafe. The constant and increasingly intense political competition for the top leadership posts may undermine effective governance. If the two coalitions do not remain in balance, the defeated faction could become less cooperative. It could, for instance, use its political resources and socioeconomic constituencies to engage in a more vicious power struggle and could even risk splitting the Party. Public resentment against official corruption, nepotism, and especially the dominance of power and wealth by several “big families” or “red nobilities” further weakens the legitimacy of the political system, threatening the stability of the country at large.

The biggest challenge to CCP rule likely comes from forces internal rather than external to the Party. This makes the above discussion of potential problems within the leadership critically important. Yet, this discussion should be closely linked to the tensions in Chinese society and the imminent danger of social uprising. China’s official data reveal that there are roughly 180,000 mass protests annually, or about 500 incidents per day. According to the official media in China, these protests have become increasingly violent in recent years, especially in ethnic minority regions.

On the domestic front, the regime has been beset by growing economic disparities, social dislocation, repeated industrial and environmental disasters, food safety problems, public health crises, and a manual labor shortage in some coastal cities that coincides with high unemployment rates for college graduates. In recent years, the property bubble, inflation, and the monopolies and meteoric growth of state-owned enterprises (at the expense of the private sector) have signaled that there is an urgent need for fundamental changes to China’s economic growth model. Foreign policy challenges have also become more acute as the PRC confronts an unstable and increasingly complicated external environment. Ultra-nationalistic sentiment seems to have gained much momentum, reverberating increasingly loudly in this era of teleconnectivity.

The scenario of abrupt bottom-up revolution has recently generated much discussion within China. One of the most popular books in elite circles today is the Chinese translation of Alexis de Tocqueville’s 1856 classic *The Old Regime and the Revolution*. Senior leaders of the CCP (most noticeably Li Keqiang and new PSC member of Wang Qishan) were reported to have strongly recommended that officials read the book. In speeches given after becoming CCP General Secretary, Xi warned that the Party and the country could collapse if the leadership failed to seize the opportunity to reform and improve governance.

Positive Aspects of the Assessment

Despite the above negative aspects, there are at the same time some important positive trends in Chinese elite politics. Despite all the problems in the formation of this new leadership prior to the 18th Party Congress, one should not overlook the fact that this political succession was overall another orderly, peaceful, and institutionalized power transition. The members of the new PSC are perhaps hesitant to pursue much needed political reforms, but as a result they may be more inclined to accelerate economic reforms. Such policies would gain them support from

the public, especially from the middle class. The concentration of power that Xi and his team now possess may prevent the policy deadlock that often plagued the country during Hu's leadership, thus leading to improved governance and better implementation of major socioeconomic policies. The first two months of Xi's tenure as a new Party chief have shown promise toward establishing a more accountable leadership.

Institutional Mechanisms in Elite Selection

Some institutional mechanisms have been enduring and effective. The leadership change at the 18th Party Congress primarily followed the rules and norms regarding age limits, and all members and alternates of the previous Central Committee who were born in or before 1944 no longer serve on the new Central Committee. As expected, 71 percent of the PSC, 70 percent of military members of the CMC, and 70 percent of the incoming executive committee of the State Council are newcomers.

The turnover rates in other important leadership organs selected at the congress are also remarkably high: 64 percent of the Central Committee (the leadership body made up of the most important national, provincial, and military leaders in the country), 77 percent of the Central Commission for Discipline Inspection (the country's top anti-corruption agency), and 86 percent of the Secretariat (the crucial CCP organ that handles daily administrative affairs of the country, decides top leaders' activities, and sets the agenda before major meetings).

As with previous Party congresses, the Chinese leadership employed a method of multi-candidate election for the Central Committee known as a "more candidates than seats"-style election (*cha'e xuanju*). At the election for full members of the Central Committee, 2,270 delegates of the congress chose 205 full members from the 224 candidates on the ballot (i.e., 9.3 percent were eliminated). Similarly, in the election for alternate members of the Central Committee, 171 leaders were elected from a candidate pool of 190 (for an elimination rate of 11.1 percent).

Those eliminated included prominent figures such as Minister of Commerce Chen Deming (who some in China thought had been a contender for the Politburo), Shanghai Executive Vice Mayor Yang Xiong (who was later appointed to be Shanghai Mayor), and Ma Wen, head of the Ministry of Supervision, the body that monitors government officials (who was one of the most influential female leaders in the country). Minister of Finance Xie Xuren, Minister of the National Development and Reform Commission Zhang Ping, and top military official Zhang Qingsheng were not elected to the new Central Committee, even though they are all of eligible age.

In addition, full memberships were distributed evenly across the provinces, government ministries, CCP departments, and military organizations. For example, the norm that each province has two full membership seats was adhered to (although some members were assigned to another province or to the national leadership soon after the congress).

Instead of following the practice of his predecessor Jiang, who retained the chairmanship of the CMC for two years following the last succession, Hu Jintao gave up this military position during this leadership transition. By surrendering the post of commander-in-chief to Xi, Hu

strengthened not only the norm of an institutionalized and undivided political succession but also the relationship among the Party, state, and army. It is too early to assess the larger impact of this move, however, because the earlier-than-expected military power handover will need to be evaluated in the context and complexity of China's military tensions with its neighboring countries.

Most of these institutional rules and norms are not new. Many important institutional measures adopted at the 18th Party Congress were first used either at the 13th Party Congress in 1987 or the 15th Party Congress in 1997. As early as 1987, the Party had adopted the "more candidates than seats"-style election for the Central Committee. The scope and scale of open competition in terms of the percentage of candidates eliminated have not increased significantly over the past 25 years. There appears to have been no intra-Party multiple-candidate elections for the Politburo and PSC. These leaders are still selected the old-fashioned way: through behind-the-scenes deal-making, a process that retired leaders still influence heavily.

The dominance of Jiang's men in the new PSC does not necessarily mean that now the winner again takes all in Chinese elite politics. It should be noted that Hu's protégés are still well represented in other important leadership bodies. Although the Jiang camp has dominated the new PSC, the balance between the two camps in the 25-member Politburo, the Secretariat, and the CMC have largely remained intact. In fact, many *tuanpai* leaders have made it into the new 376-member Central Committee. My research indicates that *tuanpai* leaders now occupy 96 seats in the new Central Committee, constituting 25.5 percent of this very crucial decision-making body. This is a steep uptick when compared with the *tuanpai*'s 86 seats in the previous 371-member Central Committee (23.2 percent).

Prominent *tuanpai* leaders such as the aforementioned Li Yuanchao and Wang Yang will still meet the age requirement for the next PSC in five years. Li and Wang will likely serve as PRC Vice President and Vice Premier after the National People's Congress (NPC) meeting in March, respectively, and thus may continue to have their own political platform. If the "one Party, two coalitions" dynamic is a new experiment in Chinese elite politics, the CCP may also experiment with a new mechanism of "factional rotation" (*paixi lunhuan*). This may explain why the Hu camp quietly acquiesced to its own political Waterloo in the latest leadership succession.

Capable Economic Reformers

The new top leadership seems to be very capable on the economic front and most—or perhaps all—members of the PSC are known for their strong support for market reform. Six of them have had substantial leadership experience serving as Party chiefs at the province level. Four princeling leaders on the PSC—Xi Jinping, Zhang Dejiang, Yu Zhengsheng, and Wang Qishan—all have decades of experience and high levels of competence in economic and financial affairs. In spite of—or because of—their weaknesses and liabilities in terms of fundamental political reforms, the new leaders will likely opt for bolder and more aggressive economic reforms to lift public confidence.

Xi has long been known for a market-friendly approach to economic development that is welcomed by both domestic and foreign businesses alike. Xi's leadership experience running Fujian, Zhejiang, and Shanghai, three economically-advanced regions in the country, has

prepared him well to pursue policies promoting the development of the private sector, foreign investment and trade, and the liberalization of China's financial system—all of which experienced serious setbacks in recent years under the previous administration. Xi's first domestic trip after becoming the party secretary general was to Shenzhen, the point of origin for Deng Xiaoping's "reform and opening" policy in the late 1970s. China's stock market, after two years' of sluggishness, rebounded very strongly after Xi's symbolic trip.

Another good example of effective leadership is Wang Qishan, the newly appointed anti-corruption tsar. Over the past few years Wang has served as a principal convener for China in the Sino-U.S. Strategic and Economic Dialogue. Wang, whose nickname is "the chief of the fire brigade," is arguably the most competent policy maker in economic and financial affairs in the Chinese leadership. The Chinese public regards Wang as a leader who is capable and trustworthy during times of emergency or crisis, whether it be China's response to the 1997 Asian financial crisis, the 2003 Severe Acute Respiratory Syndrome (SARS) epidemic, or China's ongoing rampant official corruption.

The coming economic reforms will probably center on revitalizing the private sector and expanding the middle class. The leadership will likely alter the current "strong state sector, weak private sector" environment by adopting policies such as tax cuts, more loans to private small and medium enterprises (SMEs), and more preferential policies to the services sector. A richer and larger middle class in China would also help to stimulate domestic consumption, the next main driver of China's economic growth. According to the Work Report delivered at the 18th Party Congress, the new leaders will allow for fair competition in all industries except for those that are associated with national defense (e.g., military-related industries and telecommunication).

The promotion of the private sector and the acceleration of market reform will inevitably undermine the vested interest of monopolized state-owned enterprises (SOEs), which have strong ties with political leaders, especially princelings. In the wake of rampant official corruption and going public resentment, CCP leaders must make a choice between, on the one hand, surrendering some existing interests in order to stay in power and revitalize the economy, or confronting a bottom-up revolution, on the other. This choice should not be difficult to make.

Some Chinese analysts argue that princeling leaders, given their privileged backgrounds, have more political capital and resources than their predecessors Hu Jintao and Wen Jiabao (who came from humble family backgrounds) in terms of running the Chinese economy, controlling SOEs, and coordinating various governmental agencies. The central question, however, is whether Xi and the princeling-dominated PSC can achieve sustainable economic development without pursuing systemic political reform. Can China really adopt an innovation-driven economy while the country's political system remains as it is?

Xi's Momentum and Ultimate Choice

China's much needed political reforms include several important components, including intra-Party democracy, local elections, the rule of law (especially judicial independence), media

supervision and openness, government accountability and transparency, and the role of civil society. One may argue quite reasonably that all of these components are inherently interrelated and ultimately tend to reinforce each other. But this does not necessarily mean that Chinese political reformers should pursue all of them simultaneously without a well-planned strategy and set of priorities. As noted above, the new PSC is politically conservative, but Xi and his team—whether by choice or by necessity—may still pursue some degree of political change.

During his first two to three months as Party chief, Xi has made some important moves. Chinese legal professionals and especially liberal intellectuals have applauded the speech Xi gave on the 30th anniversary of the Constitution Amendment. In his remarks he emphasized the supreme power of the Constitution, which is the imperative for rule of law in China. Xi's eight-point regulations for Party leaders and his call for stronger measures to crackdown on official corruption, particularly his recent remarks that “power must be put in the cage of regulations,” have resonated very well with the general public.

These calls are certainly not pure lip service. The elimination of two of the PSC's functional posts (the police czar and the propaganda czar) at the 18th Party Congress was a positive development in the structural change of the Chinese political system. Another move in the right direction was the official decision made early this year to end the forced labor camps (known *as laogai*), an unlawful practice that had tarnished China's criminal justice system for far too long. Though the Chinese public is still cynical about the real objectives of the new anti-corruption measures, Xi's recently proposed regulations and Wang Qishan's tough stand on corruption have already changed official behavior. Purchases of luxury houses and cars have declined and VIP rooms in Macao's casinos have witnessed far fewer visits by CCP elites.

It is important to point out that some of Xi's words and deeds have also pleased China's left-wing intellectuals and ultra-nationalists. Xi's favorable comments regarding the Mao era, his uncompromising stand on territorial disputes, and particularly his call to prepare for a war with Japan are worrisome for many both in China and abroad. At this point, both liberal and left-wing intellectuals still have high expectations for Xi. Party leaders, regardless of their factional affiliation, by and large want to unite under the new boss in Zhongnanhai, especially in the wake of the headline-grabbing crises and scandals that have captured the world's attention and severely damaged the legitimacy of the CCP.

Because the country faces so many daunting challenges, however, this broadly shared expectation and enthusiasm for reform in China cannot last for long. Like elsewhere in the world, the honeymoon period for new state leaders is short-lived, and leaders are always forced to make many tough political decisions. In Xi's case, many of the tough decisions must address the pressing social, economic, demographic, and environmental challenges that China now faces.

Some Chinese public intellectuals explicitly regard Xi as mainland China's Chiang Ching-kuo. As the son of Generalissimo Chiang Kai-shek, Chiang Ching-kuo was a princeling who was a political conservative for most of his career. Chiang Ching-kuo surprised many in the mid-1980s, however, with his bold and historical move to lift the ban on opposition parties and media censorship in Taiwan, initiating the island's transition from authoritarianism to

democracy. Xi Jinping faces similar opportunities and constraints, and only time will reveal how he perceives his mandate in this rapidly changing country.

Policy Recommendations for the United States

China's economic power, political uncertainty, social dynamics, and military tensions with its neighboring countries constitute a complicated challenge to the United States. Our assessment of and approach to China at this critical juncture of global economic development and regional security should be cautious, multi-faceted, and forward-looking. We need to pursue several crucial and delicate balances.

- We must avoid hewing to conventional, old-fashioned perceptions of this rapidly changing country, taking special care to steer clear of dogmatic cynicism, on the one hand, and ill-grounded optimism or wishful thinking on the other.
- We need to be fully aware of the new institutional norms and rapidly changing rules of the game in Chinese elite politics. But at the same time, we cannot allow ourselves to be led astray by superficial phenomena or CCP propaganda.
- We should be sensitive to Chinese factional politics, but not prematurely choose a side. We should be aware that Chinese political conservatives have the potential to be strong economic reformers.
- We should fully engage with the Chinese civilian and military leadership, focusing on the cultivation of a deeper relationship with Xi Jinping and his new leadership team. At the same time, we should reach out to the Chinese public, clearly expressing America's firm commitment to democracy, human rights, media freedom, and the rule of law, all of which the United States holds as fundamental to the long-term stability of any country.
- We should openly articulate to the Chinese people the longstanding goodwill that the United States extends to the Chinese people and our understanding of their national and historical sentiment. At the same time, we should consistently exert influence on our allies and partners in the Asia-Pacific region (including China) to prevent the use of force by any party.

Note:

The author thanks Andrew Marble and Ryan McElveen for their helpful comments on an

earlier version of this written testimony. Part of the discussion here previously appeared in several recent publications by the author. See, for example, Cheng Li, “Top-Level Reform or Bottom-Up Revolution?” *Journal of Democracy*, Vol. 24, No. 1: (January): 41-48; “Rule of the Princes.” *The Cairo Review of Global Affairs*, No. 8 (Winter, 2013): 94-106; “China in Revolution and War,” in Martin Indyk, Tanvi Madan, and Thomas Wright, (eds.), *A Presidential Briefing Book: Policy Recommendation for President Obama’s Second Term* (Washington DC: Brookings Institution Press, 2013); and “Opportunity Lost? Inside China's leadership transition.” *Foreign Policy* Online. November 16, 2012,

PANEL 1 QUESTION AND ANSWER

CHAIRMAN REINSCH: Thank you, and thank you both for some very enlightening testimony.

Commissioner Wortzel.

COMMISSIONER WORTZEL: I want to thank both of you for some very thoughtful written testimony and comments. I have a short question for each of you.

Dr. Li, you have a single sentence on page two of your testimony that fascinated me, but I didn't see fleshed out. And it is: "Ideological disputes among the leaders apparently have become too divisive to reconcile."

Now, you outlined intra-Party camps. You outlined differences in background, but you really never discussed ideological disputes, and to me, those are the role of the Party, things about intra-Party discipline, so I wondered if you would take a minute to discuss that?

And, Mr. Johnson, it struck me that with respect to your comments on the influence of Hu and Jiang, I wonder if you could lay out what you see as Hu's options to influence policy other than just outliving Jiang Zemin?

DR. LI: It has been widely known in China that there are serious debates within the top leadership. It's not secret; it's already become public knowledge. Of course, we can use Bo Xilai, on the one hand, and Wen Jiabao, on the other hand, and these are the two extremes. They basically disagree on almost everything regarding China's history: the Mao era, the Deng era, the Cultural Revolution, and, as we know, that Bo Xilai started a campaign that really kind of fantasized the Mao era, the Leninists, et cetera. But Wen Jiabao even refused to visit Mao's home-place when he had visited Hunan eight times, and he also publicly called Bo Xilai and this kind of phenomenon remnants of the Cultural Revolution.

And in terms of the China model which is also quite different, that some of the nationalists think about how China has a model, one of economic market liberalization but within a political one-Party state, while at the same time liberal intellectuals and also leaders like Wen Jiabao talk about universal values, the necessity for fundamental political change.

My four "un" words actually borrow from Wen Jiabao's similar four "un" words for the Chinese economy that were so very critical about the China model. But it's not just Bo Xilai. As we know, Wu Bangguo, the Chairman of the NPC, former Politburo Standing Committee member, also talks about five "no's."

So these kind of ideological disputes really emerge and are thus very important. This is the reason I said that sooner or later Xi Jinping needs to take a position and to lead the country and not just say that everything was good in the past, but make a serious review: what went

wrong, what are the things we should keep, what are the new things we should take?

Thank you very much.

COMMISSIONER WORTZEL: Thank you.

MR. JOHNSON: My own sense is that Hu's options for influencing policy from retirement are actually going to be fairly limited. It's hard to tell so far exactly how this is going to break down, and I think there's a lot of controversy, appropriately so, over what role he might play from retirement.

My own sense in just looking at the results of the Party Congress, however, is that it was a fairly major political blow for him. Increasingly, without the revolutionary credentials of the elder generation and the charismatic sort of leadership style, your ability, as Dr. Li pointed out in his opening statement, to influence is very dependent on personnel.

A lot of analysis has looked at the idea that while Hu Jintao didn't do very well on the Politburo Standing Committee, he has seated a lot of his official people from his network onto the full Politburo and, therefore, five years from now, he'll be in the position to sort of dictate the Politburo Standing Committee. And there's been some comparisons to what Jiang Zemin did in 2002 with stacking the full Politburo.

My own sense is that these comparisons aren't apt because at the time, in 2002, the sort of achievement of Jiang was to dominate both the Standing Committee and the full Politburo and to hold on to the Military Commission Chair as well, which Hu Jintao didn't do.

My assessment of that process is that this wasn't some magnanimous gesture by Hu Jintao. Rather, I believe he wasn't able to hang on to the Military Commission Chair and they subsequently dressed it up because they have to for public consumption.

So the real question, and I think a lot of this is going to focus on Xi Jinping, is how willing will he be to accommodate Hu Jintao's interests and how much pressure will he feel that he has to accommodate to Hu's interests? In other words, will he go along with the kind of pattern that we've seen over the last couple of years in terms of accommodating these folks, or will he be a much stronger personal power control leader? And, as Dr. Li suggested, I think we'll see in the next couple of years exactly how he's going to approach that problem.

COMMISSIONER WORTZEL: Thank you.

CHAIRMAN REINSCH: Commissioner Shea.

VICE CHAIRMAN SHEA: Thank you both for being here.

Wonderful testimony from both of you.

Dr. Li, and, Mr. Johnson, you mentioned that personnel is policy so let's remember that for a second. There's wide agreement that the Chinese economy needs to move from an investment/export-led economy to a consumption-oriented economy, and that might require liberalizing interest rates, which would hurt SOEs who have benefitted from very low bank financing; lifting currency controls, which could hurt exporters; and less of

a dependence on investment, which can hurt infrastructure. Yet you often read about all these vested interests in China that are going to make this very difficult to happen.

I guess my questions to you are who will these vested interests run to on the Standing Committee to protect their interests? I mean can you name names? Can you give us a little guidance on that?

DR. LI: Well, I would be very cautious and don't want to name names.

VICE CHAIRMAN SHEA: I thought so.

DR. LI: --first of all, I do not have access, like The New York Times, to all this kind of secret information, although I'm very cynical about their findings.

But it is fair to say that it is public knowledge that the leadership, including not only the local leaders but now the Bo Xilai case, will reveal the national leaders who are involved with some serious corruption. Some big families, the "red nobilities"--this is a term used--are involved. These are the people behind the vested interest groups, particularly state-owned enterprises that dominate China's economy, hurt China's middle class development, and hurt the foreign companies.

Now the question is whether the leadership, with such strong ties, particularly the princeling-dominated leadership, will really crack down on the state monopolized companies? I actually think they will, because this is a choice between whether you want to put China's economy back on track because an innovation-driven economy needs real competition, needs political openness. So, therefore, you need to sacrifice some of your interests and privileges.

On the other hand, the Chinese economy could continue to decline and, consequently, a political uprising against state-owned enterprises starts. This is what the Chinese leaders talk about, the so-called "revolution." So with this choice, on the one hand a revolution and the economy never recovering and forgoing what has been so far an impressive case over the past 20 years, or you surrender some of the power, some of the privilege, to survive.

So for me the choice is very easy to make: to survive. And also because of the concentration of power and tight control of the state-owned enterprises, you can argue they are probably in a better position than Hu Jintao and Wen Jiabao to do so. That's my opinion.

VICE CHAIRMAN SHEA: So to summarize, you feel there's sufficient will among the members of the Standing Committee to go against the interests of these vested interests?

DR. LI: To a certain extent. Surrender some power and privileges for the sake of survival.

VICE CHAIRMAN SHEA: Okay. Thank you.

Mr. Johnson.

MR. JOHNSON: I would agree with that general assessment, but I'm a little more cautious in terms of whether or not I believe they have the

will to do it, and there are several reasons. One is this is where I think some of the commentary that's been made about the conservatism of the new Politburo Standing Committee is somewhat apt. I mean Zhang Dejiang, for example, had been overseeing the industrial portfolio for the last five years. So he's very closely affiliated with a lot of these state firm bosses and so on.

Likewise, Zhang Gaoli presided over a massive fixed investment bubble--

VICE CHAIRMAN SHEA: You're naming names.

MR. JOHNSON: Yeah--in Tianjin municipality. So those are undeniable aspects of their sort of background.

Does that mean, though, that somehow they're allergic to reform? Here's where I think it's going to come down to Xi Jinping and Li Keqiang, and how much they're willing to work together. My own sense is that because of the pressing retirement of the other five members of the Standing Committee, if there's a strong consensus between Xi and Li to do something about this, and I think Wang Qishan is a critical player in this set-up as well, not only because he's running the corruption portfolio but because of his economic and financial expertise. If there's a strong consensus by the two of them, my own sense is that the other members won't resist, you know, will go along to some degree.

The other piece, though, is the question that can a princeling really take on the state-owned firms and vested interests? In a lot of ways, it's fair to say that this is almost like cutting their left arm off, you know.

On the flip side, though, there is an idea out there that only a princeling can take on corruption in these state firms in the same way only Nixon can go to China, and only a princeling can take on these sort of vested interests because they know where the bodies are buried, and they know the outlines of the process, and they're able to do it in a way that reassures the key vested interests, the really key vested interests, that their interests are protected while going after the broad landscape of the state firms.

VICE CHAIRMAN SHEA: Thank you. Dr. Li.

DR. LI: Can I add something?

CHAIRMAN REINSCH: Yes. Go ahead.

DR. LI: Of course, people have every reason to be cynical about the anti-corruption effort, about the crackdown of state-owned enterprises, but I believe that the behavior of leaders is really starting to change with Xi Jinping's eight points regulation with Wang Qishan's remarks that he himself does not have children. I try to remind people that he wanted to do what Zhu Rongji did. Zhu Rongji said about 15 years ago, he wanted to buy 100 bullets to use 99 bullets to kill corrupt officials and leave the last one for himself. Now, people may say this is a joke, but this is a recorded quote.

Now, the behavior change is quite evident, in my view. If you go to Macau casinos, the VIP rooms are not as crowded as before, and the luxury cars and villas, which were usually bought for a mistress, those sales have slowed down and dropped dramatically, but, of course, it's still very difficult to deal with corruption.

In my opinion there are only two ways to deal with corruption. One is Chairman Mao's way in the Cultural Revolution. At that time, the corruption was severely controlled. Bo Xilai's way is similar to Mao's. The other is to use the legal profession, rule of law, but that takes time. So that's why I believe what Xi Jinping said on the 30th anniversary of the Constitution Amendment is potentially very important and positive.

VICE CHAIRMAN SHEA: Thank you, both.

CHAIRMAN REINSCH: Commissioner Fiedler.

COMMISSIONER FIEDLER: I have a couple of questions leading back to the corruption question, but first is a factional political question. The role of Zeng Qinghong in the transition, given the fact that he's well-known to be the brains behind Jiang Zemin throughout his history, what was his role in this transition? Was it really Zeng or was it a sort of core group around Zeng that is manipulating the situation?

DR. LI: That's a very good question. It's an excellent question. This is a question I also have been pondering. But, of course, there is evidence that Zeng Qinghong is still heavily involved in the decision-making, in the selection process, but how important, how big, is subject to debate.

And I would also say that Jiang Zemin's power is very complicated. To a certain extent, the activities he used, the things that he violated in terms of institutional norms could be seen as a weakness rather than strength. But I think the most important thing we tend to forget sometimes that his protégées, whether in power, in top leadership or wanting to be in the top leadership, actually are more important than Jiang himself. They occupy the previous Standing Committee. They fight for the next Politburo Standing Committee members. So they use Jiang Zemin's leverage to achieve that.

And the case with Zeng Qinghong is that he is a brilliant politician because he can cut a deal and he's willing to compromise. He stepped down as Politburo Standing Committee member, but traded with the three seats five years ago. Now, unfortunately, there is no such figure at the moment in Chinese politics, which is cause for serious concern.

Early on, I believed that Li Yuanchao could have played such a role, but apparently he is not. He himself is out, not willingly, so that's the problem. Yes, that's a concern.

COMMISSIONER FIEDLER: In the interest of time, let me lead from that into the corruption discussion. The previous discussion that we had was focused on state enterprise princeling corruption, but taking Zeng Qinghong, for instance, whose son, who never had a position in business, who's in the Party all his life, whose son buys a \$32 million house in Australia to knock down, so one would have to conjecture that he had an extraordinary amount of money to spend \$32 million to knock down a house. That level of corruption at the princeling level raises the question: if Zeng Qinghong had anything to do with factional leaders, is the anti-corruption campaign that we're about to witness really a consolidation of power in the

old "we'll go after the other faction"? Isn't the real test of Xi Jinping's anti-corruption campaign to go after some part of his own faction?

MR. JOHNSON: Let me just say real quickly on Zeng Qinghong, to me, he played a strong role this time, but it dates back really to the brilliance of the cooperation between he and Jiang in 2002, and prior to that actually when he was in the Organization Department, the Party's personnel arm. You saw them very adroitly stack the line-up in a way that would put their people in position to move up to the Politburo and then ultimately to the Standing Committee. I think Zeng Qinghong played a fundamental role in helping Xi Jinping leap over Li Keqiang as the now newly designated leader.

So he, I think, plays an important role, but it's always from behind the scenes. Jiang Zemin is very vain. He wants to be seen as wielding power.

COMMISSIONER FIEDLER: That's understood.

MR. JOHNSON: Zeng does it from behind the scenes.

On the corruption piece, I'm not so sure that he has to go after his own faction. In fact, that's the most difficult challenge, is that he has to assure his own faction that their interests are protected while he goes about a broader sweep.

One thing that I think is interesting in the public reaction we're seeing to the anti-corruption campaign is they're not necessarily interested in the pursuit of the "big fish" cases. In fact, they're very skeptical about those cases, for example Bo Xilai and other big cases, because they see it as just political infighting and score-settling.

What I think Xi Jinping needs to do with the anti-corruption campaign is to send a much broader message about his seriousness, about clamping down on the things--

COMMISSIONER FIEDLER: Because it's endemic.

MR. JOHNSON: That's right. Clamping down on these things that the people at the local level see everyday, you know, in their sort of experiences. Whether it's a consolidation, a power move, I think will be somewhat transparent, and whether or not this current anti-corruption campaign morphs into a more traditional Party rectification campaign, taking a page out of Jiang Zemin's book from the late 1990s, with the "Three Stresses Campaign," that would suggest much more strongly to me that what Xi is about, what this program is, to consolidate his own personal political power, presumably on the road toward launching whatever economic primarily reform campaign he intends to unfold.

COMMISSIONER FIEDLER: Thank you very much.

CHAIRMAN REINSCH: Commissioner Wessel.

Oh, I'm sorry. Dr. Li.

DR. LI: I want to respond. While the sentiment in China and also in China study communities is that all leaders are corrupt in China, I disagree with that. I think probably maybe 90 percent or 85 percent. We do not know who the 15 percent or ten percent are because you can imagine

other leaders also trash them and they try to--and also it's a system problem because if you are a leader, all the forces will come to you--state-owned enterprises, many other businesses will just try to approach you, approach your family members. So that's a system problem.

Now, you mentioned Zeng Qinghong. Zeng Qinghong played a direct role in promoting Xi Jinping five years ago to the Politburo Standing Committee. Now, Chinese leadership has the commitment. You talk about "big fish." The Chinese metaphor is the "flies and the tigers." They will attack flies and the tiger together, but, of course, we have yet to see whether they will deal with flies seriously.

COMMISSIONER FIEDLER: Or "kill the chicken to scare the monkey."

DR. LI: But also--that's right--but also that it's everyone's disaster if they really put these 90 percent of leaders in jail. I mean the country cannot sustain this kind of a drastic change.

[Laughter.]

DR. LI: So Chinese leaders talk about, even liberal intellectuals talk about how under these kinds of circumstances, how to pursue real political reform, rule of law, and anti-corruption. There are different ideas. Talk about if in the future you want to be leader, you should really report your family income, and et cetera. You should make a choice between power or money. This is one argument in the media.

The second is a kind of immunity. What you did before, it's okay, but not in the future. This is another one. And also, there's an idea that in the region, like a province, give immunity to corrupt officials, but in return these leaders should pursue serious political reform, election, media openness, and rule of law. These are all the ideas around.

But the important thing is that the perception, public perception, whether they believe that the corruption is really hopeless or corruption to a certain extent is already constrained, or there's hope that China will deal with corruption very seriously under Xi Jinping and Wang Qishan.

Let me also mention that China executes thousands of corrupt leaders every year. This is also human rights issue, that sometimes if you steal half million, you will be executed. In my view, it's quite excessive, but that's the reality. Each year, according to official statistics, that is probably 6,000 or 7,000. The real number is probably even higher than that.

So, again, this is a battle. It's very, very difficult to fight, you can imagine. Wang Qishan probably is the best person to do so. On the one hand, he himself is also linked to princelings. He himself is a princeling, but at the same time, he understands the danger of that crisis and also how to uplift public confidence, which is so low at the moment.

CHAIRMAN REINSCH: Let me pursue the last couple points for just a second before we go to Commissioner Wessel, if I may.

Dr. Li, from what you said, both with respect to the endemic nature of the corruption problem and the 90 percent, or whatever percent it is, as well as the rule of law method of dealing with it, it seems to me that

you can't solve this problem without undermining the Party's control of the state, which seems to me makes it an insoluble problem for them.

Do you want to comment on that? Either of you?

DR. LI: Well, it is a serious legitimacy crisis, and while we actually only mentioned the Bo Xilai crisis, there were others as well. The reason to explain Hu Jintao's political Waterloo or his camp's political Waterloo is related with Ling Jihua scandal. This is the Chief of Staff whose son was killed in the Ferrari incident. Now, the problem was the coverup and also the personality assassination and the other issues involved, all cross-faction dealmaking, et cetera. We do not know. We only see the tip of the iceberg probably.

So it's a serious crisis in the making, but it's important to point out why with this kind of serious political scandal and crisis, the largest since 1989 Tiananmen, and someone argued probably the biggest ever in the PRC history, particularly many people in China believe that way, because the Communist Party's power is in jeopardy. But why the Chinese economy have been relatively less or not disrupted as was 24 years, 23 years ago, during the Tiananmen crisis, the answer to me is simple: the forces that now work in China very actively, social forces, simply did not exist 23 years ago or were very trivial.

Let me give you some of the top on my list. One is the entrepreneurial class that did not emerge until 1989. They legitimized entrepreneurs. The middle class is extremely dynamic, and actually I wrote a book in the middle 1990s about the rise of the Shanghai middle class. As I mentioned elsewhere, I wanted to publish it, but they rejected it several times because the reviewers thought that there was no such a thing as a "China middle class." But that was 15 years ago. But now everyone talks about China's middle class.

Secondly, commercialize the media, which is very powerful. We have not talked about what happened at Southern Weekend or Southern Weekly, and they really pushed the envelope. The report--largely because of the media commercialization. And the social media is entirely new.

The legal profession is very dynamic. They are allowed to petition. They're really very active and call for real constitutionalism.

And foreign-educated returnees, so called "sea turtles," also play a very important role.

All these forces, they actually are very critical of the corruption, but at the same time, they don't want chaos. They don't want the revolution, by and large, unless it really becomes completely hopeless. So China is at this critical juncture in its history. Either you will face a serious crisis like what happened in Egypt and other countries over the past few years or still find kind of gradual change—both top down and bottom up--these kinds of forces acting together.

I think the potential is much greater for the peaceful transition, but we cannot eliminate the danger of the real social uprising, but that constitutes a very difficult policy discussion for the United States in how to

deal with China.

CHAIRMAN REINSCH: We'll come back to that. Chris, do you want to make a comment before we go on?

MR. JOHNSON: Yes. Let me just kind of zero in on what I think was your question, which was how do they manage this problem, which is they'll have to give up some authority to be able to move toward the rule of law, but how do they do it without giving away the store basically?

And I think you've seen already in the signaling, especially from Xi Jinping, this concern is there. There were two comments that he's made that I think are quite apropos to that point. The first is this Politburo study session that they had on New Year's Eve where they were talking about how do we move reform forward, and what was striking to me in his remarks, on the margins of that, was he made repeated references to this idea of "crossing the river by feeling the stones."

In other words a very cautious approach. It's also a throwback to Deng Xiaoping, which he has been doing a lot, but it's a very cautious comment, and to me it's a strong symbol to the liberal elements in the Party because this was right on the heels of the Southern Weekend episode and everything else. Don't push too hard. I hear you. I'm trying to get something done. If you push too hard, then, the conservative forces will retrench, and we won't get anything done.

What is striking as well about the anti-corruption element of this whole process is that it wasn't coincidental to me that at the same time they were moving toward more talk about the anti-corruption campaign, there was a series of articles in the central media about the fall of the Soviet Union where they highlighted the issue of corruption and its role in undermining the Soviet Union.

This, to me, was a response to the classic response that you get when you start trying to tweak in a political space in the system of, oh, you're Gorbachev; don't do it. You know, you'll undermine our power. So those forces are definitely there and making those comments, and Xi is trying to walk a fine line in between those two positions. I have doubts whether it's walkable, but we'll see.

CHAIRMAN REINSCH: So do I. Thank you.

Commissioner Wessel.

COMMISSIONER WESSEL: Thank you both for being here. Fascinating discussion with enormous repercussions.

Dr. Li, I found your discussion of the iPhone apt for a number of reasons because, as I recall, the 4S is where they introduced Siri and the voice activation and voice recognition. So using your analogy and comments, corruption is being dealt with as corruption and is in many ways a proxy for the economic anxiety and problems that the public faces.

But the issue-- the concern I have, is by focusing on some outlying or some important corruption activities, the broad reform that probably is needed in their economy is not going to be fulfilled.

Can you both comment on whether the voice activation, meaning

the public's anxiety, is going to be addressed by some high profile corruption cases, but the integral reforms that are needed, will they or will they not be introduced over time by the new leadership?

DR. LI: Well, it's already started in the past two or three months, after the 18th Party Congress, that the three leaders already are under investigation. They're more minister level, deputy minister, vice minister level leaders. And what happened in Chongqing is fascinating. A reporter called a citizen journalist or citizen reporter just reviewed all these videotapes about the sex nature involved with leaders in Chongqing, but he probably possessed more of these kind of videotapes or DVDs or these kind of things. So this is one way.

The other way is--

COMMISSIONER WESSEL: But will that be enough, meaning that again, is the corruption a proxy for economic change or is it being dealt with as a palliative, if you will, that will reduce demand and give them time to continue the current process or approach?

DR. LI: Well, we do not know the answer. I think no one knows the answer. That's the question in many people's minds, and when we talk to people in China, talk to leaders, they certainly still want to control the media, and to a certain extent, the CCP propaganda still functions very well. On the one hand, some people, sort of like the U.S., want to put China down, and they believe some of the sensational accusations against the foreign press and foreign countries, and that's effective propaganda to a certain extent.

Of course, we also need to do much better in terms of directly talking to them, articulating our values, our goodwill, et cetera. But this tells us that they're fighting for media, which is also important. The dilemma for Chinese leadership is the more you control the social media then sensational stories become more powerful, so when you try to crack down, you shut down some of the media or social media or official or semi-official media, but that will not work because an innovation-driven economy requires this kind of openness. This will hurt you eventually.

So, therefore, I believe that in a matter of years, they will gradually open the media, and that, therefore, the mainstream media will become main source of information. Then the government, Chinese leadership, the Communist Party, can also try to influence in that way. But they are very, very nervous.

So when we talk about democratic change in China, it includes several components: rule of law; intra-Party democracy; real democracy; civil society; and the media openness; and government accountability. Now all these things will eventually, ultimately, come together, but the sequence, what comes earlier, what comes relatively later, will make a huge difference in terms of social stability and the nature of peaceful change.

In that regard, the Chinese scholars are debating. Chinese leaders, as I say, are also thinking about that. I hope that it would be on the right side of history to gradually open the media rather than just think that

they can control it because it's only the beginning. Some of the IT companies told me that within 18 months, China's twitterers, I mean the-- they're called twitterers?

COMMISSIONER WESSEL: Uh-huh.

DR. LI: Right, they went from zero to 300 million within three months and that's only the beginning. In the future, those kind of walls will all be broken down because of technological innovation. So that's a huge battle on the moral high ground for the media. I think that's a dimension we should monitor very closely.

MR. JOHNSON: Let me just add two very quick points on the issue of public anxiety in addressing that. I think there's a debate here, it seems to me, within not only the new leadership team, but the broad Party elite, over the role of the public in supervising the Party.

This has been one of Xi Jinping's themes so far that these regulations that he put out on getting rid of formal banqueting and not stopping all the traffic when a senior leader comes. Again, these things seems sort of ridiculous on their face, but what he's saying to the public effectively is these are observable things which you then can watch and report on. He's effectively saying to the public we want you to supervise us, and I'm doing this in a way that is monitorable by you.

There also has been a strong Party anti-corruption campaign that he has launched, has been this idea of Internet "gotcha's," and the public coming out and highlighting these cases. When that first started to happen, suddenly things were, you know, there were case after case being put out there.

I think that there was some concern, especially in the more conservative part of the propaganda sphere, that this is going to go too far, and Xi Jinping has so far endorsed several times again this idea of public supervision using the Internet, but I think it's still very much a debate.

The other thing in terms of whether their anxiety will be addressed, I think this speaks to the fundamental issue of the degree to which one of the key challenges for the new leadership--Dr. Li referred to this--is they've got to get the emerging middle class back on side in a lot of ways. You know, to me one of the brilliances of this leadership and their pragmatism and so on has been their steady coaptation of China's rising middle class.

They did it very effectively by allowing entrepreneurs to join the Party. My own sense is that in the last couple of years, as they focused on more diffuse social stability threats, like the Jasmine Revolution or Arab Spring or something like that happened, they've taken their eyes off the ball of this key constituency a little bit, and they're very fed up with official corruption, with environmental degradation, with food safety issues, all of those sort of things.

And let's face it, it's not the people scratching a living out of the dirt that make revolutions; it's the people with rising expectations such as the emerging middle class. So what I'm looking for is a sign out of the new

leadership that they get that problem, and that they're addressing some of these concerns in a visible and tangible way that will relieve that anxiety you referred to.

COMMISSIONER WESSEL: Thank you.

CHAIRMAN REINSCH: Thank you. Commissioner Talent.

COMMISSIONER TALENT: Thank you, Mr. Chairman. I'd also like to thank the two witnesses.

One question for you both to answer, and then one for each of you. The question for you both is how pervasive, if at all, do you believe there's a belief within the leadership in these different factions that they have to move forward with these broader economic reforms that witnesses are going to testify about later, you know, the systemic type of reforms allowing interest rates to go up, having the economy more consumption driven?

How pervasive, if at all, is there sense that if they don't do that, they're not going to be able to stay in power? Is that a commonality among all these different groups? Something that might pull them together and that the new leaders can use to sort of drive a consensus behind reform?

Mr. Johnson, you said that there's a general sense among the different leaders that the last decade was a lost decade. Could you just explain that a little bit? I'd just like a little more detail on that. I thought that was very interesting.

And, Dr. Li, you said that it was a positive sign that Xi announced they were ending the labor camps or rolling them back. I understand they have retrenched on that, that they've sort of qualified that. Is that qualification a sense that perhaps he was constrained here, or, in your view, is that did he sort of plan all along to move it two steps forward and then one back?

MR. JOHNSON: Thank you for those questions. Let me start off with kind of the general question of is there a broad consensus among them? I think there is a broad consensus that they understand that they have squeezed as much juice out of the orange as they possibly can with the economic system as it is currently configured.

What they should do about it, I think there is no consensus on that, you know, the precise policies, and I think there's a couple of reasons for that. The primary one is that the next wave of reforms that they need to undertake, they've already undertaken all the easy reforms. The low-hanging fruit has been picked. So the new challenges that they face and the reform proposals that they need to look at it are very complex, number one, and I think they realize as well that in the broad category areas of reform that they're thinking about, there are also nested reforms in each one of those areas, each one of which is difficult in its own right, and if they get that sub-reform, if you will, wrong, then the whole thing could come loose.

So this is a serious debate, you know, within the Party right now. So take as one example, the broad category of urbanization. Li Keqiang, the incoming Premier, has been talking a lot about this. They understand that

greater urbanization is critical to unlocking the next wave of serious economic growth for the system.

They understand that under that broad umbrella of urbanization, though, there are several of these very challenging reforms. There's hukou, the household registration system reform. There's land rights reform. There's social security aspects, the health insurance, and the retirement policies that have to go with it. And so because there are these nested reforms under these broad categories, and it's a consensus-oriented system, first they have to get general consensus on the broad categories, and which ones they have the political capital and will to address.

Then we need to get into the nitty-gritty of how to do those and tackle those sub-reforms. So my sense is what they've signaled so far is that there is a broad consensus. I think actually they've been quite critical of the previous regime, and this touches on the lost decade issue. You know, Xi Jinping when he went on this tour down in Guangdong talked a lot about how, you know, "empty talk damages the nation."

And this is at least implicitly critical of the previous regime. Likewise, Li Keqiang in an important speech talked about reform being like a boat, that if it doesn't move forward, it moves backward, and he's implicitly saying it's been moving backward.

So the idea of the lost decade is pretty much that they had this phenomenal growth year after year after year, and like so many systems they didn't take advantage of the good times to do the hard reforms. Instead, they found themselves in a position where they're trying to do it when the economy has cooled, you know, and they're having to accept lower GDP growth as a new reality. And how do they then make that bridge from the high GDP growth to a more sustainable GDP growth function?

And I think there is also just a sense that, again, that previous Politburo Standing Committee with the nine members, first of all, was large, which made it difficult in a consensus-oriented system. And secondly, it was so finely factionally balanced that they really couldn't get anything done other than lowest common denominator policy solutions. We saw a lot of that over the last ten years, and so people's expectations are much higher, and this is one of the real challenges, I think, for Xi Jinping and Li Keqiang, is finding a way to buy themselves the time that they need to sort out the laundry on how to handle these nested reforms despite the fact that there's this large expectations gap between what the society expects and what the system as currently configured can actually deliver.

DR. LI: Well, let me answer these two questions. One, the general question about how pervasive, it is pervasive in terms of the sense of a crisis, the sense of challenges is. Imagine the Politburo Standing Committee member when you look at their agenda, look at the issues they discuss. They're all very, very serious--food safety, environmental degradation, and economic disparity, et cetera, and foreign policies, all of these big challenges.

So that explains the leadership sometimes has to cooperate. It

does not mean that--we talk about factional politics--it does not necessarily mean that the factional tension is always conflictual. Sometimes they have cooperated. But that when you come to exact policies, you will see they will divide.

You mentioned urbanization--I think it is a good example. Let me interpret in that way. Now you talk about urbanization, I think everyone here would think it's a good idea, but what about abolishing hukou system for major cities? That immediately caused serious tensions between these elite groups and between social groups at large because middle class residents in Shanghai, Beijing, Tianjin, Shenzhen will think their privileges are threatened, for example, the quota of their children to attend college. Previously like probably 85 percent of them can enter college, but when you abolish the hukou system migrant workers also have the same privileges. So the percentage of admission will jump by at least half. So you will not support that policy.

At the same time that Hu Jintao and Wen Jiabao had policy, I don't think the "lost decade" is the right phrase for it. But the middle class was disappointed because in the past three or four years, their interests were hurt, and, of course, the reason is more complicated. So, therefore, the new leadership policy will be very, very, you know, supportive of pleasing the middle class. At the same time, you need to consider how to deal with the poor people, poor migrant workers and farmers. So you will see all these tensions that will immediately emerge when they talk about specifics.

Now, in terms of the decision to end the labor camps, we do not know who made that decision. Maybe that decision was made even earlier than Xi Jinping. But certainly a similarly important development, for example, was the downsizing of Politburo Standing Committee by abolishing two seats. One is the police czar; the other is the propaganda czar. Particularly, the police czar is out of the top leadership. It's an important decision to crack down on police power to enhance the legal profession. Judicial independence is a step in that direction.

But this is all about symbolism because this occurred in the first few weeks for Xi Jinping. It certainly made the liberal intellectuals happy. This is, to a certain extent, also a policy move for foreigners, as the United States and Western powers have been critical of China. So the real substantial change compared with this one, this is still very, very tiny, small.

For example, are they going to release Liu Xiaobo? And actually his wife is more tightly controlled at the moment. And how should they deal with the issues of ethnic tensions in Xinjiang and Tibet? And what about Falun Gong? All these issues will emerge when you really talk about serious political reform.

So the challenges from his perspective are overwhelming, but again this may be a small step, but it's really long overdue policy change for this kind of lawful development to deal with the so-called "criminal justice system."

CHAIRMAN REINSCH: Commissioner Fiedler, you want to

make a point on this issue?

COMMISSIONER FIEDLER: I just want to make one thing clear. The discussion has been the elimination of re-education through labor as a process, "laojiao." The discussion has not been the elimination of "laogai," reform through labor. So the forced labor system is not being discussed as being eliminated. It is administrative detention without due process for a period of up to three years that is being discussed. I just want the facts to be clear.

DR. LI: Technically you're right. But in the announcement released to the people, laogai and the lao jiao in the Chinese context, are very, very similar.

COMMISSIONER FIEDLER: No, but prisoners who are convicted will still be forced to labor in the system.

DR. LI: Yes.

CHAIRMAN REINSCH: Okay. Commissioner Shea.

VICE CHAIRMAN SHEA: Second round here-- elite politics, factionalism in the high levels of Chinese politics. Help us understand that. You hinted, Dr. Li, that there are ideological differences potentially between the Jiang Zemin faction, the Shanghai clique, and tuanpai, the Communist Youth League, and you mentioned hukou, which I assume the Communist Youth League faction would be more open to changing than the Shanghai faction.

So I was wondering if you could--are there other ideological differences, number one, or number two, is it more about power? It's really sort of two power centers. Are there red lines that each faction won't cross when competing for power against the other? As China watchers, are there things that you look for to say, wow, factionalism in China at the elite level has really been heating up because this is happening to so-and-so? If you could comment on both of those questions.

DR. LI: These kinds of divisions in terms of the Jiang camp and the Hu Jintao camp--one is led by princelings, previously led by the Shanghai Gang, as you mentioned; the other is largely led by the Chinese Communist Youth League. Is the way to analyze Chinese politics after the strongman politics? When you have collective leadership, you have factions. When you have factions, factions tend to come together through coalitions or camps. That's a very, very important way to look at Chinese politics.

If you do not pay attention to factional politics, you really miss the most important landscape. But having said that, the relationship is very, very complicated. There is some overlap. Sometimes the policy differences may not be that clear, and also you have the Bo Xilai-like figure. He is a princeling. He is elitist. He is a Jiang Zemin follower, but all a sudden he reached out to the public for support. Sounds like he takes Hu Jintao's populist approach as a person of the people that confused the people; right.

So that makes our analysis even more complicated, but by and large, you do see they come from different backgrounds. Usually, the Communist Youth League members come from very humble backgrounds,

usually from inland regions, usually have talked about the issues, you know, inequality, distribution, and also affordable housing. And they're more concerned about the rural areas, et cetera, so the other is more about the development and the middle class, entrepreneurial development, and GDP growth, et cetera.

But sometimes they also have overlapping issues. You are right. Ultimately, it's fighting for power, but at the same time, that does not mean that it's purely for power because they do want to reach out to the public for support. They have the kind of hot button issues resonate very well, and for example, the two Communist Youth League officials who are out in the Standing Committee, Wang Yang and Li Yuanchao, both are considered political reformers. Talk about political reform issues. So they are out. It's to send a very clear message that political reform is not on the agenda. So that tells you that the Chinese public can also sense the policy differences.

VICE CHAIRMAN SHEA: But when you say that, I mean those two individuals, I believe, are affiliated with the Communist Youth League faction.

DR. LI: Correct.

VICE CHAIRMAN SHEA: So they've had ten years where Hu Jintao was in charge, and political reform at any kind of significant level has not occurred. So, anyway, Mr. Johnson.

MR. JOHNSON: Yeah. Let me just say a couple of broad overview points, because that was a very good assessment from Dr. Li. I tend to try to shy away from the term "factionalism" simply because I don't think the factions are hard, if you will, in the way that they were in the Mao period or even in the Deng period where you had distinctive factional groupings around a single leader.

They are still sort of broken down that way, but they're more interest groups at this point. I personally have always felt that the tuanpai faction, the Communist Youth League idea, is pretty weak. Hu Jintao was actually only the head of the Communist Youth League for a very brief time during his tenure, and because he became the Party Secretary, in my analysis, there were a lot of people who had that background and wanted to associate themselves with him. But it wasn't the same kind of longstanding ties that we see, for example, with a lot of Jiang's group or some of the other groups.

There also is tremendous overlap, as Dr. Li pointed out. You know there are some people who are princelings and Communist Youth League leaders. They didn't do that well--

[Laughter.]

MR. JOHNSON: --in this recent round, but there are people with that dual background, if you will, or there's triple backgrounds, as well, in some cases. So I think you run a risk of distilling a very complex environment down to too simple of an argument, if you will, if you try to break it down into however many major competing factions. It's a pretty rich tableau that we deal with.

Your question was about what would be a sign that the wheels are coming off, if you will, and I do think that this is the fundamental challenge. As they try to tackle a lot of these very complicated issues, as Dr. Li, was talking about, there is the real danger for ideological divisions in a way that we really haven't seen since the 1980s, you know, when likewise, if you consider the context emerging from the Cultural Revolution, they were dealing with very hard issues.

And to me, one of the key things to watch for would be now that the Party Congress and the whole personnel horse-trading and guaranteeing one's interests as a retired person has passed. If you see the competing groupings activating their respective elders, suddenly the elders that are associated with the various groups start showing up in public and making comments and so on, that traditionally in the system has been a signal of trouble. So that's something that I would look for.

VICE CHAIRMAN SHEA: Interesting. Thank you.

CHAIRMAN REINSCH: Thank you.

I started the second round inadvertently, not realizing that we have two Commissioners who haven't had a first round. So if we don't mind changing the order, let's go with Commissioner Tobin and then Commissioner Cleveland.

COMMISSIONER TOBIN: Thank you, gentlemen.

I'm going to ask each of you, if you would, to envision, to help me see how something might happen. Mr. Johnson, you spoke about the nested reforms, and Dr. Li, you referred to rule of law and that being an option in the future counter to revolution. And you've also conveyed, both of you, the idea of reaching out to get public support.

As I think about reform in our culture, the only way effective reform, particularly nested reform, could occur is that there is predictability, and that we do move towards rule of law. Can you envision or help me imagine how we can have any reform and connect it to the current judicial system? With your expertise, I would like each of your thoughts on that.

DR. LI: Well, thank you for that excellent question. I think that you also remind me to look at Western democracies, such as the United States, that also took a long time in terms of the rule of law, constitutionalism. Relatively speaking, China is, of course, in the early stage, and the Chinese economic growth is actually quite remarkable. It's achieved in its timeframe what it took the UK over a hundred years, the United States over 80 years, and Japan 60 years, et cetera.

So you do see the condensing of this time and space in the case of China. I'm not arguing that the Chinese people should wait for a hundred years for real political reform, real rule of law. I think the demand is on the rise, but we should put it in a perspective. It's not an easy job. It's very complicated.

Sometimes some events would drastically change the course of history, but if the societal forces are real, if China's integration with the outside world is real, if foreign business interests wanted to see China do the

right things in the right, leading in the right direction, I think these are all important factors in the push for change.

So I think some of the events happening in China, like the media, like legal cases, like social demand, protests, is exactly what happened in Taiwan and many other Southeastern and East Asian countries in the past two or three decades.

So I think that it's similar that China is experiencing this kind of development, and what happened in Indonesia about ten years ago or a decade ago probably is exactly the situation in China.

Now, this also raises the issue of transition. What kind of a transition? One is a peaceful, gradual one; the other is erupted crisis. Another is uprising. Then the immediate question is whether China's military will do the same thing they did 23 years ago. So if not, what does that mean for China's future political stability and change?

Now these are all issues, not just secrets. People are thinking about that. Leaders are talking about it privately and sometimes publicly. So these are the different scenarios. We do not know which one will occur, but we can say which one is more likely going to happen. Still, I think, that the gradual change and through this kind of tension, this kind of give and take, and this kind of demand, like what happened in Taiwan, South Korea, Indonesia, probably will happen in China.

MR. JOHNSON: I would just add very briefly that what is striking to me about the evolution of the judiciary, in particular, in the last 15, 20 years, is that it's a very negative direction or it has been.

And what's striking to me about the reform debate in this area, especially regarding political reform, is they're talking about things that they talked about at the high water mark of reform in 1987, at the 13th Party Congress. So it demonstrates how long the shadow of the Tiananmen crackdown has been, you know, in this particular area.

And it's been very corrosive, I think, as the Party through the Politics and Law Commission over the last decade, decade-and-a-half, has really taken over. So in that late 1980s period, there was this effort. They called it separation of Party and government functions where they were trying to create a real Ministry of Justice and, you know, a functioning court system that's outside of the Party's total control. I'm encouraged by the decision to knock down the power of the Politics and Law Commission, taking them off the Politburo Standing Committee and kind of knock them down a peg to the full Politburo level. That does empower, you know--kind of the message that Xi Jinping as Party Secretary gets to decide how that, you know, portfolio is handled again and desire to kind of empower him.

So I think this is a key space to watch, especially as they do try to tackle some of these nested reforms and so on. If that can be done in the context of an emerging rule of law infrastructure, it really does serve to mitigate the infighting, if you will, over how to approach those nested reforms.

COMMISSIONER TOBIN: Can you see it emerging?

MR. JOHNSON: Yeah. I think they're sending the right signals so far. The question is will they come through with the follow-through? There are a lot of problems, for example, with the power that the local officials have over the courts that operate in their jurisdictions, you know, because there's too cozy of a relationship there, and so on.

So these are many--you know, talking about nested reforms, these are many difficult issues, and they have to, again, break a lot of iron rice bowls at the local level to be able to do this properly.

COMMISSIONER TOBIN: Thank you.

CHAIRMAN REINSCH: Commissioner Cleveland.

COMMISSIONER CLEVELAND: My question actually follows nicely on yours. I'm interested in the elevation of Wang Qishan and what it implies. In the staff memo, they suggest it was sort of a mismatch and a surprise.

Given his stature, given his role in the past, can you describe how this came about, if it's at all obvious; who his supporters may or may not be; and does it imply, as I think, that there will be a deliberate effort to address the corruption issues? Because he seems to be sort of above the fray, not above the law, but has an august standing that may suggest the effort will be credible.

MR. JOHNSON: Two things. One I think there was a lot of surprise because here you have a guy who's got a whole career working an economic portfolio, and I think there were two primary drivers. One, in my own estimation, certainly has to be with Jiang Zemin's strong--I mean, as Dr. Li pointed out, six of seven of the new Standing Committee members are sort of allied loosely with the Jiang camp, there had to be, I think, a sense from Hu Jintao and his folks that Li Keqiang, the incoming Premier, should not be in a position then where he has to constantly look over his shoulder.

The position that Wang Qishan was likely to get was this executive vice premier position, where he would have had substantial purview over the economy.

I think there are also very different views between Wang and Li Keqiang over the emphasis points of economic reform. As Dr. Li was saying, I think Li Keqiang very much emphasizes much more the sort of soft issues, if you will, of the economy, the housing issue. They are serious issues. I don't mean to say they're not serious. But it's that kind of social piece.

Wang Qishan is much more of a finance guy and a banking guy, and so there is a lot of concern, I think, for example, that with him not in that portfolio, some of the things that they need to do in the financial reform area might not come to pass.

But it doesn't necessarily mean it's a bad thing that he's over there, and, in fact, if you look at the two kinds of core issues that we've been talking about in the context of today's discussion of the corruption issue, one of the key concerns the Chinese public has is all these revelations about the red nobility and their wealth and so on.

How do they get this money out of the country is a key question that a lot of people have. What is the immigration status of the children of senior leaders? Do they hold foreign passports? That's another key question. So, again, if you want to approach the problem from a sort of forensic accounting point of view, who better than Wang Qishan, to take on that responsibility. Certainly, he's more capable in that regard than his predecessor.

So the question in my mind, then, is will he be unleashed, unshackled in that position? If he is, I think it's potentially transformational. The question is does Xi have the power and willingness to make that happen and what are the constraints that Wang Qishan is dealing with?

His own background is to be pretty tough. In his previous positions, he has this reputation of the fire brigade commander and so on, but on this corruption issue, again, it's going to require a scalpel, not a sledgehammer, to make sure that the vested interests feel safe about how this is going to unroll. And the question is does Wang Qishan's personal style lend itself to that?

DR. LI: Well, Mr. Johnson already covered most of the things I wanted to say. I do not have any disagreement. The one thing is that he mentioned the chief of the fire brigade, and there are some specific cases in China--one is the 1997 financial crisis—in which he did remarkably well. The other better case is SARS in 2003. So that really scored well. He is a person that, whether you like him or not, he's quite capable. He's a no-nonsense person in the Chinese perception.

Now, the job is not a demotion. It's actually a very, very important position. Whoever gets a seat in the Politburo Standing Committee wins a big victory, in my view, but that position almost puts him as the third-most powerful figure in the country next only to Xi Jinping and Li Keqiang.

Now whether he can achieve this anti-corruption, of course, you cannot just expect one person, but he will draw a delicate balance on the one hand to not leave the system upside down or really create a chaotic situation, while at the same time uplifting public confidence, at least that there are some policies on the way. He may end up very, very well, but, again, it's still too early to say.

COMMISSIONER CLEVELAND: But you share my impression that this was a crucial choice or decision?

DR. LI: Absolutely, but also I want to add one thing. Although he is not on the State Council, will not be on the State Council, he still can play a very important role in terms of finance. One thing is that corruption is certainly related to the financial sector very, very strongly, and China is going to have a very important governmental structural change. We already see some plans. This includes the merging of the three commissions and regulatory commissions, et cetera.

Now, his expertise will be still sought, and also his proteges

may play very, very important roles, but the important thing is how the public perceives it.

COMMISSIONER CLEVELAND: Right.

DR. LI: And I think sometimes we should know that the public sometimes is also dissatisfied with the fact that you only deal with the flies, not the tigers, and also there's no real institutional development except these eight regulations that the people will also be disappointed in. But now it's still the early stage. Let's see what he does next, in the coming months and couple of years.

COMMISSIONER CLEVELAND: Thank you.

CHAIRMAN REINSCH: Okay. We are supposed to finish, but we have one short question from Commissioner Wortzel and one short question from Commissioner Wessel, to which you will give short answers. Commissioner Wortzel.

COMMISSIONER WORTZEL: Barry Naughton in China Leadership Monitor has an interesting discussion of Xi Zhongxun's attitude toward Hu Yaobang and Zhao Ziyang and makes a great deal of Xi Jinping's trip down to the South. He kind of implies that Xi is really a political reformer waiting for his chance. So I'd like your thoughts on that.

DR. LI: There is lot of symbolism involved in his Southern trip. And one is certainly that his father has been widely considered a political reformer along with Hu Yaobang to a certain extent. And so that's one dimension. But I think most important is the symbolism of opening up China's economy, accelerating China's financial reform, et cetera. That's a very important message, the most important message.

But also there's another symbolism, the fact that he appeared along with Wang Yang, you know, potentially his political rival. This shows the kind of leadership unity and cooperation which is very, very important, because people after the leadership announcement already talk about this kind of split, this kind of divide. So that's also a part of symbolism.

But what Barry Naughton and you said, on the other hand, Xi Jinping really has been careful not to talk too much about political reform. To a certain extent, in my view, he is still politically conservative, but the question is whether he would give us a pleasant surprise. That's the issue. That's what I referred to early on, like China's Chiang Ching-kuo.

CHAIRMAN REINSCH: Okay. Commissioner Wessel, final question.

COMMISSIONER WESSEL: Since Larry took my question.

CHAIRMAN REINSCH: Oh.

COMMISSIONER WESSEL: No.

[Laughter.]

COMMISSIONER WESSEL: My question is rather long. If the witnesses are willing to respond to some questions later in writing, that would be fine. I will submit it that way.

CHAIRMAN REINSCH: Okay. Thank you. Thank you, both, for some very thoughtful comments that obviously stirred everybody up and

got us thinking. We appreciate it.

The next panel will begin in about five minutes. So thanks very much to the two of you. We'll take a very short break.

PANEL II INTRODUCTION BY CHAIRMAN REINSCH

CHAIRMAN REINSCH: Let's reconvene and try to stay on schedule. Our next panel will consider China's economic transition. Dr. Eswar Prasad is a Senior Professor of Trade Policy at Cornell University and also holds positions at Brookings and at the National Bureau of Economic Research.

Nicholas Borst is the China Program Manager and Research Associate at the Peterson Institute for International Economics. He previously worked as a consultant with the International Finance Corporation and the Multilateral Investment Guarantee Agency, otherwise known as MIGA.

Thank you, both, for joining us today and providing testimony. We ask you to stick to seven minutes. Your full statements will be entered into the record, and Dr. Prasad, we'll start with you. Please go ahead.

**OPENING STATEMENT OF DR. ESWAR PRASAD
SENIOR PROFESSOR OF TRADE POLICY, CORNELL UNIVERSITY**

DR. PRASAD: Commissioner Reinsch, Vice Chairman Shea, Commissioners, thank you for the opportunity to share with you my views about progress on economic rebalancing and the reform process in China.

I'm happy to say I bring good tidings. In fact, on the economic front, there has been very significant progress. What we've been focusing on, what much of the world focuses on, is the headline growth number in China. As you all heard, China did not do too badly over the last year, turning in growth of about eight percent of GDP, eight percent on an annual basis. But what is far more remarkable is what has happened to the nature of the growth process, and I'm going to argue in my testimony there has been a very significant shift, especially over the last couple of years, but carrying on from something that started at the beginning of the financial crisis.

When one speaks about imbalances in China, much of the attention tends to be focused on the external imbalances, the current account surplus, which was at a peak of 10.1 percent of GDP in 2007, or the trade surplus, which was above seven percent of GDP in 2007.

After the financial crisis, those two surpluses began to decline to a significant extent because of cyclical reasons. China was growing fast; the rest of the world, especially China's export markets, weren't.

But that pattern has persisted. Now the cyclical factors have not entirely disappeared, but the fact that we've had a persistent decline in these two surpluses, both of which have come in under three percent of GDP in 2012, suggest that something has shifted domestically.

Now, over the last year, what has happened to the currency is worth watching because there has been an argument made, especially in the U.S., that the currency is very important part of the reason why we've had these large imbalances. In the past, of course, China has intervened massively in foreign exchange markets to keep the value of the renminbi from rising.

Over the last year, the value of the renminbi rose relative to the U.S. dollar by just over one percent, on an inflation-adjusted basis by about two percent. In previous years, such a low level of appreciation would have been accompanied by a massive amount of reserve accumulation, which is one way of capturing how much foreign exchange market intervention there is.

Last year, the amount of reserves that were built up in terms of the change in the stock of reserves was \$130 billion, a large amount except if you compare it to the previous five years, where the average annual accumulation was \$420 billion, and last year, in fact, was the first year that China actually recorded an outflow in its capital account of about \$100 billion. So something definitely has shifted.

Now, these outflows have created some concern that there is, in fact, capital flying out of China because those in the know suspect that things are not going to go well in China. But to my mind, there is a much more benign interpretation: that, in fact, China has been opening up the capital account, making it much easier to bring in and to take out capital so Chinese households, corporations, institutional investors are all using the opportunity to take capital out. So, in that sense, I think we have to take more seriously the notion that there might have been a fundamental shift.

Now, the interesting question is where does internal rebalancing fit into this? The notion was always that the external imbalance reflected an internal imbalance, the fact that the investment rate, although very high, was much lower than an even higher saving rate, and the additional aspect of imbalance domestically was that much of growth was being driven by investment rather than consumption.

There, too, the picture has changed. Over the last two years, it turns out that, in fact, consumption growth--this is private consumption and government consumption added together--have contributed about 55 percent of GDP growth. Now, this is not very large by comparison with many other economies, especially the U.S., which is still a consumption-driven economy, but for China, it represents a fundamental shift because until then, over the previous decade, investment growth there accounted for about 60 to 65 percent of GDP growth. In fact, in the year of the financial crisis hit, in 2008 and 2009, investment growth contributed nearly 90 percent of overall GDP growth, although, of course, net exports made a negative contribution to growth in those two years.

And there are other signs that are positive. Service sector employment in 2012 was as much as the increase in manufacturing sector employment. The shares of the service sector and the manufacturing sector in GDP have now pretty much equalized. So I don't want to paint a picture that everything is okay. It's much too early to declare victory.

If, for instance, you look at the level of private consumption GDP, that number stopped declining, flattened in 2011, and has gone back up a tic, but it's still below 40 percent of GDP, which is well below the advanced economies and virtually every other emerging market economy. So it's not like they have actually made enough progress to declare victory, but I want you to be aware that there has, in fact, been significant progress.

But a big question in thinking about internal rebalancing is what caused this to happen. There was a very clear reform agenda on the table, and the question is whether the reform agenda has been met. And it turns out there is a lot of work still to be done on financial market reforms: dealing with the industrial policy; dealing with interest rate liberalization; and breaking up the power of the large banks. The social safety net needs to be reformed. So the reform agenda hasn't been shifted, but what is interesting and worth observing also is the reform strategy.

In 2011 March, the National People's Congress approved the 12th Five Year Plan, which laid out a very nice blueprint for reforms, and in the

first half of the year, there was some opportunistic moves taken in order to make some progress on these fronts, but not a great deal was accomplished.

In the second half of last year, reform momentum essentially ground to a halt as the leadership transition got underway. The new leadership has made its intentions very clear in broad terms, that they do want to continue this process of economic reforms, but specifics have been somewhat lacking, except a couple of days ago, the government did lay out this plan for reducing inequality.

Now, one might think that directing economic policies to reduce inequality is not necessarily the best approach, but what is interesting is that they're using this as a framework to think about a variety of policies that need to be put in place, and once one thinks about accepting this framework, it's going to be much harder for the vested interests to block these reforms because now the idea is that these reforms, the financial sector reforms, social safety net, and everything else I mentioned, are going to be seen as leading to something that is good for the masses.

So I think in terms of the strategy, as well, it is going in a reasonably positive direction, but, again, this is not to belie the enormous challenges that still lie ahead and the enormous resistance that is likely to come forward.

So what does all this mean for the U.S.?

Now, even though China's external surpluses have been declining, the U.S. bilateral trade deficit with China, in fact, is likely to cross \$300 billion this year, and that's going to get a lot of attention, but, of course, going back to the iPhone analogy, one has to be careful to make sure that the amount of value added in the trade is taken into account, and the amount of value added in Chinese exports to the U.S. is probably nowhere near \$300 billion.

In terms of financial flows, the fact that China isn't accumulating as many reserves means that China won't be buying as many Treasuries. In fact, in 2012, the amount of net purchases of U.S. Treasuries by China was essentially zero. So counting on Chinese official financing is going to be not good for the U.S., but on the other hand, there are many other channels through which money is coming from China to the U.S. so I think we'll see a very significant shift in terms of the nature of flows to the U.S.

And I think ultimately what you're also going to see is much greater political assertiveness by China in the international space because the new administration does need to essentially earn its chops, and it has to do that partly by appearing strong internationally. So I think that we're entering a period when flashpoints on the currency are going to be less important, and there is potentially good room to focus on this bilateral relationship, which can, I think, be a much more constructive one than it has been in the past.

Thanks.

**PREPARED STATEMENT OF DR. ESWAR PRASAD
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U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

HEARING ON “CHINA’S NEW LEADERSHIP AND IMPLICATIONS FOR THE UNITED STATES”

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Rebalancing and Reforms in China

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Chairman Reinsch, Vice Chairman Shea, and honorable members of the Commission, thank you for the opportunity to share with you my views on China’s progress towards rebalancing its economy and the prospects for economic reforms under the new leadership.

Since the financial crisis, China has made substantial progress on reducing its external imbalances, with the surpluses on both the current account and the trade balance falling sharply from their peaks in 2007. China has also made some progress on domestic rebalancing. Recent data suggest that it is time for a revision of the view that the country’s growth is driven largely by exports and investment. Private and government consumption together accounted for more than half of China’s output growth in 2011-12, signaling a significant change in the composition of domestic demand. Physical capital investment, the main driver of growth over the previous decade, is no longer the dominant contributor to growth while a shrinking trade balance in fact made a negative contribution to growth in these two years.

Despite all of this progress, there remain major challenges to putting in place the reforms needed to improve the quality and efficiency of growth, continue the shift away from capital-intensive production, generate more employment, and allow more of the benefits of growth to filter down to the average household.

The twelfth five-year plan that was approved by the National People’s Congress in March 2011 appeared to herald a turning point in China’s economic development. It represented, at least in rhetoric, a marked shift in emphasis from high growth to the quality, balance and sustainability of that growth. The longer-term objective of the plan was to reorient growth to make it more balanced and sustainable from different perspectives--economic, social and environmental.

¹ I am grateful to Karim Foda, Parul Sharma, Lei (Sandy) Ye, and especially Boyang Zhang for excellent research assistance.

There were promising signs of a push for reforms in the first half of 2012, as a number of modest but significant actions signaled continued progress towards economic reforms. This reform momentum stalled in the latter half of the year, however, partly due to some unexpected political turmoil in the lead-up to the political transition that got underway last fall. Nevertheless, the economy has continued to turn in a good performance despite a weak external environment. While steady growth and low inflation have eased immediate policy concerns, China still faces a number of challenges related to the longer-term structural transformation of the economy. The new leadership has indicated a desire to push forward with reforms, but there have been few indications of specific measures under consideration.

In this testimony, I will review progress on different aspects of China's rebalancing, discuss the main policy reforms that are needed, and summarize the implications for the United States.

Progress on External Rebalancing

China's current account and trade surpluses have shrunk steadily and markedly relative to their peaks in 2007, when they hit 10.1 percent of GDP and 7.6 percent of GDP, respectively. In 2012, both of these surpluses were below 3 percent of GDP (Figure 1). The decline in the trade surplus is due to sluggish export growth as many of China's major export markets, including the European Union and the U.S., have been experiencing economic difficulties. Meanwhile, bolstered by strong domestic growth, China's imports have increased at a faster pace than exports.

China's currency policy—tightly managing the value of the renminbi relative to the U.S. dollar--has been seen as a determinant of its external balances. During 2012, the renminbi appreciated by 1.4 percent relative to the dollar and around 2 percent in inflation-adjusted terms as China's inflation has been slightly higher than U.S. inflation over the past year. A broader measure of the currency's value is the real effective exchange rate—a trade-weighted measure of the inflation-adjusted exchange rates relative to major trading partners. By this measure, China's currency appreciated by 1.7 percent during 2012, much less than the 5 percent appreciation during 2011.

In previous years, such slow appreciation required China's central bank, the People's Bank of China, to intervene heavily in foreign exchange markets to offset pressures for faster currency appreciation. However, the increase in the stock of foreign exchange reserves in fact slowed sharply to \$130 billion in 2012, compared to average annual increases of \$420 billion in each of the previous 5 years. The fact that the increase in foreign exchange reserves was quite modest even though the renminbi appreciated very slowly during 2012 indicates weakening appreciation pressures on the currency.

This shift is attributable to two factors—the decline in China's trade surplus and the deficit on the capital account in 2012, implying that more capital (other than accumulation of reserves) flowed out of the country relative to the amount that came in.

This represents an important shift in the nature of China's overall capital exports (which is roughly equivalent to the current account surplus). Balance of payments data show that, in

2011, China's current account surplus was \$202 billion while the increase in international reserves, which effectively amounts to official capital outflows, was \$388 billion. This implies that net capital inflows amounted to about \$186 billion. By contrast, in 2012, the current account surplus was \$214 billion while accumulation of new reserves was only \$97 billion. The difference represents a net outflow of capital of about \$117 billion in 2012. Since the Asian financial crisis of 1997-98, this was the first year that China has experienced a significant capital account deficit.²

The decline in China's trade and current account surpluses in the immediate aftermath of the financial crisis led many researchers (including myself) to predict that those declines were largely cyclical—China was continuing to grow strongly while its advanced economy export markets were in recession—and would be reversed once cyclical conditions were normalized. While there are still significant differences in the business cycle positions of China versus its major export markets, the persistent and continued decline in the external surpluses suggest a more fundamental shift in China's dependence on exports to generate growth. Acknowledging this shift, the IMF recently reduced its forecast of the medium-term current account to about 4-4.5 percent of GDP, well below the level of 7-8 percent it had been forecasting only a year ago.

The capital account deficit in 2012 has sparked concerns of capital flight, with the connotation being that capital is being sent out of the country by domestic residents and corporations that see trouble brewing on the domestic macroeconomic front. A more benign interpretation, which I favor, is that rising capital outflows are a natural consequence of steps that China is taking to open up its capital account and remove restrictions on outflows. As the economy matures and financial markets develop, domestic retail and institutional investors will look to foreign investments as a way of diversifying their portfolios. Moreover, Chinese corporations and financial institutions are in quest of investments abroad to diversify their operations and as a conduit for acquiring technical and managerial expertise.

Back in the days when the current account surplus was larger and growing, Chinese officials made the argument that the external surplus was largely a reflection of internal imbalances that needed to be fixed with better domestic policies rather than through currency appreciation. It is therefore interesting to juxtapose the progress that has been made on external rebalancing with the somewhat more limited progress in shifting the structure of the domestic economy.

² These numbers in this paragraph are based on balance of payments (BOP) data provided by the State Administration of Foreign Exchange. The net outflows figure for 2011 is the sum of the financial account surplus (\$221 billion) and net errors and omissions (minus \$35 billion). The BOP figures for accumulation of reserves (both total and foreign exchange reserves) do not include mark-to-market changes or currency valuation effects on the value of the outstanding stock of reserves. Hence, the increase or decrease in foreign exchange reserves (which amount to about 98 percent of China's total international reserves) based on BOP data may be a better indicator of the degree of foreign exchange intervention. The headline number for China's stock of foreign exchange reserves—\$3.31 trillion at the end of 2012—comes from the People's Bank of China (PBC). Those numbers do seem to incorporate mark-to-market and valuation effects. In 2011, accumulation of foreign exchange reserves amounted to \$385 billion according to BOP data and \$334 billion according to the PBC. In 2012, the accumulation was \$99 billion according to BOP data and \$130 billion according to the PBC.

Internal Rebalancing Remains a Challenge

Despite global financial turbulence and weak growth in most other major economies, China delivered 7.8 percent GDP growth in 2012, with industrial production growing by about 10 percent (Figure 2). Inflationary pressures have moderated, with CPI inflation now under 3 percent and producer prices falling (deflation) (Figure 3). This has given Chinese policymakers the luxury of focusing on longer-term policies to make growth more balanced and sustainable.

A major objective laid out in the twelfth five-year plan is to rebalance domestic growth and increase the share of private consumption in GDP. This is seen as necessary to ensure greater social stability by increasing the benefits that accrue to the average household from China's strong GDP growth. In addition, shifting away from a capital-intensive production structure is important for increasing job growth and ameliorating the destructive environmental consequences of rapid growth. There has been progress on these dimensions but it is far too early to declare victory.

Investment growth propelled China's growth over the last decade, accounting for more than half of GDP growth (Figure 4).³ During and right after the financial crisis, investment growth was crucial for sustaining economic momentum. In 2009, the contribution of investment growth amounted to a remarkable 88 percent of GDP growth, far higher than the contribution of consumption (net exports made a large negative contribution to growth that year). Real estate investment and infrastructure investment have been important contributors to overall investment growth.

For an economy with a capital stock per worker ratio that is about 9 percent of the U.S. level (as estimated by the World Bank), additional investment in physical capital seems desirable. However, much of the investment that China has undertaken in recent years has been financed through loans provided by state-owned banks, raising concerns about the emergence of nonperforming assets on the books of the large state-owned banks if these investments turn out not to be commercially viable. Investment-led growth meant that employment growth, which has averaged less than 1 percent a year over the last decade, was relatively muted compared to the fast pace of output growth.²³⁴ This pattern of growth also has deleterious environmental consequences.

The Chinese government has had to cope with the twin challenges of boosting domestic consumption in order to make growth more welfare enhancing for its citizens and of generating higher employment growth in order to maintain social stability. The growth model fostered by government policies had, until recently, resulted in a rising share of investment and a declining share of private consumption in GDP. Moreover, weak employment growth and high investment growth had resulted in labor income falling as a share of national income and personal disposable income falling as a share of GDP. The government has

³ For more details, see Eswar Prasad, 2009, "Is China's Growth Miracle Built to Last?" *China Economic Review*, Vol. 20, pp. 103–123.

⁴ The annual growth rate of non-agricultural employment averaged around 2.5 percent during this period, although this in turn has to be set against the growth rate of non-agricultural output, which has been 2-3 percentage points higher than that of overall GDP.

also been trying to channel more bank credit towards the services sector, which has the potential to provide more employment.

In the last two years, there has been progress in many of these dimensions. As noted earlier, consumption growth has overtaken investment growth as the main contributor to GDP growth. In 2012, the share of private consumption in total GDP stopped declining and rose slightly, although the level of this ratio still remains well below that of virtually every other advanced or emerging market economy (Figure 5). Another positive development is that, in 2011, service sector employment climbed to 3.6 percent, higher than in recent years and also higher than industrial sector employment growth of 3.2 percent. In 2012, the shares of the industrial and service sectors in total GDP were almost the same, at 45 percent each. This is a marked change from the situation in 2000, when the GDP share of the industrial sector was 46 percent (it reached a peak of 48 percent in 2006) and that of the service sector was just 39 percent.

This relatively benign picture is not without risks. The level of investment remains high, at nearly 47 percent of GDP. This investment boom is to some extent feeding on itself—so long as financing is available for construction and infrastructure projects, investment in ancillary industries pays off. But a slowdown in the investment machine, especially if the government tightens the supply of bank credit further, could result in excess capacity in industries such as steel, aluminum and hard glass. This could eventually dampen employment and household income growth. Banks fear a resurgence of bad loans on their books if consumption demand doesn't grow fast enough to soak up output from the new factories. In turn, a weakening of domestic consumption growth could eventually increase the dependence on export-led growth, exactly the reverse of the balanced private consumption-led economy that Chinese leaders want. These concerns have not been borne out recently but still remain risks to China's growth.

Moreover, the Chinese household saving rate has trended upward in recent years; the economic uncertainty associated with the crisis and the weak global economic recovery are likely to increase savings for precautionary purposes. The household saving rate, as a share of household disposable income, is now close to 30 percent (Figure 6). Factors such as rising wages could help boost consumption demand. Other fundamental reforms, including a stronger social safety net and a better government-funded health care system, are also necessary to shift consumption patterns of Chinese households.⁵ The twelfth five-year plan acknowledged these issues and proposed a number of measures that would increase the coverage and extent of government financing of health care, pensions and the broader social safety net.

There are other aspects of balanced growth where the government has taken measures that seem to have yielded at least modest results. Growth needs to become more balanced in terms of reducing regional disparities in economic development, especially when one compares the coastal versus the interior provinces. To respond to this issue, the

⁵ For an analysis of the factors driving the trend increase in saving rates of urban households, see Marcos Chamon and Eswar Prasad, 2010, "Why Are Saving Rates of Urban Households in China Rising?" *American Economic Journal: Macroeconomics*, Vol. 2, No. 1, pp 93–130; and Marcos Chamon, Kai Liu and Eswar Prasad, 2010, "Income Uncertainty and Household Savings in China," NBER Working Paper No. 16565.

government has directed large amounts of infrastructure funds towards interior provinces through the Develop the West campaign. The rise in food prices in recent years has reduced rural-urban income disparities although both official data and estimates by academics suggest that overall inequality, as measured by the Gini coefficient, remain very high by international standards.

In short, the picture that one can paint with macroeconomic data is one of small but notable improvements in the balance of domestic growth in most dimensions, although there are many underlying risks that are being masked by high growth. Maintaining high and stable growth, even if somewhat below the levels of the past decade, is therefore an important objective of policy reforms.

The Reform Agenda

The main challenge for China, especially since it faces a rapidly aging population and a labor force that is likely to start shrinking soon, is to maintain rapid productivity growth. This will require a shift towards higher value-added production, a more efficient allocation of resources through a better financial system, and more balanced growth.

The twelfth five-year plan (the Plan) remains the blueprint for China's reform agenda. It lists a large number of reform priorities but has limited detail on specific courses of action for achieving the long-term objectives. The Plan highlights the objectives of further financial system reform and progress towards capital account convertibility, but offers few details. The Plan has more details concerning policies that have direct implications for the average Chinese household--controlling inflation, increasing wages and employment, and strengthening the social safety net.

In the remainder of this section, I selectively summarize a few key reform priorities. There are many more--including reforms to the tax and expenditure systems, pension reforms, reforms to corporate governance in state-owned enterprises--that I do not examine in detail.

Financial sector development

Financial sector reform and development remain key priorities. The Chinese government recognizes that a more efficient financial system can play an important role in increasing productivity by reducing inefficiencies in the allocation of capital. A reformed banking system may also respond to incentives to lend more to small- and medium-sized enterprises, especially in the services sector, that tend to be better than large enterprises at generating employment.

China's banking system appears well capitalized and the ratio of nonperforming loans relative to assets for the overall banking system is low. These figures mask a number of well-known problems, including persistent incentives to lend to state-owned enterprises rather than private sector enterprises, weak risk management capacity that results in rationing of credit to small and medium-sized enterprises, and asset portfolios that include a large amount of subpar assets that may turn into nonperforming loans if GDP growth were to slow. Indeed, concerned about the possible fallout from the surge in bank lending during the financial crisis, the government has clamped down on growth in monetary aggregates and bank credit (Figure 7). The policy complication is that tightening credit hurts

employment growth as it tends to disproportionately affect credit flows to small and medium sized enterprises, especially those in the private sector.

Interest rate liberalization is an important element of banking reforms. At present, there is a ceiling on deposit rates and a floor on lending rates, resulting in a comfortable and noncompetitive spread that helps the profitability of banks. One effect is that households earn low or negative inflation-adjusted rates of return on their copious deposits in the banking system. Another is that the absence of price competition makes the banking system less efficient. Belying expectations--as many Chinese officials have mentioned this as a reform priority--the Plan did not contain any specific language about interest rate liberalization, suggesting that the prospects for any major reforms in this area are remote for the time being.

China's financial system remains bank-dominated, with limited corporate bond market development and limited scope of securities markets. The Plan recognizes the need to broaden and deepen financial markets in order to improve their overall functioning and enhance their contribution to balanced growth. But this remains an aspiration rather than an objective backed up by a well-defined strategy.

Capital account opening

China is eager to make the renminbi an international currency and has already taken a number of steps in that direction.⁶ However, contrary to expectations in some quarters, the Plan did not lay out a timeline for opening up the capital account and making the currency fully convertible. There are other indications that this is seen as a policy objective over the next 5-10 years as it would set the stage for China's ascendancy in global financial markets and make the renminbi an international currency. Indeed, the Chinese government has recently taken a number of relatively modest but symbolically significant steps to increase the use of the renminbi in international transactions, including trade settlement. The government is appropriately reticent about dismantling capital controls and allowing freer cross-border movement of capital without having a robust and well-functioning financial system in place.

Exchange rate flexibility

Although pressures on the currency have eased off, a more flexible exchange rate regime would serve China well in the long run, particularly as the capital account becomes more open and it becomes more difficult to tightly manage the currency's value. A more flexible currency would give the central bank a much freer hand in changing interest rates to meet the twin objectives of high growth and low inflation. Faster currency appreciation, which is likely to happen over time anyway as China has higher productivity growth than its major trading partners, would help rebalance growth by increasing the purchasing power of domestic households. This would happen directly through the fall in the price of imported goods and, at times of high inflation, also by giving the central bank room to raise deposit rates, giving households a better rate of return on their savings.

Industrial policy

⁶ See Eswar Prasad and Lei Ye, *The Renminbi's Role in the Global Monetary System*, Brookings Institution Report, February 2012.

The Plan lays out two sets of objectives in this area. The first is to upgrade and restructure a group of traditional industries. Industries such as iron and steel, automobiles, and textiles are identified as needing technical upgrading as well as consolidation to benefit from scale efficiencies. The second objective is to foster and develop strategic emerging industries that are intended to develop into future pillars of the economy. These tend to have a hi-tech or environmental focus and include energy conservation and environmental protection; bio-tech; high-end manufacturing equipment; and new energy (including nuclear and renewable energy). The government intends to set up special funds to develop these new strategic industries. These funds will encourage start-ups and also complement private investment in these industries. One concern that needs to be tracked carefully as these objectives are transformed into concrete policy measures is whether they will shift industry dynamics in a way that favors state-owned firms. This might have the effect of rolling back some of the gradual shift in the last two decades towards a more private sector-led industrial structure.

Small Steps in the Right Direction

While the political process in China is highly opaque, it is important not to underestimate the enormous political and institutional constraints to reforms, even if backed by the top leadership. Consider for instance that the Plan sent a direct and unambiguous message to provincial governments that they should shift from a focus purely on growth to broader economic and social considerations. But it is not clear that incentives facing provincial governments, which still view high growth as the ultimate objective, can be shifted easily.

In the first half of 2012, the central government made some opportunistic moves to kick-start momentum on a few key reforms. It increased the flexibility of the exchange rate (in principle) when the renminbi was not under pressure to appreciate, relaxed the cap on interest rates paid on deposits, increased foreign investors' access to capital markets, and encouraged certain informal financial firms to become part of the formal banking system. Each of these moves has broader significance.

For instance, giving informal financial firms the opportunity to join the formal banking system serves multiple ends. It brings these institutions under the ambit of the banking regulator and reduces the risks they pose to financial stability. Moreover, they now provide more overt competition for established banks.

The need for interest rate liberalization is widely recognized. Freeing up deposit rates and abandoning the fixed spread between deposit and loan rates would result in better returns for depositors (as banks competed for deposits) and encourage banks to sharpen their lending practices. The big banks have resisted this fiercely as it would cut into profits. So the government cleverly took a small step when it cut rates—freeing up banks to offer deposit rates marginally higher than the base rate, arguing that this would make the rate cut more palatable to depositors.

A one-shot approach to breaking up big banks or freeing interest rates risked a backlash and concerted opposition that could block changes altogether. Reform-minded officials therefore took a more subtle approach—using a megaphone to draw attention to the problems but avoiding a frontal attack, instead chipping away at the foundations of the current financial structure.

Even these modest steps towards reforms came to a halt in the latter half of 2012 as the leadership transition got underway, preceded by some domestic political turmoil.

Intentions of the New Leadership

The priorities are clear but what is less certain is whether the government has the political will to take on an ambitious reform agenda, battling against the vested interests that want to maintain the status quo and coping with social pressures from the short-term dislocations that the reforms might create. China's leaders may have little choice, however, if they want to maintain their legitimacy and social stability.

The new leadership has strongly signaled in its public statements that there will be continued impetus for reforms, including to tackle corruption. But there have been few specifics offered about particular measures as yet. Appointments to some key positions, such as the governorship of the central bank, will be made in the coming months and could provide some signals about the reform-mindedness of the top leadership.

One specific proposal is that the government has recently indicated its intention to speed up reform of the “hukou” system of household registration that restricts the movement of rural residents to urban areas. The new leaders have stressed the importance of urbanization as an engine of growth and reform of the hukou system is seen as an important element of that process, which should also improve labor mobility.

Implications for the United States

China's growth and reform process will have direct and indirect implications for the U.S. through a number of channels.

Trade: Although its overall trade balance fell steadily and sharply from 2007 to 2012, the bilateral trade surplus that China runs with the U.S. has in fact increased and hit a peak of \$295 billion in 2011. In 2012, this surplus had reached \$291 billion by November, making it likely that the figure for the full year will top \$300 billion.⁷ These numbers are overstated because of the fact that about two-fifths of China's trade is processing trade, with relatively low value added in China.

If the shift towards private consumption-led growth proves durable and intensifies, China's demand for imports of consumer goods and services would rise, especially if the exchange rate continues to appreciate. This could help boost U.S. exports to China. Indeed, China is the one country to which U.S. exports are on track to double over a five-year period, an objective set by President Obama in his January 2010 State of the Union speech. The ability of U.S. firms to take better advantage of this growing market of course depends on a number of factors, including the level of market access that is provided to them.

Financial flows: If external rebalancing turns out to be durable, the pace of reserve accumulation will remain slower than in the past and, as a consequence, China will demand

⁷ These numbers are based on U.S. trade data. Chinese data show a smaller surplus of \$197 billion in 2011, rising to \$221 billion in 2012.

fewer U.S. Treasury securities. Even during 2012, China's identified holdings of Treasury securities barely changed from the level at the end of 2011 (\$1.15 trillion). Lower levels of official purchases of Treasuries could be offset by financial flows to the U.S. through other channels, including mergers and acquisitions activity, equity investments by state-owned enterprises and banks, as well as investments by private and institutional investors. Many of these investors may also choose to acquire U.S. Treasuries but probably not at the same level as official purchases by the central bank.

Industrial policy: China is clearly taking some important steps towards upgrading its industries and moving towards more hi-tech and high value added production. With various incentives and explicit government support, China is likely to make quick progress in clean energy and information technologies. The U.S. and other advanced economies could start losing ground in new technologies if China successfully implements its strategy of technology leap-frogging.

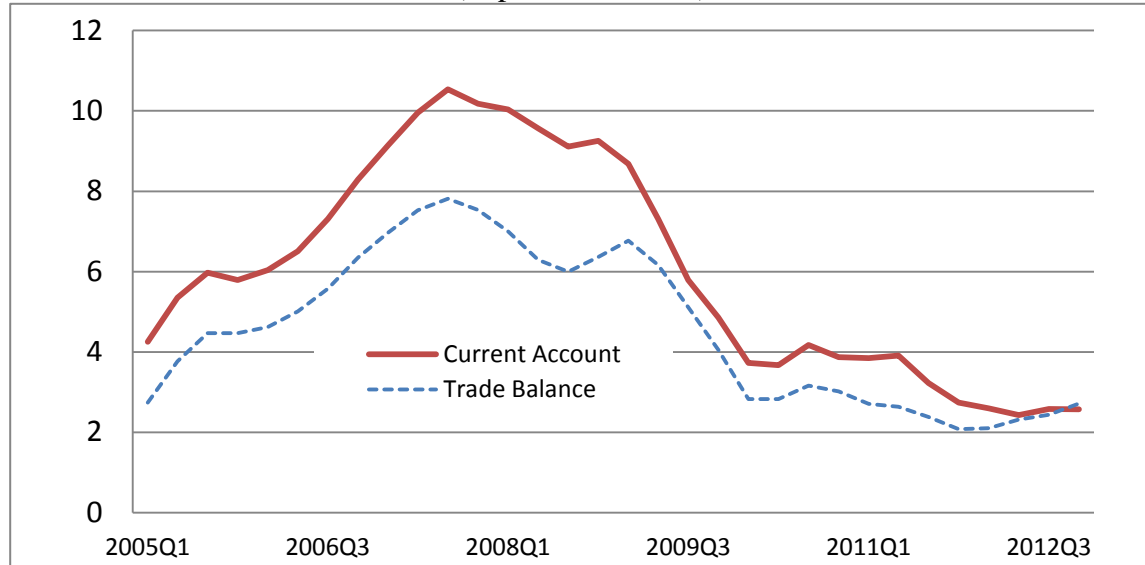
Potential tensions: China's high and rising bilateral trade surplus with the U.S. will continue to attract attention in the U.S., but there is increasing understanding that it is of limited significance by itself in driving the overall U.S. trade deficit. Assuming that turbulence in global financial markets settles down, capital will once again start flowing to China and other emerging markets. The Federal Reserve's continued policy of taking aggressive unconventional monetary policy actions could result in heightened tensions if there are renewed pressures for China's currency to appreciate. Nevertheless, given the greater openness of China's capital account, rising outflows are likely to balance out some of these pressures.

While stable and more balanced growth in China will have largely positive effects for the U.S., there is no doubt that China will become more assertive in economic and geopolitical discussions as its economic power increases. Indeed, the Chinese government has become increasingly vocal about its concerns that U.S. policymaking is contributing to global financial instability (while the subtext is that its own policies are arguably more on the right track).

Conclusion

The stated desire of China's new leaders to promote economic reforms provides grounds for cautious optimism. The twelfth five-year plan developed in 2011 remains the blueprint for improving the country's pattern of economic development. The broad objective of the plan is to reorient growth to make it more balanced and sustainable, even if it means settling for slower average growth than in the previous decade. The challenge for the new leadership is to break down the opposition of interest groups that prefer the status quo and to implement reforms needed to attain the plan's objectives. It is likely that the major elements of the Plan will not be acted upon forcefully until the new leaders have found their footing and consolidated their power bases. The next few months, when the macroeconomic environment is relatively benign and provides space for policy changes, will be a good test of the government's commitment to push for reforms. Progress on these reforms will further solidify China's growth prospects and will have beneficial effects on the U.S. and the rest of the world economy as well.

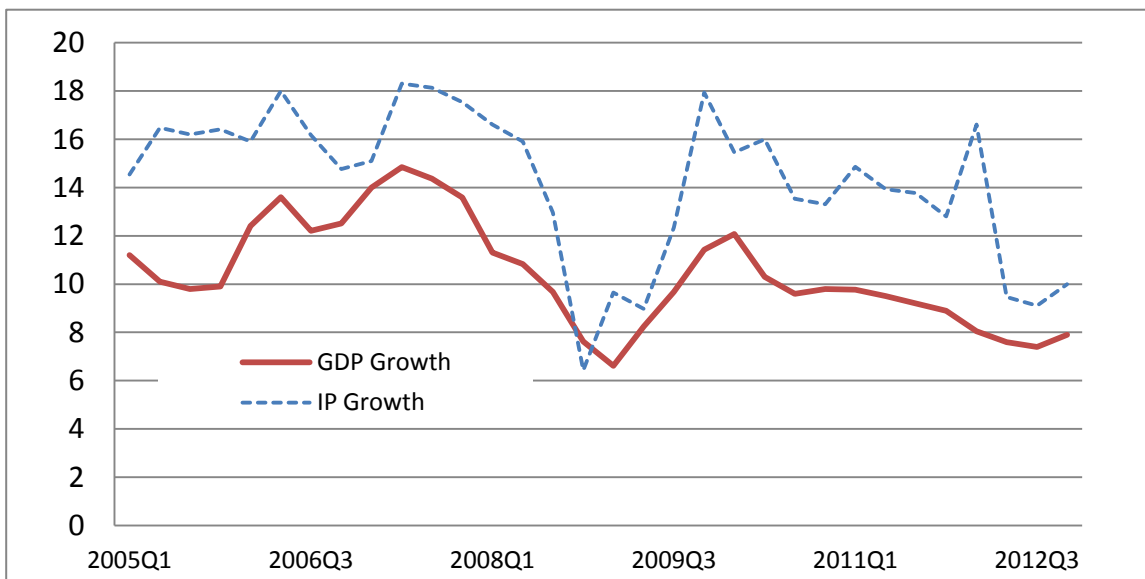
Figure 1. China: Current Account and Trade Balance
(in percent of GDP)



Data sources: State Administration of Foreign Exchange and National Bureau of Statistics.

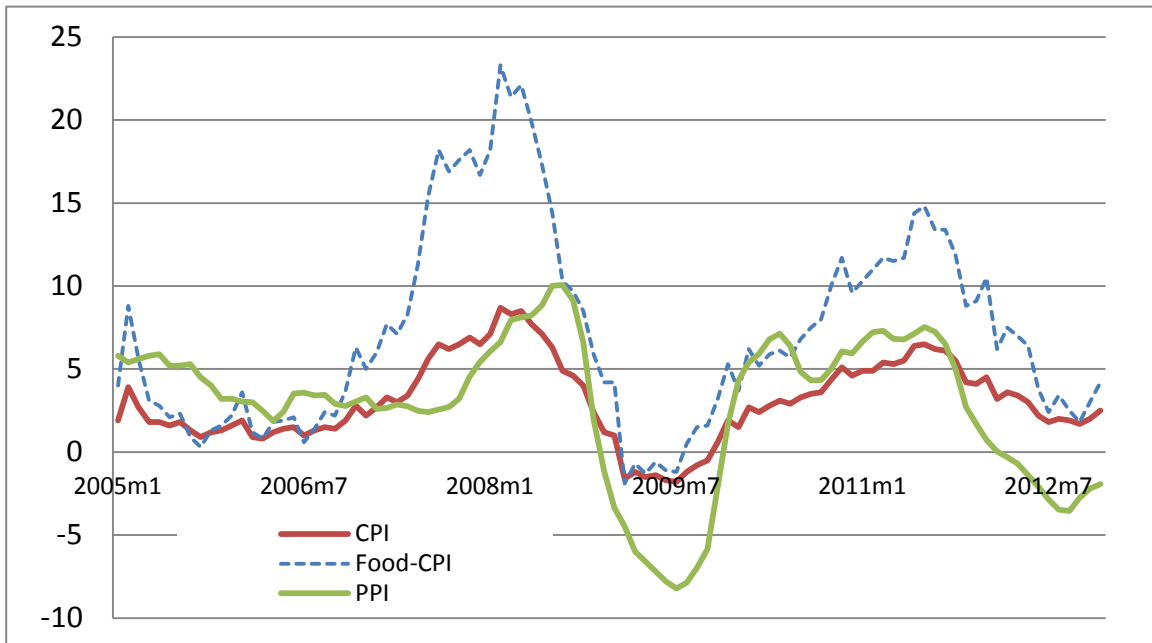
Notes: Current account balance and trade balance are both expressed as ratios to nominal GDP. The figure shows four-quarter trailing moving averages for both variables.

Figure 2. China: GDP and Industrial Production Growth
(year over year quarterly growth rates; in percent)



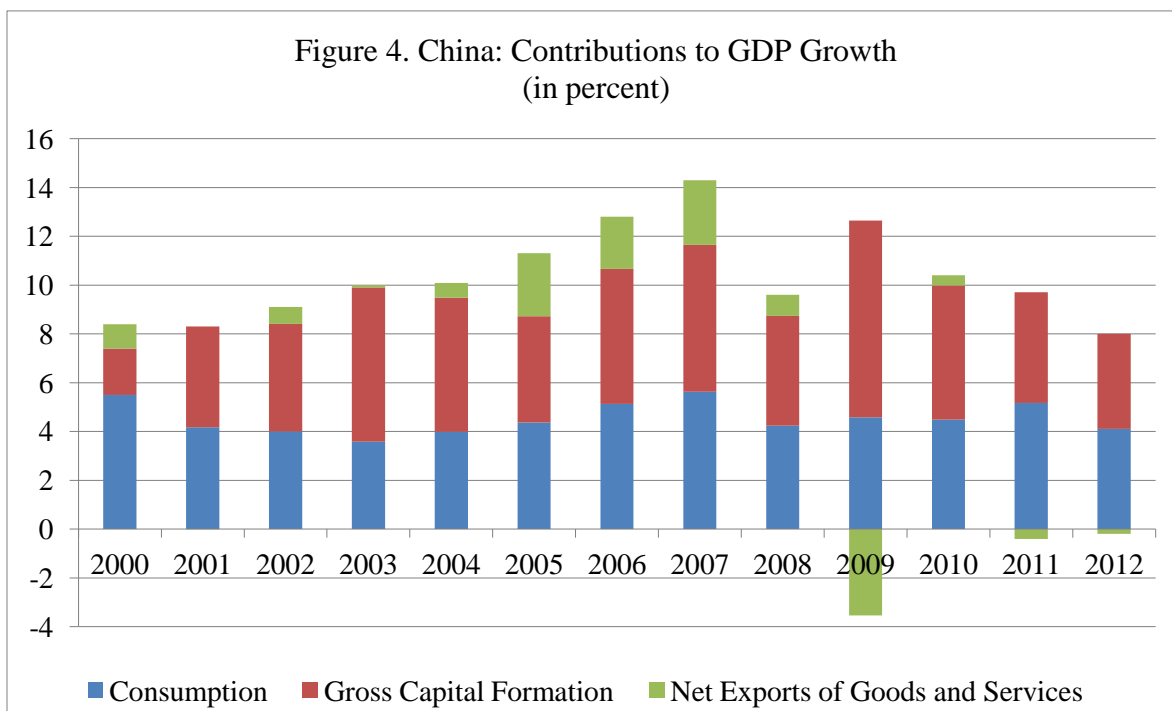
Data source: National Bureau of Statistics.

Figure 3. China: Inflation
(year over year changes in price indexes; in percent)



Data source: National Bureau of Statistics.

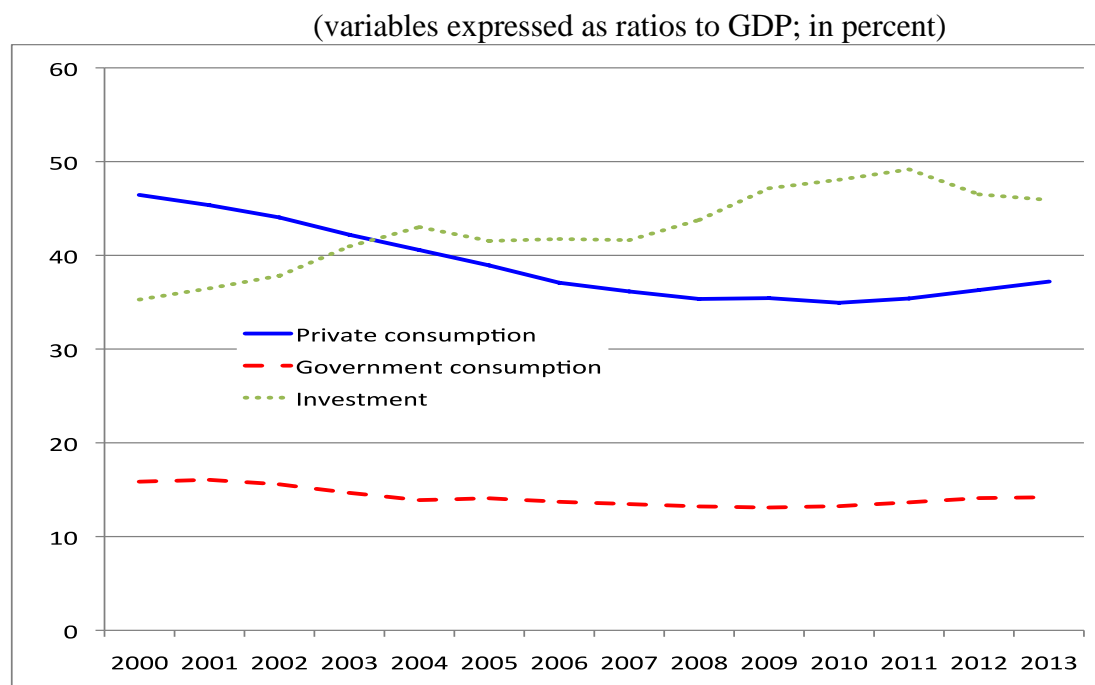
Figure 4. China: Contributions to GDP Growth
(in percent)



Data source: National Bureau of Statistics

Notes: Consumption includes private and government consumption.

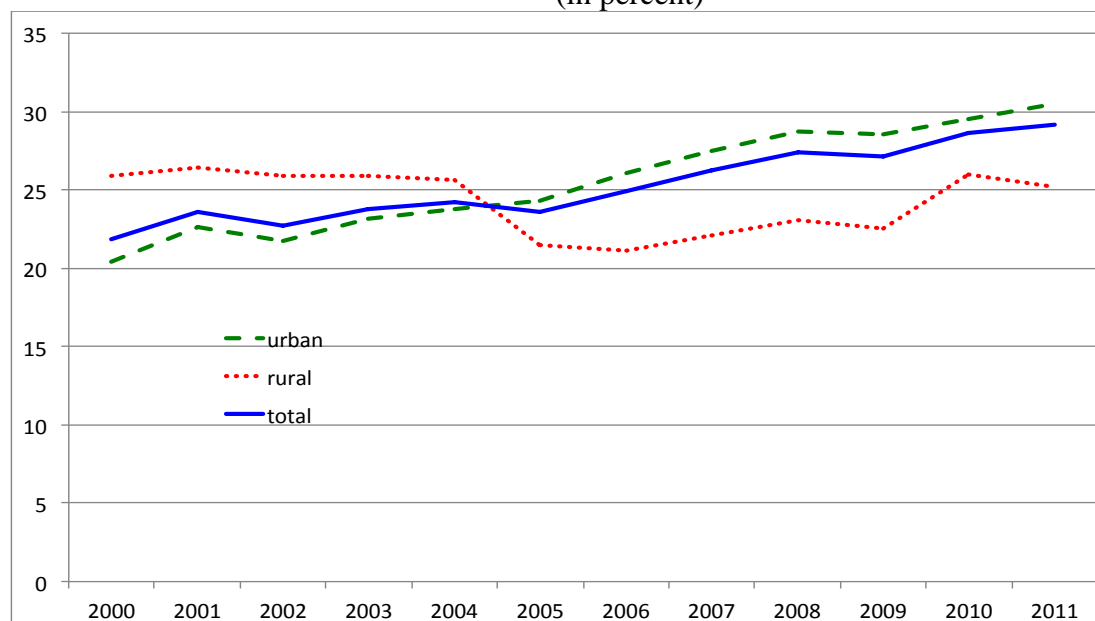
Figure 5. China: Composition of Domestic Demand



Data source: EIU CountryData.

Notes: Data for 2012 are estimates. Data for 2013 are forecasts. Investment includes gross fixed investment and stockbuilding.

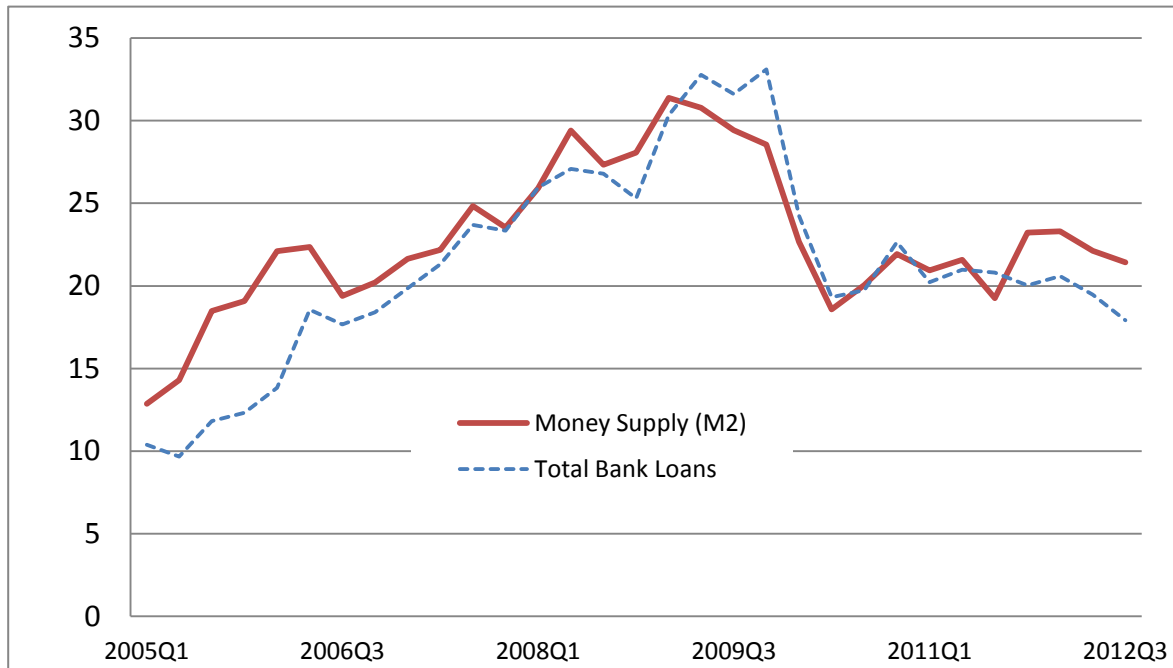
Figure 6. China: Household Saving Rate
(in percent)



Data source: CEIC.

Notes: Household savings survey data are based on per capita income and annual consumption expenditures. Saving rates from the Urban and Rural Household Surveys expressed as a share of disposable income and net income respectively.

Figure 7. China: Bank Loans and Money Supply
(year over year growth; in percent)



Data source: People's Bank of China.

**OPENING STATEMENT OF NICHOLAS BORST
RESEARCH ASSOCIATE AND CHINA PROGRAM MANAGER
PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS**

MR. BORST: Chairman Reinsch, Vice Chairman Shea, honorable members of the Commission, thank you very much for having me here to discuss this important issue.

For the past several years, China's top leadership has repeatedly described the country's current economic model as "uncoordinated, unsteady, imbalanced, and unsustainable." Chinese policymakers' gloomy rhetoric on the economy is an acknowledgement that while economic growth over the past decade may have been fast, it has not been very healthy.

During this period, the country's economic growth has been based on super-elevated levels of investment and suppression of private consumption, resulting in the build-up of significant distortions in the economy. The longer these distortions accumulate, the greater the risk the Chinese economy will face a sharp and wrenching correction. This is because overinvestment often leads to unsustainable asset bubbles and large amounts of misallocated capital.

The best indicators on the progress of economic rebalancing in China are GDP expenditure data showing investment and consumption as a share of the economy. In between these annual updates, there are several high frequency indicators we rely on to get a better sense of the progress of rebalancing.

I'll refer you to my written testimony for what these indicators are and an explanation of why they are important. Based on these indicators, the current progress of economic rebalancing in China is tepid. At the current pace, investment levels will remain elevated in China and consumption will remain depressed for the foreseeable future.

There are four policy areas where reforms could strengthen the progress of rebalancing. In rough order of importance, they are: interest rate liberalization; a market-oriented exchange rate; reducing the underpricing of energy; and addressing excessively high savings rates through strengthening the social safety net and addressing income inequality.

For a detailed explanation of why reform in these areas could reduce economic imbalances, I refer you to my written testimony and a newly released paper by Nicholas Lardy and myself called "The Blueprint for Rebalancing China's Economy." I am, also, of course, happy to answer questions about this during the Q&A session.

Many have identified the political barriers to economic rebalancing in China. A common refrain is that political reform in China is necessary to break the current deadlock on economic reform. This argument advanced by many inside and outside of China states that the growing power of vested interests has strangled economic reform over the past decade.

The political barrier to economic reform argument has some validity, but it is often overstated. In certain policy areas, vested interests are strong and have successfully resisted reform. However, with respect to the key reforms needed for economic rebalancing, the case that vested interests are organized and able to resist changes is a lot less clear. Most of the critical policy levers needed to achieve economic rebalancing are controlled by the central government.

Rather than forcing changes that may be resisted by subordinate actors, most of these reforms simply require that the central government stop actively interfering with the market. Other policy changes that require cooperation by local governments enjoy high public support, and vested interests will have a hard time resisting these policies if the central leadership vigorously and publicly promotes them.

The reforms needed for economic rebalancing are largely already government policy and within the central government's abilities. Therefore, there is no obvious reason why fundamental political reform has to precede economic reform. The slow pace of reform in the Hu Jintao - Wen Jiabao era stemmed from the top leadership's weak commitment to economic restructuring. The tremendous speed of economic growth over the past decade provided little incentive for policymakers to actually move forward with the difficult changes needed for rebalancing.

As is the case with many political systems, difficult changes are only made when forced by necessity. During the 1990s, the Chinese leadership was able to push through significant reforms in the banking and state-owned enterprise sectors when fears of the Asian financial crisis and the non-performing loan scandal came to a head. It is only with the economic slowdown in 2012, which led to the slowest pace of economic expansion in a decade, that the rebalancing agenda has taken on greater urgency in China. As rebalancing increasingly becomes a necessity to sustain economic growth and, thus, the Communist Party's legitimacy, economic reforms will be implemented with greater urgency.

The ramifications of economic rebalancing in China for the United States come primarily through the reduction of China's external surpluses. When a country runs a large and persistent external surplus, it is siphoning away global demand from other countries. It is important to note that China's external surpluses have come down significantly over the past few years. These reductions, however, may be temporary because they were driven by global economic weakness and unsustainably high levels of investment in China.

Economic rebalancing will increase consumption in China and the amount it imports from other countries. This is likely to increase American exports and facilitate our own process of economic adjustment. A reduction in the American current account deficit will have positive benefits for economic growth and ameliorate some of the adverse effects of household and government fiscal consolidation.

While economic rebalancing in China would have benefits for the

United States, it is not a cure-all for our economic problems, nor should imbalances in China be used as a scapegoat for our build-up in debt or the global financial crisis. Chinese economic rebalancing would be helpful, but domestic policy decisions will ultimately determine the fate of our economy.

American support and pressure can be helpful in promoting economic reform in China, but it is by no means decisive. Economic policy decisions in China will continue to be primarily based on domestic concerns. Policies that are viewed as threats to the core interests of economic and social stability or policies that weaken state control in sensitive economic sectors will be resisted.

Moreover, too much pressure from the United States can actually be counterproductive. When policy debates between China and the United States take on an overly critical tone, Chinese public opinion begins to view these issues through a nationalistic and anti-foreign prism, and this results in those in China who are most opposed to reform actually gaining influence.

The United States should continue to advocate for economic reform within China, and when possible frame the debate in a positive way. A commitment by both countries to engage each other directly on new international economic agreements would be helpful in improving the tone of relations. Direct engagement on regional trade agreements is one such area.

A proactive policy by the United States combined with a recognition of the limits of our influence is the best strategy for promoting economic rebalancing in China.

Thank you.

**PREPARED STATEMENT OF NICHOLAS BORST
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Economic Rebalancing in China

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

Hearing on China's New Leadership and Implications for the United States

February 7, 2013

Nicholas Borst

Research Associate and China Program Manager
Peterson Institute for International Economics

The Imperative to Rebalance

For the past several years China's top leadership has repeatedly described the country's current economic model as "uncoordinated, unsteady, imbalanced, and unsustainable." This language is in sharp contrast to what has been a decade of apparent success: high-speed economic growth and emergence into the ranks of middle-income countries. What accounts for this disparity between rhetoric and record? Chinese policymakers have correctly assessed that the country's economic growth over the past decade has been based on superelevated levels of investment and systematic suppression of private consumption. The resulting capital-intensive growth model has not generated adequate gains in consumption and employment and instead has built up significant distortions in the economy.

The longer these distortions accumulate, the greater the risk that the Chinese economy will face a sharp and wrenching correction, because overinvestment leads to unsustainable asset bubbles and large amounts of misallocated capital. China needs a different growth model for the next decade to sustain moderately fast growth. Chinese policymakers' gloomy rhetoric on the economy, therefore, is a justified acknowledgment that while economic growth over the past decade may have been fast, it has not been very healthy. The desire to move away from the excesses of the past decade and put the economy on a more sustainable growth path is the core objective of economic rebalancing.

The task of economic rebalancing is likely to demand much of the energy and attention of the new Xi Jinping–Li Keqiang administration. Rebalancing entails large changes in fundamental economic policies, such as removing lingering price controls and opening up the closed financial system. It will also bring about a shift away from the economic winners of the past decade, namely manufacturers and property developers, towards private consumers and the service sector. While a more balanced economic model will deliver more sustainable economic growth, it also requires a change in traditional modes of economic policymaking. Chinese economic

policymakers will have to reduce explicit government controls and intervention and become more comfortable with allowing market mechanisms to guide ever larger segments of the economy. Despite these challenges, economic rebalancing is eminently achievable and should be tackled sooner rather than later.

The Progress of Economic Rebalancing in China

The best indicators for economic rebalancing come in the form of yearly GDP expenditure data. This data, usually released in March, shows the share of GDP attributable to consumption, investment and net exports. This data shows that dramatic economic imbalances grew rapidly in China through most of the 2000s, plateauing at high levels over the past two years. The expenditure data for 2013 has not yet been released, but it is likely to show little to no change in the super-elevated level of investment as a share of GDP. Between annual updates, there are several more high frequency updates that can be used to monitor the progress of economic rebalancing in China.

Urban Disposable Income Growing Faster than GDP: If disposable income is growing faster than GDP, absent an increase in the savings rate, this will lead to a rising share of consumption. Disposable income growth has outpaced GDP for the past year, a positive sign for economic rebalancing. It remains to be seen whether this will continue if GDP growth accelerates in 2013.

Positive Real Interest Rates on Deposits: Positive real interest rates on bank deposits are critically important for economic rebalancing. The on-average negative real interest rates over the past decade have been a blow to household income and wealth and served as the catalyst for speculative investment bubbles in the real estate market. Keeping interest rates above inflation for a significant period of time will not only boost incomes but also dissuade savers from taking their money out of the banks and speculating in the property market. Interest rates on deposits are currently positive in China, but only barely. Absent an increase in deposit rates, rising inflation is likely to turn real interest rates negative in 2013.

Residential Real Estate Investment Growing at a Slower Pace than GDP: Growth in residential real estate has been the key driver of economic growth over much of the past decade. This sector has grown unsustainably fast, reaching a point where China is investing 11 percent of GDP in residential real estate. For comparison, this is far more than either the United States or Spain invested at the height of their housing bubbles. The housing sector must come back down to reality along with all the sectors (steel, cement, etc.) that have grown unsustainably alongside it. The growth of residential real estate investment has slowed significantly from 2011 and is roughly advancing at the same pace as GDP growth. This is a neutral sign for economic rebalancing.

Loans to Small Enterprises Growing Faster than Total Enterprise Loans: Financing in China needs to shift away from large firms towards smaller firms. In the past, large firms have captured a disproportionate share of financing and forced smaller firms to rely on informal financing. Small firms are also a good proxy for private enterprises while large and medium firms have a much higher percentage of state-owned enterprises. Private firms have a higher return on assets than state-owned firms, almost twice as high in fact. Faster credit growth to private firms represents an improvement in the allocation of capital in China. Loans to small

enterprises have grown faster than total enterprise loans for the past two years. While the gap between the two has narrowed in recent quarters, this is still a positive trend for economic rebalancing.

Growth of the Tertiary Sector Faster than the Secondary Sector: As a result of distortionary policies, industry has grown much faster in China than services for much of the past decade leaving China with a much less developed service industry than most countries at comparable levels of economic development. Faster growth in this area will be essential to rebalancing both because the service sector is more labor-intensive thus generating more employment and because the service sector pays higher wages on average. Fast service sector growth should help the wage share of GDP recover from the current low levels and thus boost consumption. Moreover, a rapidly growing service sector should reflect rebalancing because households increase their consumption of services (relative to goods) as their incomes grow. A slowdown in secondary growth over the course of 2012 has led it to grow at the same pace as the tertiary sector, a neutral indicator for economic rebalancing.

An examination of these indicators reveals that economic rebalancing is occurring in China, but at a suboptimal pace. Three out of five indicators listed above are positive, but only slightly so. The remaining two indicators are only neutral. The slow progress of rebalancing is at odds with the urgent rhetoric that policymakers use when describing the necessity of economic rebalancing. At the current pace, investment levels will remain super-elevated in China and consumption will remain depressed for at least the next decade.

Policies to Rebalance

The Interest Rate

Market-determined interest rates would lead to a rise in deposit rates, and banks would have to pass part of the costs of funds to borrowers in the form of lending rates that on average would be higher in real terms than has been the case in recent years. This would narrow the spread between the return on capital and the bank lending rate and therefore likely reduce China's extraordinarily high rate of investment, thus contributing to the policymakers' goal of reducing China's dependence on investment as a source of economic growth.

Higher deposit rates would also promote consumption through three distinct channels. First, higher deposit rates translate directly into more income for households. Second, higher deposit rates likely will lower the saving rate. This counterintuitive effect is due to severe financial repression, which has reduced the return available to savers. Because Chinese households are target savers, seeking a set amount of funds for emergencies and expenses, a lower deposit rate actually causes households to save at higher rates. Finally, higher lending rates lead to less capital intensive economic development resulting in more job creation, higher household income, and ultimately higher levels of household consumption.

The Exchange Rate

Although China's current account surplus has declined significantly from the peak levels of 2007–08, it is still large. Thus given China's persistent large current account surplus, a more market-based renminbi exchange rate almost certainly will lead to appreciation. This would

contribute to economic rebalancing in two ways. First, by making exports more expensive and imports cheaper, currency appreciation would reduce the growth of exports and increase the growth of imports, cutting China's large global external surplus. On the domestic side, an appreciation of the currency would also decrease the profitability of the export-oriented manufacturing sector to the relative benefit of the service sector of the economy, which has languished since 2002. Secondly, a more flexible renminbi will mean less intervention in the foreign exchange market, a prerequisite for liberalizing interest rates.

China's current account surplus in the first half of 2012 fell to only 2.1 percent of GDP, down dramatically from the 10.1 percent peak in 2007. This fall in the external surplus was made possible by the 30 percent appreciation in the real effective exchange rate since June 2005 and ongoing economic weakness in China's major export markets, particularly Europe. This drop in the current account surplus in part explains the ability of the central bank to significantly reduce its intervention in China's foreign exchange market in the first three quarters of 2012. Compared with an annual average of \$435 billion in 2007–11, central bank intervention in the foreign exchange market dropped dramatically to only \$64 billion in the first three quarters of 2012. Moreover, in 2012 there was substantial two-way movement in the value of the renminbi, and on some occasions the central bank actually appeared to be intervening in the market by selling foreign exchange to prevent a more sizeable depreciation of the currency. Thus in 2012 the value of the currency increasingly appeared to be determined by supply and demand in the market.

There are, however, several reasons to believe that significant intervention by the People's Bank of China may not yet be a thing of the past. In the second half of 2011, economic fears brought about by a slowdown in the Chinese economy and the European crisis put downward pressure on the exchange rate and reduced the need for intervention. These concerns have since abated and thus the upward pressure on the exchange rate has returned. Related to the concerns, foreign currency deposits in domestic banks started increasing rapidly at the end of 2011 and the beginning of 2012 as Chinese corporations no longer felt compelled to immediately convert their overseas earnings into renminbi. These deposits increased by 58 percent (\$149 billion) between 2011Q3 and 2012Q2, dramatically reducing the need for intervention by the central bank. But in the second half of 2012 the buildup of foreign currency deposits in the Chinese banking system abruptly stopped, as firms no longer expected much of a chance of renminbi depreciation.

The Price of Energy

The third price distortion that must be corrected is the cost of energy. Price controls on electricity, gasoline, and other liquid fuels act as an implicit subsidy to China's industrial sector, which consumes two-thirds of energy production. This subsidy led to a more capital-intensive form of growth at the expense of the service sector. Removing these subsidies would help eliminate the incentives for overly capital-intensive growth and gradually increase the wage share of GDP as the more labor-intensive service sector develops more rapidly.

In both electricity and liquid fuels, the central government has been unwilling to pass along the full magnitude of cost increases and has instead imposed losses or low rates of return on state-owned enterprises. This makes energy-intensive industries, primarily manufacturers, more profitable than the service sector, leading to a rising share of investment in manufacturing and industry and a falling share of investment in services. In the 1980s and 1990s China's

service sector grew so rapidly that its share of GDP rose by an average of one percentage point per year, reaching 41.5 percent in 2002. With the onset of severe financial repression and other distortions in 2003, the service sector stagnated, growing by less than two percentage points between 2002 and 2011. China's service sector share of the economy remains a full ten percentage points lower than what is typical for other emerging markets. Energy price distortions have resulted in a more capital-intensive growth path, which has rewarded capital at the expense of labor and led to a drop in the wage share of GDP. This distortion has lowered consumption levels and exacerbated income inequality.

Social Transfers and Reducing Income Inequality

The effort to unwind economic imbalances in China can be hastened by a greater emphasis on transfers and redistribution, which will bring down the saving rate and put more money in the hands of those most likely to consume. First, the Chinese government needs to continue to build out the social safety net in order to reduce precautionary saving by households. The lack of a safety net encourages households to save large amounts to deal with emergencies. A more robust social safety net will lessen the need for precautionary saving, lowering the household saving rate and increasing private consumption.

In addition to building out the social safety net, addressing China's high levels of income inequality will contribute to lowering the saving rate. The release of official Gini coefficient statistics was delayed for almost a decade as the National Bureau of Statistics worked to harmonize income measurement between rural and urban areas. In 2013, officials released revised annual Gini coefficients going back to 2003. The new data revealed that despite the populism of the Hu Jintao-Wen Jiabao administration, income inequality remained high throughout the last decade. During this period, the Gini coefficient hovered between .47 and .49, meaning that inequality in China is worse than in Russia and the United States and roughly on par with Nigeria and Mexico.

The most effective way to reduce inequality would be to adopt a more market-based interest rate, exchange rate, and energy prices, which will help increase the wage share of GDP and thereby reduce the enormous gains that have accrued to capital owners over the past decade and worsened inequality. There has been a considerable decline in the wage share of GDP since the emergence of severe economic distortions in 2003. A more balanced economic growth model should help the wage share of GDP to recover to levels more typical for emerging markets, around 55 percent. In addition, the government should increase the progressiveness of taxes in China, which relies too much on indirect, and therefore regressive, tax collection. Finally, further reforms to the hukou household registration system would reduce inequality between rural and urban areas and improve the living standards of China's migrant workers. The core of economic rebalancing is removing the distortions that pushed the economy in an unbalanced direction in the first place. These distortions are the misalignment of the fundamental prices, the exchange rate, interest rate, and price of energy. The lack of a social safety net and high levels of income inequality are important contributors to China's extremely high household saving rates. Bringing these prices back into alignment while increasing social transfers and adopting other policies to improve the distribution of income will boost consumption and establish more sustainable sources of economic growth for the future.

The Politics of Economic Rebalancing

A common refrain is that political reform in China is necessary to break the current deadlock on economic reform. This argument, advanced by many inside and outside China, states that the growing power of vested interests has strangled economic reform over the past decade. It follows that dramatic political reforms will cleanse policymaking of these roadblocks and open up space for economic reform to resume. Given the glacial pace of political reform in China, proponents of this viewpoint understandably are pessimistic about the prospects for further economic reform.

The political barrier to economic reform argument has some validity but is significantly overstated. In certain policy areas vested interests are strong and have successfully resisted reform. A clear example is state-owned enterprise dividends. Despite intense pressure by the Ministry of Finance and the State Council, dividends paid by state-owned enterprises starting in 2007 have increased only marginally and most are ultimately recycled back into the state sector. State-owned enterprises and their supervisory body, the State-Owned Asset Supervision and Administration Commission (SASAC), represent a vested interest that has successfully resisted needed reform. Other examples of vested interests resisting policy reforms include local governments ignoring central government housing purchase restrictions and resisting land acquisition reforms designed to increase compensation to peasants.

With respect to the key reforms needed for rebalancing, the case that vested interests are organized and able to resist reform is a lot less clear. The economic imperative for rebalancing is clear and shared widely amongst Chinese economists and policymakers. A brief survey of recent official economic policy documents is a testament to this point. In late 2010, the 12th Five-Year Plan (2011–15) included several core elements of rebalancing, including increasing consumption, interest rate liberalization, and opening the capital account. In September 2012, the People's Bank of China and China Banking Regulatory Commission released a financial reform plan calling for a more market-oriented exchange rate, interest rate liberalization, and opening the capital account. The change of leadership in China in the fall of 2012 also offered hope for economic rebalancing. In his opening speech to the 18th Party Congress in November 2012, Hu Jintao reiterated the need for interest rate, exchange rate, and capital account liberalization. Hu's speech reportedly was drafted by a group of high party officials led by his successor, Xi Jinping. Thus the speech almost certainly reflects the views of China's incoming top leadership. Moreover, one of Xi Jinping's first actions after taking office was to travel to the southern province of Guangdong, paying homage to Deng Xiaoping's famous Southern Tour, which reignited economic reform in the 1990s. Finally, Chinese leaders at all levels have identified income inequality as an important problem, and the NDRC is currently formulating a plan to address it.

Unlike reforms that rely on the cooperation of local governments or the many thousands of state-owned enterprises, the critical policy instruments needed to achieve economic rebalancing are centrally controlled. Rather than forcing changes that may be resisted by subordinate actors, most of these reforms simply require that the central government stop actively interfering with the market. The People's Bank of China, with approval from the State Council, can immediately move forward with liberalizing interest rates, the exchange rate, and the capital account. With respect to the interest rate, the dynamic of market competition would force all banks, even the large state-owned commercial banks, to begin offering competitive rates in order to hold on to deposits. This, in turn, is likely to put upward pressure on lending rates,

which, in turn, will contribute to a reduction in the investment share of GDP. A more market-oriented renminbi simply requires the People's Bank of China to further reduce its intervention in the foreign exchange markets. More market-determined prices for energy simply require modifying NDRC's price-setting rules so that the changing market prices for oil and coal are fully reflected in prices paid by final users of refined petroleum products and electricity.

The policy changes needed to increase social transfers and income redistribution require cooperation from subordinate actors and thus are more difficult. However, these policy changes should still be achievable given their immense public popularity. Improving the social safety net requires cooperation by local governments, but it will be difficult for them to obstruct these popular programs. The rapid roll out of the rural medical and pension programs and the rates of participation rates suggest a strong base of support and the ability for the central and local government to work together on this issue. Chinese citizens frequently cite inequality as one of their highest concerns, and the NDRC has been working on a plan to address issue since 2004. The details of the plan that have emerged so far emphasize cracking down on monopoly sectors, increasing state-owned enterprise dividends, and providing more support for lower income groups. Public support for these proposals is likely to be strong, and vested interests will have a hard time resisting these policies if the central leadership vigorously and publicly promotes them.

The reforms needed for economic rebalancing are largely already government policy. Moreover, the central government can achieve many of these policies directly without interference by other actors. The ones that it cannot are extremely politically popular and should be difficult for any vested interest to resist. Therefore, there is no obvious reason why fundamental political reform has to precede economic reform. The slow pace of reform in the Hu Jintao–Wen Jiabao era stemmed from the top leadership's weak commitment to restructuring. The tremendous speed of economic growth over the past decade provided little incentive for policymakers to actually move forward with the difficult task of rebalancing. Rocking the boat is always difficult, especially when one's country is posting the highest GDP growth rates ever achieved by a large economy. It is only with the economic slowdown in 2012, which led to the lowest pace of expansion in a decade, that the rebalancing agenda took on greater urgency. As is the case with most political systems, difficult changes are made only when they are forced by necessity. The Communist Party continues to derive much of its legitimacy from the rising living standards made possible by sustained economic growth. As rebalancing increasingly becomes seen as a necessity to sustain economic growth, economic reforms will begin to be implemented with increased urgency. Political reform in China is certainly desirable and could be helpful in addressing a wide variety of social ills, but it is not a prerequisite to achieving a more balanced economy. Instead, a renewed commitment to economic reform by the top leadership, akin to the large reform push led by Zhu Rongji in the 1990s, is needed to break the policy deadlock and put the Chinese economy back on a more sustainable footing.

Implications for the United States and Policy Options

The ramifications of economic rebalancing in China for the United States come primarily through the reduction of China's external surpluses. When a country runs large and persistent external surpluses, it is siphoning away global demand from other countries. It is important to note that China's external surpluses have come down significantly over the past few years. These reductions, however, may be temporary because they were driven global economic weakness and unsustainably high levels of investment in China. The slow progress in increasing consumption

as a share of GDP in China means that China will continue to add much more to global supply than global demand.

Economic rebalancing in China will increase consumption and add to global demand. This is likely to increase American exports and facilitate our own process of economic adjustment. A reduction in the American current account deficit will have positive benefits for economic growth and ameliorate some of the adverse effects of household and government fiscal consolidation. In some ways the economic challenges facing the two countries are mirror images. While China must take steps to increase consumption and reduce excess savings, the United States must decrease consumption and increase savings. Without economic rebalancing in China, the United States will face a worse external economic environment, making our fiscal situation more difficult to resolve.

While economic rebalancing in China would have benefits for the United States, it is not a cure-all for our current economic problems, nor should imbalances in China be used as a scapegoat for our massive buildup in public debt and the global financial crisis. Chinese economic rebalancing would be helpful, but domestic policy decisions will ultimately determine the fate of the United States economy.

This context is important to keep in mind while considering American policy towards China and specifically the role of congress. The United States has played a positive role in promoting economic reform in China in the past. From the time of Deng Xiaoping's initial reforms, through the accession to the World Trade Organization and more recently in the regular exchanges of the Strategic and Economic Dialogue, the United States has been a consistent voice for economic liberalization. American support, and sometimes criticism, has been mostly productive in terms of boosting the influence of reformers. Even during times of open disagreement, such as periodic barbs traded between the governments over the Chinese exchange rate, modest pressure by the US government is helpful in pushing Chinese policy in the right direction.

There are two important caveats to this rule. First, while American pressure can be helpful it is by no means decisive. Economic policy decisions in China will continue to be primarily based on domestic concerns. The same is true of the United States and any great power. We can help shape Chinese policy at the margin, but US negotiators should never forget that they are but one of many considerations that shape the ultimate decision. Policies that are viewed as threats to the core interests of economic and social stability or weakening state control in specified sensitive economic sectors will not be adopted, regardless of how much US negotiators press. The second caveat is that too much pressure from the United States can be counterproductive. Indeed, during the most heated periods of the exchange rate debate, some elements of Chinese public opinion began to view the issue through a nationalistic/anti-foreign prism. When policy debates take on this tone the domestic forces within China most opposed to reform gain influence.

The United States should continue to advocate for economic reform and when possible frame the debate in a positive way. A commitment by both countries to engage each other directly on new international economic agreements would be helpful in improving the tone of relations. Specifically, the rise in competing regional trade agreements in Asia should not prevent the US and China from engaging each other directly. A proactive policy by the United

State combined with recognition of the limits of our influence is the best strategy for promoting economic rebalancing in China.

PANEL II QUESTION AND ANSWER

CHAIRMAN REINSCH: Great. Thank you very much. Let's begin with Commissioner Wessel.

COMMISSIONER WESSEL: Thank you, both, and Dr. Prasad, good to see you again.

This is an important panel, and I think, as you both know, last year's campaign here was fueled in many ways on both sides of the aisle by questions about the U.S. posture vis-a-vis China on some specific policy issues, currency, and many others.

We now have a change of leadership and a new administration in office. Mr. Borst, you seem to be arguing, and I don't think anyone questions the need for us to address some policy issues here, but you seem to be arguing that we should diminish attention on the U.S.-China issues and let them work their way through proper course. And Dr. Prasad, you seem to paint an optimistic picture of the change that's occurring in China.

To what extent do you think the new leadership is going to seek-- "honeymoon" is probably the wrong word--but a period of quiet engagement between the U.S. and China as it seeks to implement the policies and gain control over its processes, and how patient should we be? You talked about bilateral trade issues, surpluses and deficits, but, as you know, the issues go much deeper, the intellectual property rights and many other things that are not always measured in the exact trade flows.

So what's your perception of the change in China, change in leadership, and how should we be engaging as we look at the problems that many have raised on the U.S.-China bilateral front? Both witnesses, please.

MR. BORST: Well, I would never recommend diminishing the attention that the U.S. government places on these issues. I would just like to emphasize that I think it's very much worthy of attention, but we should be realistic about how much we can actually achieve.

In terms of where the new Chinese leadership stands, I can tell you the conventional wisdom a year or so ago was that the new administration would take about a year to sort of consolidate before they begin to push through any significant reforms. As Eswar mentioned, I think the release of this income inequality plan last week actually negates some of that, and it's a hopeful sign that we might see more reform coming more quickly than people expected even just a year ago.

COMMISSIONER WESSEL: But in terms of that reform, what do you think it means for us? There is a tendency in China for them to want to source domestically. They have an aversion to imports. They have a number of barriers, et cetera. So as they increase consumption, are they going to also increase openness?

MR. BORST: My hope is that they will, but I also think that, as you mentioned, every new Chinese administration feels the need to sort of

establish their credibility as a defender of the Chinese national interests, and I think there's a high likelihood, at least in the first year or so, that they might take sort of nationalist stands on issues like that.

COMMISSIONER WESSEL: Dr. Prasad.

DR. PRASAD: I'm going to step a little bit out of my normal field of expertise. I think, of course, one has to see to see politics and economics together, and the new leadership does have an imperative to solidify its own political base to appear strong, and political developments, especially vis-a-vis Japan and other events in the South China Sea, have given them that opportunity.

So I suspect that, in fact, they're going to use the cover provided by that to engage more constructively on the economic side, especially with the U.S. My sense is that there is a clear understanding in Beijing and in Washington of the quid pro quo that would benefit both sides.

Tim Geithner in his speech in the lead-up to the S&ED meetings a couple of years ago laid this out very clearly. What China wants is access to investment opportunities, technology and so forth in the U.S.; the U.S. wants market access, and better protection of intellectual property rights.

And I think under the surface, that dialogue is now going to become a much more productive one. As I mentioned, the traditional flashpoints, like the currency, have essentially dissipated. Now, of course, this is going to be driven to some extent by political dynamics in our capital as well. So long as the jobs picture continues to improve, then I think the bilateral trade deficit that we're running with China is going to get less attention, and frankly I don't think that's a number any of us should be focusing on, but it does get attention.

So if the economic situation here improves, I see a situation where we can have a better relationship.

Now, the Chinese government, as Mr. Borst said, has, in fact, indicated that it has a framework for reforms, but there are important steps that we will see in the coming weeks or months. For instance, what sort of appointments they make at the second tier, for instance, who is going to head the People's Bank of China now that it's been made clear that Governor Zhou will not remain in that position.

And there will be a little bit of movement around that appointment, and I think that will be a very significant signal about the seriousness with which this new leadership intends to push forward its reforms, but so far the signs are positive.

COMMISSIONER WESSEL: Thank you.

CHAIRMAN REINSCH: Commissioner Shea.

VICE CHAIRMAN SHEA: Thank you, both, for being here. I enjoyed your testimony.

I have a question for Dr. Prasad and then a question for Mr. Borst. Dr. Prasad--I've got to take my glasses off to read--can meaningful rebalancing actually occur in China without wealth being transferred from the state sector say through privatization of the state enterprises, as the

World Bank 2030 report suggested, and have you seen any evidence that this is actually going to happen?

I've seen evidence to the contrary. The Chinese government just announced a massive reconsolidation of a number of different industries. So that's my question for you. Can there be rebalancing without privatization of the state economy?

And for Mr. Borst, I know you mentioned as one of the four items needed for rebalancing is greater precautionary savings and a stronger Chinese social safety net, and that's often stated.

I read a book by Mike Pettis who pooh-poohs that point and says that household saving in China is relatively equal, roughly approximate to what the household saving is in other Asian countries. It's really the extraordinary savings by the corporate and government sectors is the problem, and that we place too much emphasis on this precautionary savings at the household level. So I'd like you to respond to that.

DR. PRASAD: So just to be clear again, I was trying to paint as optimistic a picture as possible, and it is true that in some sense, things are not getting worse, but they're not getting that much better, and that is a serious concern that the Chinese leadership is dealing with. They do want to make consumption an important driver of growth, and right now it's government and private consumption together that are driving growth.

Making private consumption a bigger part of overall GDP is really something they are very keen to do. Now, the issue here again is whether they have the right intentions and the right approach? This plan to reduce inequality that both of us have referred to has a very specific measure: to ask state-owned enterprises to transfer another five percent of their profits through the state rather than hang on to it.

And that, for instance, is something that we have not seen in the past, a very specific measure, because there had been a push in the past to get state enterprises to provide more resources to the state, which in turn could be used to support social and other programs. But I think at least the intention does seem to be very much there.

Now, the question is whether the other reforms are going to be fast enough and strong enough to support this rebalancing process, and there, again, the intentions are right. Last year, we saw some small steps, but the big steps that need to be taken, liberalizing interest rates, breaking the power of the big banks, are going to be very difficult.

But here again the government is showing some degree of astuteness in approaching this because taking on the big banks is difficult because the system as it is now structured works very well for them. The way to do it again is to put it in the right framework and then to take small steps. So last year when they reduced both deposit and lending rates, they told the banks we're going to allow you to offer slightly higher deposit rates related to the benchmark so that people won't get hurt.

So this was a little bit of covert liberalization taken in an opportunistic way so I'm somewhat more optimistic that they're making

progress but very slowly.

VICE CHAIRMAN SHEA: But my question was about the state-owned enterprises. We commissioned research; they say that the state-owned portion of the economy is--roughly 40 to 50 percent of the Chinese economy is state-owned, and there are many hundred more and more large state-owned enterprises. Can there really be true rebalancing in China without breaking up a large part of the state sector? Breaking up these SOEs and privatizing them?

DR. PRASAD: That's a crucial point because, in fact, during the financial crisis, the investment boom actually strengthened the position of the state enterprise sector and made things a little worse in the dimension you're talking about.

What the Chinese government has tried to do is rather than privatizing the state enterprises, which is a very difficult task, and the financial system is not well-equipped enough at this stage to provide enough direct financing, what they're trying to do is corporatize them. In other words, get state-owned enterprises to behave more on commercial principles.

Now that's a little difficult to do when you have large state enterprises in some sectors that are basically monopolies that are protected by the state. So I think privatization is a very long-term objective. If they can get the state enterprises to function a little more effectively, bring in some more competition from the private sector by adding more financing through the banking system, then they'll be making progress, but what you're suggesting is probably the right ultimate objective, but it's going to take a long time.

VICE CHAIRMAN SHEA: Thank you.

Mr. Borst, if you could just take a minute to answer my question.

MR. BORST: Sure. Yeah. First, to address the issue of household savings and household consumption, Chinese household consumption as a share of GDP is a historic low, sort of an outlier for any major economy. I believe the last figure we have is 35 percent of GDP. And there's a little bit of debate concerning whether is consumption being measured exactly perfectly in China, and even if you sort of build in a margin of error, it's still far, far too low.

So reducing household savings is definitely a necessary policy, and part of this is building out the social safety net, and I think that's been a well-covered topic, but one thing we've been focusing on more recently is actually looking at income distribution, and so the National Bureau of Statistics in China released, after sort of a ten-year hiatus, Gini-coefficient figures for China for the past decade. It shows that China is at a very high level of income inequality.

So if you look at the distribution of income within the country, those with savings or much higher income have a much higher propensity to save, and so you really need some efforts to get money, to get income into the hands of lower income people with much higher marginal propensity to consume.

On the issue of corporate savings, this is something we've looked at quite a bit, and we think changes to the interest rate could help produce corporate savings. And also tying that in--Dr. Prasad mentioned the issue of corporate dividends, specifically SOE dividends. So, on the one hand, we're asking the government to build out the social safety net, but if this is funded through government savings, it doesn't actually alter the consumption balance within China.

So what we advocate for is that really a lot of the new build-out of the social safety net needs to come from higher dividends placed on state-owned enterprises. And as Dr. Prasad mentioned, there has been progress. So before 2007, the state-owned enterprises were paying no dividends. They moved up to a 0-5-10 tiered bracket. In 2011, those tiers moved up to 5-10-15, and if this policy outlined in the new income inequality plan is followed through with, it will be at a 10-15-20. So I think over the course of five years, that's pretty solid progress.

VICE CHAIRMAN SHEA: Okay. Thank you.

CHAIRMAN REINSCH: If I could follow up before we go to Commissioner Slane, you mentioned the Gini-coefficient. There seems to be a small debate about the size of that. I think the Chinese have published--what--.47 or something. Other people are saying more,.61 or so. Where are you on that, either of you on that controversy?

MR. BORST: Yeah. So their explanation of why they basically skipped a decade of publishing these is that they were harmonizing income accounting between urban and rural areas, which is a legitimate issue in China, but, you know, whether it's .47, .49, or there's an alternative study where people have suggested it's .61, regardless of where you sort of fall in between that mix, it's high, and the exact number I think matters less than the idea that it's higher than the U.S., it's higher than Russia, you know, it's on par with countries like Mexico and Nigeria.

DR. PRASAD: Yes. If you'll pardon the expression, by any measure, it's pretty damn high. Two things, two quick observations I'd like to make on that, is most household surveys on which these calculations are based are not very good at tracking the incomes of those of the very top of the income distribution, and including those typically tends to provide much greater measures of inequality. So, unless we actually have the household-level data and see where the distribution has sort of been truncated, we won't really know what the level of inequality is.

But one possible development in inequality is that a major contributor to inequality in recent years has been the widening gap between rural and urban incomes, which was a very significant contributor. With the rise in food prices over the last three or four years, that gap has actually narrowed. So, in fact, at least on that dimension, the rural/urban contribution to overall inequality has actually declined in the last two or three years, but still it's a major problem.

CHAIRMAN REINSCH: Thank you.

Commissioner Slane.

COMMISSIONER SLANE: Thank you, both, for your testimony. It was really helpful.

Dr. Prasad gave me some hope, and then Mr. Borst took it all away. My question is this edict that was issued some years ago by the central government to go abroad and to encourage their companies to do direct foreign investment, we've seen very little of it in the United States. We keep expecting them to come. How do you see that? Do you see the central government incentivizing or pressuring their companies to start going abroad, and how does that all fit into the rebalancing?

DR. PRASAD: This has been a determined attempt by the Chinese government. Until about three or four years ago, the idea was more to offset the pressures coming from the capital coming into China, but now the nature of that has changed because what China is also very keen to do with very large stockpile of foreign exchange reserves is to think about using at least additional reserve accumulation in a way that generates higher yield and helps them further other economic and political objectives.

So what they are very keen for their corporations to do, and also their institutional investors, is to go out of the country, first of all, for diversification reasons, second, as a conduit for better technology and managerial expertise. And in addition, they've also made it somewhat easier for households, which in principle can take out up to \$50,000 a year out of the country, in principle, with no questions asked.

They are making it a little easier by providing the financial market structure to make that happen. You and I can walk down to a mutual fund down the street and buy a mutual fund that gives us exposure to other countries. In China, you can't do that. So although there is this large limit, it cannot be used by the average household.

So China is making a very strong effort, and this ties in also with internationalization plan because the more renminbi they have outside the economy, the greater use it's going to be in other financial markets, which is going to help promote the renminbi's role.

So I think it is a part of the rebalancing process, and it does fit into the overall approach of internationalizing the renminbi and trying to take the pressure off inflows.

MR. BORST: I think Dr. Prasad is exactly right on this. You know this push began as a way to offset hot money inflows that they were quite concerned about. It's now developed into a method to sort of gain access to needed natural resources that China has in short supply and also gain higher yields to move away from basically relying on foreign government debt which pays very little yields.

I would like to point out, though, that there has been a significant boost in Chinese overseas foreign direct investment to the U.S. just this past year. But despite this boost, one of the most repeated complaints we hear when we interact with Chinese colleagues is this idea of the politicization of foreign direct investment into the U.S. And so there's a couple issues that stand out in terms of Sanyi, the wind farm case, Haier, and

things like that, but even though I know that the CFIUS standards are very well laid out, transparent, work according to the rule of law, there is a real and I think significant Chinese perception that they're excluded from some opportunities, and I think to the extent that people in Congress and the executive branch can help address those Chinese concerns, even if they're not based on the actual reality, I think it would be helpful.

COMMISSIONER SLANE: Thank you.

CHAIRMAN REINSCH: Okay. Commissioner Wortzel.

COMMISSIONER WORTZEL: Appreciate both of you being here today and your written and oral testimony.

Mr. Borst, on page two of your written testimony, you discussed five indicators for economic rebalancing in China. Two of those indicators are the urban disposable income is growing faster than GDP, and another is-- well, three actually--residential real estate investment is growing slower than GDP, and you also have a statement that the positive interests on bank deposits just aren't there. You're not getting a lot of people--so if urban disposable income keeps growing, where is it going?

MR. BORST: As opposed to--

COMMISSIONER WORTZEL: I mean what are people doing with that income? If they're not buying real estate and they're not banking it and they're not consuming a lot of other things, which is the goal of rebalancing, where is the money going?

MR. BORST: Well, first, I would just like to point out that urban residential real estate investment is growing faster than GDP. It's come down significantly from 2011 when it was growing at about 30 percent year-on-year. We're now growing at about 11 percent year-on-year. But we would like to see it grow slower than GDP for a sustained period to get China's real estate investment share of GDP down to something more reasonable. So we did a cross-country comparison where we looked at where real estate investment in the U.S. peaked, where it peaked in Spain, looking at where it peaked in India and Taiwan, and China is just way off the charts.

So we're not predicting a housing crash or anything like that in China, but we do think China needs to gradually bring that down as a share of GDP to get in a more sustainable area. In terms of where Chinese household incomes are going, one of the things we've been watching quite closely is the development of sort of non-traditional banking products, commonly referred to as wealth management products, and this is an area of the financial sector that has grown by leaps and bounds over the past couple of years.

So normally household deposits in China have a capped interest rate, but these wealth management products have a free-floating interest rate. So people have been very attracted to them to get a higher return, but one of the problems is we think a lot of these wealth management products are investing in relatively risky things like real estate, infrastructure.

Just, I think two months ago, there was a blow up at one of these wealth management products at Huaxia Bank. So I think the more the

Chinese government restricts things like the property market and keeps financial repression in place, the more these sort of non-traditional avenues for people's savings are going to grow and increase and pose threats.

CHAIRMAN REINSCH: Okay. Thank you.

Commissioner Goodwin.

COMMISSIONER GOODWIN: Thank you, Mr. Chairman. Thank you, gentlemen. Please excuse my hoarse voice today. I'm fighting a cold brought home by one of my kids. They're little carrier monkeys from the day care.

One of our earlier witnesses actually talked in his written testimony about the distortions to the Chinese economy brought about by the Chinese government's response to the global financial crisis. Talk a little bit about precisely what those distortions are and the effect that these distortions have on the government's efforts to initiate and implement economic reform.

DR. PRASAD: So even before the financial crisis hit, the government was talking about the rebalancing effort and was making attempts to reform the financial system to essentially get the banks to behave like real banks, to direct more lending towards private enterprises, towards small and medium enterprises in the service sector, and so forth.

The financial crisis put the kibosh on all of that because essentially what happened was that by October 2008, it was clear that the economy was stalling, and the way they decided to revive the economy was essentially through a massive bank-financed investment program. The banks were a little reluctant to lend because they had been told to be careful about new non-performing loans appearing on their books, but then they were told go out and lend, and they did lend to the tune of about 1.3 to \$1.4 trillion in just that one year, about 30 percent of GDP.

So that had the salutary effect of putting the economy back on track, and as I mentioned, the contribution of investment to GDP growth in 2009 was nearly 90 percent. So it was really investment power surge, and that set back the entire reform effort in many ways. First of all, the rebalancing effort was set back because investment was now powering growth again. The state-owned banks had now lent out a lot of credit so the discipline that had been imposed on them was significantly reduced.

The state-owned enterprises were now flush with cash, and they were now in a much more felicitous position than the private sector and the service sector. So in that sense it set back the rebalancing and reform effort in a variety of dimensions, but it had the effect of the economy continuing to grow, continuing to have momentum, and that in a sense has created room for them to be able to deal with many of the problems, and this is the way China has always approached its problems. You build up problems, but so long as you can keep GDP growing, what matters is problem divided by GDP, and it's worked for them.

MR. BORST: I think two of the most pressing problems facing the Chinese economy right now can be traced directly back to the response to

2008 and the stimulus that followed. One of these is local government debt in China, and sort of when they opened the floodgates of lending to fight the financial crisis, local governments who were prohibited from directly borrowing created these platform companies that did borrowing for infrastructure projects on their behest, and previously local government debt was relatively low, and then all of a sudden it sprang out to about 10.7 trillion renminbi, and since then they've made a big effort to crack down on local government borrowing. But it's still sort of a lingering concern.

The second thing was in addition to lots of enterprise loans, also mortgage lending shot up during 2009 and 2010. And that filtered directly into the housing boom that we saw, and so much of the policy, economic policy of the past two years, has been addressed at sort of gradually tamping down the housing market in China without popping what might be a bubble.

So those two things I think have significantly contributed to the slow down in growth and our lingering worries that sort of have to be digested over the next couple of years and cannot be resolved immediately.

COMMISSIONER GOODWIN: Thank you.

CHAIRMAN REINSCH: Commissioner Talent.

COMMISSIONER TALENT: Thank you, Mr. Chairman.

I have kind of a broad-based question, and I'd like you both to comment on, and I'm picking up on what you said, Dr. Prasad, about the interplay between politics and economic policy here.

I think we all understand, and certainly the last panel emphasized, this is a government and a leadership network that's resting its legitimacy on its economic policies in the way of benefits to the people, and it's not going to move forward anywhere near as fast with political reforms that might give it legitimacy from a political standpoint.

Now you both talk about, and the other materials the staff has provided, this rebalancing with the asset bubbles and the other distortions in the economy. It strikes me it's very unlikely that they're going to be able to do this without further episodes of severe dislocation. You just commented, Doctor, that when the last one happened, they went back to the old policies. It was almost like going to a life raft, and no doubt because they were concerned that if they didn't get the GDP growth up right away, it undermined the legitimacy of the leadership, and they're certainly not going to put the government itself at risk.

So I guess what I'm saying to you is how likely is it that they can do this without the kind of at least temporary dislocations that a government that had greater political legitimacy could work through because they can stay in power and have credibility with people based on that, but they're not going to be able to do it? You see the picture I'm drawing, and it's a global kind of question, but I'd like your comments on it.

MR. BORST: I actually believe that rebalancing can be achieved in China, and that it can be achieved while sustaining moderately fast economic growth.

I think the key is to not force sort of a self-defeating rapid

correction, but actually to put in place a series of policy reforms that over the course of the next decade would gradually get investment levels down and consumption levels up, and so the key here is to not shrink the size of investment in China in absolute terms, but to actually have it grow more slowly than consumption.

And so reforms in the area of interest rate liberalization, more market-based exchange rate, reducing subsidies for industrial firms, lowering the savings rate in China. I think all of those things will gradually boost consumption in China to where it needs to be.

And one sort of misconception that we hear a lot is that consumption hasn't been growing quickly in China. It has. Over the past five years, household consumption in China has been growing at 9.5 percent, which is amazing. The problem has been that everything else has been growing so much more quickly. So the idea is to slow down investment while doing a series of policies to keep consumption strong while this adjustment is taking place and to get to a more balanced place perhaps a decade from now.

DR. PRASAD: You're right, Commissioner Talent, that ultimately what sustains the Chinese government is not in terms of legitimacy; it's its ability to deliver high growth, growth that is sustainable in a variety of dimensions, and that may require better distribution. And there are enormous risks building up in the system because it is not a very flexible system.

Mr. Borst has pointed out the local government debts, which could blow up especially if the economy slows down. There are lots of hidden problems in the banking system. The social safety net isn't functioning very well, but there are two issues to consider here. One is are these problems manageable given the trajectory the economy is on; and, second, does the government have resources to deal with these dislocations?

Again, so long as they can keep growth going by hook or by crook, it actually does reduce the scale of the problems. In some cases, it makes the problems a little worse, but so long as the resources are increasing, they can deal with this, and I think that's one thing that is to be kept in mind. If you look at the level of public debt in China, the central government explicit public debt is less than 20 percent of GDP. You add in what we think we understand about the local government debt and so on, it's still under about 40 to 45 percent of GDP. Perhaps even if you push it up to 50, that still gives you a lot of space in fiscal policy to respond if there are external shocks or if there are domestic shocks.

Likewise, in monetary policy, they are somewhat constrained by the exchange rate regime, but right now, they don't have lots of capital inflows coming into China. Inflation is well under control so they do have a lot of room in monetary policy.

So I fully expect that we will see some more bumps in the road, but my sense is that China has enough macroeconomic policy space to be able to make sure those are just bumps in the road rather than having the

train go off the rails, although I'm sorry about the mixed metaphor, but you get my point.

COMMISSIONER TALENT: Yes, thank you.

CHAIRMAN REINSCH: Commissioner Fiedler is next.

COMMISSIONER FIEDLER: There was this public debate between Nick Lardy and Mike Pettis that I read some of. I want to simplify it, I think. Nick doesn't think they're in for a hard landing, and Michael does. Is that a fair simplification?

MR. BORST: I think that's a fair simplification.

COMMISSIONER FIEDLER: Okay. So you are giving us the rosy optimistic view to start with, and you've been backing away ever since in response to questions.

Where are the potholes that are sort of soft in the road right now? And let me just suggest a couple. Unemployment and underemployment and job creation are a significant problem and growing, and at a time when there is this laissez-faire capitalist supply and demand and the cost of labor, but you see a whole bunch of light-manufacturing, low-end manufacturing starting to leave the country, which is going to exacerbate the job creation problem, and if I were cynical, I would say that they haven't stolen enough technology yet to have high-end manufacturing on their own.

And our manufacturers are not moving their high-end there because they're worried about losing their technology. So where are the bumps in the road that are surely there since this is not a perfect economy?

DR. PRASAD: Commissioner Fiedler, I should make it very clear that there are enormous risks, but one thing I've learned about the Chinese economy, and I've been studying it for about a little over a decade right now, is the more I study it, the less I understand it because the risks are very easy to point to, and there are enormous risks in the system, but, again, the Chinese government has been able to manage this extremely delicate balancing given how little flexibility they have with their institutional mechanisms, with their policy mechanisms. It works in a very strange way, but this is not to say that there are no risks.

COMMISSIONER FIEDLER: No, what strikes me, let's take the Wal-Mart analogy. Wal-Mart, when it started, was small and it was growing, and it was rapid growth. Same-store sales were 20 percent a year, and this and that, and then it hit a maturation point. Right? And for years, the stock has been nowhere.

Now, China grew because it came out of a cave, virtually, economically. Now, when it matures, it has a mature set of problems, and what Mr. Shea was talking about on the state enterprises is if you're wedded to such a high percentage of state ownership of the functioning economy, aren't you restricted in your ability to deal with that maturation problem and all the problems that come with maturation?

DR. PRASAD: That's a very good characterization of China. It's a mature economy in terms of size with very immature financial systems, with very immature production structure, and this is really the challenge they

face because the size of the labor force is apparently already beginning to shrink, as you pointed out. The low wage jobs are jobs where China is going to be less competitive relative to other competitors, including in East Asia.

So what China really needs to do is generate more productivity growth. Now, they have again been able to generate more productivity growth than you would expect in an economy that has a weak financial system, a terrible allocation of resources, and so on, because no matter how you do the math, the only way to explain China's growth in the range of eight to ten percent is that they've had total factor productivity growth. That is to say once you account for labor inputs and capital inputs, then this other stuff, the magic or the efficiency with which you put those together, they've been generating about two to three percent growth a year.

But that is going to be the driving force for growth for them. If they cannot move more resources to the more productive parts of the economy, if they cannot get the financial system to allocate resources better, that productivity growth is going to slow down. And if that slows down at the same time that you have the labor force growth slowing down, then you are going to have long-term growth slowing down, and long-term growth is almost certainly going to slow down from the pace we had last year. We've already seen signs of that.

But I think it's still an economy that has a ways to go to catch up to the advanced economies. Per capita income is still less than one-tenth that of the U.S. The capital stock is one-tenth that of the U.S., capital stock per worker. So they have a ways to go, and I think that catch-up process still has a number of years to run.

MR. BORST: I would just add that unemployment and underemployment are an issue of concern for us in China, particularly the data issues around measuring that, and actually the economic growth model that emerged over the past decade was inferior to what came before it in terms of generating new employment.

So we think the key for China going forward is to really look at service sector growth because per unit of economic output, service sector pays higher wages, employs more people, and so you could have a shrink in the relative share of manufacturing and still increase employment in China.

I think the days of nine and ten percent economic growth in China are probably gone, and we're looking more now in the six, seven, eight percent range. And the biggest concern we see going forward would be a sharp correction in investment growth that would have destabilizing effects for the rest of the economy.

COMMISSIONER FIEDLER: Thank you very much.

CHAIRMAN REINSCH: Commissioner Cleveland.

COMMISSIONER CLEVELAND: You've led right to the question I wanted to discuss.

CHAIRMAN REINSCH: It was all orchestrated that way.

COMMISSIONER CLEVELAND: To please me; is that right?

CHAIRMAN REINSCH: Exactly.

COMMISSIONER CLEVELAND: Dr. Prasad, I share your view-- I'm looking at an op-ed piece that you did in the New York Times on September of 2012, where you comment that it's difficult to think of another government, democratic or not, that so bluntly acknowledges major problems in areas where its policies have failed to deliver much progress. And I share that view. I find it stunning often, the acknowledgement of the issues.

You go on to talk about the economic environment and the modest but significant steps that have been taken on a number of issues, including freeing up of restrictions on capital inflows.

And Mr. Borst, you just talked about the service sector. I'm interested in your assessment of inflows and capital available to the private sector, the emerging private sector. Where do you see that investment taking off? What's the source of financing? Will they be energy intensive and, if so, will they benefit from the same kind of price controls on fuel that SOEs have?

I guess what I'm asking for is an assessment of resources available to finance this emerging private sector and specifically the service sector that Mr. Borst was just talking about.

DR. PRASAD: In China, despite all we hear about foreign direct investment, the equity market and so on, bank finance still remains the major game in town. And bank finance, and here there is a bit of difference in views between myself and Nick Lardy, my sense is that although the data suggested there has been more lending going to the private sector, it's still largely going to enterprises that are in one form or another state controlled.

Now, the government has been using the approach of encouraging foreign inflows, not just through foreign direct investment but also into the equity markets, as a way of building up the equity markets and trying to bring some order to other financial markets, not just equity markets, but also perhaps eventually also the corporate bond market which they really need.

But the level of financial market development and the incentives facing the banking system have not been dealt with yet. So the banks don't have a great deal of competition with the mandate that's spread between deposit and lending rates. They don't have that much competition. They just compete amongst themselves. So they don't really have an incentive to lend to the private sector.

Foreign investment is one way around this, and it's been helping, but in terms of magnitude, it's not enough. What China really needs is a much broader set of markets, including a corporate bond market that would help people get better returns on their savings and channel capital more effectively.

So what has happened is that the informal financial system, as Mr. Borst mentioned, has sort of stepped into the breach. It's not very well regulated, which is what the government has tried to do, is bring that into the regulatory fold, which I think is sort of clever move but doesn't really substitute for the fundamental reforms they need to undertake.

MR. BORST: I would just add that the private sector in China is

growing, mostly despite government policy. If you look at the data on growth of loans to small and medium enterprises, it's growing dramatically. There are some concerns about whether there might be some smaller SOEs included in there.

But also, we have about two years of data now on actual loans to private enterprises, and while starting from a small base, they too are growing quite rapidly. So the key source of finance for the private sector in China over these years has actually been retained earnings. So they've sort of been so productive and so profitable that they could finance most of their expansion from their own earnings.

But going forward, that will be harder, and we think one of the key changes would be interest rate reform, which would result in a higher lending rate and so would give greater incentive to banks to actually make loans to these private enterprises, which might be a little bit riskier. And in the previous system, there was very little incentive to step over that bound and make loans to them as opposed to traditional big SOEs.

COMMISSIONER CLEVELAND: Can you speak to your comments on or elaborate on your comments on the service sector and why you see that as the potential area for the most growth?

MR. BORST: There is great potential for catch-up growth in the service sector in China. It grew rapidly during the '90s, and basically stagnated through most of 2000s. And China is underweight in its service sector compared to many emerging markets and particularly developed markets. So I think there is a lot of potential for catch-up growth in the service sector in China, particularly if some of these implicit subsidies that we think have been boosting industry and manufacturing in China are removed, making them excessively profitable at the expense of the service sector.

COMMISSIONER CLEVELAND: Thank you.

CHAIRMAN REINSCH: Commissioner Tobin.

COMMISSIONER TOBIN: I think you've answered my first question. And so let me move to another. I come from--I'm new to the Commission--I come having been a businesswoman, and I'm also a researcher, and you spoke, Mr. Borst, about data and measures. As I begin to read all the stats, how confident can I be that what I'm reading is actually what's going on there?

Let me ask it another way. How confident are you as an economist that the data that you are reporting is accurate data; how much of your data--and you can speak not just about your own but fellow economists--how much of your data is coming from international sources that are somewhat--that you understand how they're gathering that data, and how much is coming through the channels of the Chinese government?

So any guidance you can have on knowing how clear these stats are would be helpful as I read.

MR. BORST: Well, I'll just go through--

COMMISSIONER TOBIN: And candor obviously is what I'm

seeking.

MR. BORST: I think there are still some problems with Chinese economic statistics, but there is progress in the right direction, and I think if you compared Chinese economic statistics to a lot of other developing countries, they would come across pretty well.

There are a couple of areas where we always take the reports with a grain of salt. Specifically, if you look at GDP data, provincial GDP aggregated together is always bigger than the national total.

COMMISSIONER TOBIN: Uh-huh.

MR. BORST: But the central statistical bureau knows that and makes adjustments. Now, they're not very forthcoming in what these adjustments are, but it's a problem they've recognized.

COMMISSIONER TOBIN: And you can see that, and do you comment on that at points in reports?

MR. BORST: We comment on it to the extent we can get any new information on why they're making these adjustments. If you, as Dr. Prasad mentioned, there are some questions about consumption numbers in China, particularly measuring the incomes of high-income earners, but there's also a question of measuring the incomes of China's 200 million migrant workers who sort of exist in a legal gray area. So there are problems on the high end and the low end for measuring consumption in China.

If you look at things like--one commonly referred to figure is the retail sales of consumer goods, which comes out every month, so people love to look at it. But when you really dig into that data, you discover there are some things in there that are not really consumer goods. You know there're chemicals and metal materials. So that's an example of not specific Chinese distortion of anything, but just sort of an analyst misunderstanding of what this is actually measuring.

I think the same thing holds true for the monthly fixed asset investment numbers where there's things like purchases of previously owned equipment and land, which are not economically counted as new investments, which get lumped in there, which tend to distort things a bit.

So I think it's a mix of developing better statistical capabilities and also interpreting statistics the way they should be, looking at in detail what's actually included.

COMMISSIONER TOBIN: Thank you.

DR. PRASAD: My advice on this would be do not believe any single piece of data that we see from China, but taken together, one does get a feel over time about what sort of indicators have to move in the right direction to paint a particular picture about China. So when a lot is made of quarter-to-quarter or even month-to-month movements in certain cities like industrial production or the purchasing managers' index, I think those are somewhat overstated--the amount of interest paid to the month-to-month fluctuations.

When I go to Beijing, I can't quite see out the window, but there

is a sense that there is significant progress, and in the urban areas of China, there is very clearly enormous level of development that is taking place. The rural areas, of course, are a different picture all together, but overall, over the last decade, it's hard to believe that this is an economy that has not had a very significant increase in its per capita incomes.

My sense is that there isn't a grand conspiracy to provide fraudulent data. There is a lot of incompetence. There is a lot of lack of technical expertise when it comes to collecting statistics, but the National Bureau of Statistics, which I've dealt with when I used to work for the International Monetary Fund and now as an academic researcher, is very open to, first of all, admitting there are problems with some of its data, and to seeking input about how to improve those problems.

So, again, these data are not entirely reliable, but overall, taken together, if you look at a variety of indicators, they do provide a reasonably consistent picture over time, not over very short periods.

COMMISSIONER TOBIN: That's very helpful. What are you both going to be looking at next in the coming year? What statistics in particular are you going to be focused on?

DR. PRASAD: Well, we've talked about the internal and external rebalancing so the sort of indicators that Mr. Borst and I have in our testimony, looking at the level of growth, the composition of growth, and how that ties in with retail sales, personal income numbers, a sense of different types of goods. That is one indicator. If one starts looking at investment numbers, one would also like to get numbers on residential investment and other types of investment, and some of these data come from different sources.

Likewise, on the external balances, there is data one can look at from the U.S. side, as well as the Chinese side, and the International Monetary Fund does make a very determined attempt to get the data as consistent with international formats as possible. The Chinese, of course, have to report these data, but given the sort of reporting requirements, it would take an enormously sophisticated operation to provide data that looked completely consistent but were misleading.

COMMISSIONER TOBIN: Very helpful.

MR. BORST: I'll just briefly mention that the three indicators I'm most interested in right now are residential real estate investment; aggregate amounts of local government debt; and the growth of the corporate bond market.

COMMISSIONER TOBIN: Thank you.

CHAIRMAN REINSCH: Okay. Thank you.

We have a couple more minutes. We have a question from Commissioner Wessel and one from--

COMMISSIONER WESSEL: Actually, three quick questions, if I can. One, do you think the current-- the new leadership is going to be bound to the 12th Five Year Plan or are they going to be seeking to adjust that?

Number two, for some time there has been this magic number

that eight percent growth in China is the key to stability. Do you believe that? Do you think it's higher, lower, et cetera?

And, finally, Mr. Borst, since you made some comments about China's criticism of the U.S. and the lack of transparency in our investment system, going back to some comments about SOEs, and the fact that, I believe, any investment over a certain amount has to go through governmental approval in China, and up to three separate governmental approvals. Many people here look at Chinese investment in the U.S. as furthering the 12th Five Year plan or other activities, and therefore we'd like to see more transparency in Chinese investments and understanding the intent, et cetera, and believe that strict scrutiny is appropriate.

So some quick comments to that, if you could.

DR. PRASAD: The 12th Five Year Plan provides a very useful blueprint. In fact, it lists every major reform they need to undertake. It had virtually no specifics. So I think it will, in a sense, guide the reform process because everything that they need to do is in there, and now with this inequality plan, for instance, we're beginning to see some more specifics, but I think the overall overarching sort of reform agenda is in the 12th Five Year Plan.

Eight percent growth is pretty good. I think what is more important really is the balance of that growth. If they can get the balance of growth better, if they can do some of the things that Mr. Borst was talking about, including moving to service sector-led growth generating more employment, that I think will allow the economy to do well and for political and social stability to be maintained, even with growth in the six to eight percent range.

COMMISSIONER WESSEL: So the composition, not the actual number, the composition of the growth is more important?

DR. PRASAD: Yes, and how it feeds into employment growth and so forth.

COMMISSIONER WESSEL: Okay.

MR. BORST: Just to echo what Dr. Prasad said, I would say there is a lot of stuff in the 12th Five Year Plan, much too ambitious an agenda to actually achieve in five years, and I don't expect that the new leadership will deviate from what's in there, but the emphasis might change.

So, previously, the Hu Jintao administration was more focused on issues like inland development, developing less developed parts of the country like the west. We might see a pretty considerable change. You know, the incoming premier has mentioned that urbanization is going to be a new focus.

So I think there are elements within the Five Year Plan that talk about urbanization, but there wasn't much progress on those over the previous couple of years, and going forward, there might be more of an emphasis on that. So not a change of policy but a change of emphasis within those policies.

In regards to the eight percent threshold, in my opinion, I think

that was a number sort of plucked out of the air, and it doesn't have too much real relevance. I would say if personal incomes are growing rapidly and employment is growing rapidly, you could get by with a much lower headline GDP growth and people would still feel like their personal living standards were improving year to year.

And I just want to emphasize I agree with you in terms of restrictions on FDI. I think there've been a couple of changes over the past year that might ease things, but if you look at the balance between openness and transparency, of course, the United States is much more open and transparent when it comes to welcoming foreign investment.

I think the issue in addressing Chinese concerns about investing in the U.S. is more about perceptions than reality.

COMMISSIONER WESSEL: Thank you.

CHAIRMAN REINSCH: Commissioner Shea.

VICE CHAIRMAN SHEA: Gentlemen, it's almost over. Just a quick question. Dr. Prasad, you seem to, in my view--I might be unfairly characterizing it--but seemed to minimize the debt issue. I think you said the non-performing loan scandal came to a head, and you also suggested that local and central government debt was about maximum 40 percent of GDP. I guess my question is does that include debt held by state-owned enterprises? That figure? And aren't there other serious folks who feel that the debt levels are higher? I believe Victor Shih, for instance, thinks it's a major problem. And when you said it came to a head, didn't the Chinese government essentially recapitalize some of the large Chinese state-owned banks and just basically borrow money to pay back borrowed money and just push the problem down the road? So it really wasn't a long-term solution to the problem.

DR. PRASAD: First of all, Commissioner Shea, just to be clear, we enjoy this, and I'm happy to stay here all afternoon and talk more about this.

[Laughter.]

VICE CHAIRMAN SHEA: Great. Well, we enjoy your comments.

DR. PRASAD: Thank you.

The debt limits are a serious concern. Nobody knows. We have estimates that are done by official institutions that are based on the Chinese data. The Chinese have taken a very hard look at this, but we don't really know, and the reason is that many of these are what are called "contingent liabilities," in the sense that these are liabilities that are going to become a problem if growth slows down. So if you think about much of the loans given out by the state-owned banking system, these loans may look good so long as the economy is growing fast. So if you have fast investment growth in infrastructure, that means more demand for cement, hard glass, steel and so forth. If infrastructure investment slows down, a risk that Mr. Borst pointed out, too, you have a growth in the other industries slowing down. So then all of those start becoming non-performing loans.

So it's very difficult to separate this and make an unconditional statement about the level of debt. The issue here again is that central government debt is relatively low. What we can measure in terms of local government debt is large and very worrying, and there is probably a lot more hidden in there. So I don't intend to minimize the debt problem, but, again, if the Chinese can continue this balancing act of keeping growth going, that's going to generate enough resources to take care of the problem. It does mean a lot of missed allocation and distortion along the way.

VICE CHAIRMAN SHEA: Let me just--before you respond, Mr. Borst--I used your comment to us two years ago, I think, that so long as the denominator--the denominator being growth-- is growing bigger than the numerator--the numerator being all the misallocation of capital and corruption--then the Chinese can get by. Do you still believe that? Well, first of all, am I appropriately remembering what you said to us a couple years ago? And if so, do you still sort of believe that?

DR. PRASAD: I think that's still a fair characterization, and it's almost mechanically true that if you keep the denominator growing and the ratio is what you care about, it's okay. I mean Greece is in trouble right now because both the numerator and denominator are going in directions they shouldn't be going. But this has always been the puzzle. Can China continue along this growth process? But I think the Chinese government is also beginning to realize that increasing the size of the pie is creating a lot more trouble along the way, and that trouble is becoming an increasing concern to the population as environmental consequences are starting to affect the population. If you can't see out of the window in Beijing, people start sensing that something is wrong, and that, I think, is a problem they're facing now.

VICE CHAIRMAN SHEA: Thank you.

MR. BORST: I would just mention that the non-performing loan issue in the '90s was basically settled by carving off that debt from the banks and imposing pretty restrictive low interest rates on the households, where households were basically subsidizing bank profitability going forward.

And, as Dr. Prasad mentioned, you know, growth can sort of cure all these evils, but I think going forward, growth is going to be slower. The most important challenge facing China now is getting the price of capital right, and as long as capital is underpriced in China, one will see overinvestment and wasted investment.

But that has to be done carefully and methodically. Government debt, there's some worries, not for central debt, but for local government debt and contingent liabilities, and one of the things we've looked at is corporate debt, which is now almost 100 percent of GDP. And so you can't have a sort of wrenching change in the interest rate without imperiling a lot of these corporations, which are highly indebted.

So the key for China is to get the price of capital right, quickly, but not so quickly that it ends up pushing a lot of what would otherwise be healthy enterprises into bankruptcy.

VICE CHAIRMAN SHEA: Thank you.

CHAIRMAN REINSCH: Okay. Last, but by no means least, is a very brief comment from Commissioner Fiedler.

COMMISSIONER FIEDLER: You, Mr. Borst, you made a comment about, sort of an admonition that we shouldn't be too critical of the Chinese, and that they're very sensitive, and--after all, they do have nuclear weapons. I think we ought to treat them as adults, and we, I think the trust level is we trust them more than the North Koreans and less than the British. Okay. But being straightforward is always probably a better thing than avoiding expressing our concerns.

I mean certainly that's the way I feel as a Commissioner anyway. Thank you.

CHAIRMAN REINSCH: Thank you. Thank you, both of you, for your enlightening and helpful testimony.

We will take a break now for lunch. We'll reconvene at 12:50. Thank you.

PANEL III INTRODUCTION BY VICE CHAIRMAN SHEA

VICE CHAIRMAN SHEA: If we could all please be seated for the afternoon session. Welcome back, everyone.

Our third panel today discusses China's military leadership transition. Before introducing our guests for this panel, I would like to remind all of our witnesses this afternoon to please keep your remarks to seven minutes. This will ensure that we have sufficient time for our question and answer session.

Dr. James Mulvenon, Defense Group, Inc., runs the Center for Intelligence Research and Analysis. He's a specialist on Chinese military and cyberwarfare and has published frequently on China's military leadership issues.

Our second witness this afternoon is Roy Kamphausen. He's a Senior Advisor for Political and Security Affairs at the National Bureau of Asian Research. A former U.S. Army officer, Mr. Kamphausen has served as the Country Director for China-Taiwan-Mongolia Affairs in the Office of the Secretary of Defense.

Welcome to both of our witnesses this afternoon, and I think we'll start with Dr. Mulvenon.

**OPENING STATEMENT OF DR. JAMES MULVENON
VICE-PRESIDENT, INTELLIGENCE DIVISION, DEFENSE GROUP, INC.**

DR. MULVENON: Thank you, Commissioner. I'm very happy to be here. I'd like to thank the Commission for inviting me back yet again to talk about a topic that I work on fairly regularly as the military editor for the China Leadership Monitor, which is the last Pekingology journal that's out there. Of course, it's online at Stanford.

We've gone through a very significant military leadership change in the last three or four months, and I just want to give you some of the highlights for that. My written testimony has more of the gory details if you're interested.

Probably the top highlight for the whole process at the Party Congress last October was that there was pretty feverish speculation as to whether the current Supreme Leader, Xi Jinping, was going to get the chairmanship of the Central Military Commission. His predecessor, Hu Jintao, and Hu Jintao's predecessor, Jiang Zemin, had both been forced to wait at least two years by their predecessors to be able to get the position on the Military Commission. So they got the State and the Party positions, but not the Military.

But Xi Jinping was elevated at the Party Congress to be chair of the Central Military Commission so there was no two-year delay. Even Xinhua, the Chinese state media, described this as, quote, "an unusual twist in leadership transitions," which I thought was probably as much expressing their own surprise at what happened.

But Xi Jinping has some significant advantages over both Hu Jintao and Jiang Zemin as former senior leaders with respect to their relationship with the military. Obviously, he's a PLA princeling, a Chinese military princeling. His father Xi Zhongxun, was a significant revolutionary hero, who was he himself in the run-up to getting this position. A long article appeared that many of us noticed, which noted all of the connections he had to the Chinese military over his career, not the least of which was a previously unknown stint as basically military assistant to the then Defense Minister Geng Biao in the late '70s when he wore a uniform and had significant experience. So that was a surprise to many of us.

The rest of the Central Military Commission is largely a new group. Eight out of ten of the members were replaced, and there were many surprises. And I'll discuss at the end, make significant self-criticism on behalf of the PLA- watching community about many of the things that we did not predict. I know you don't hear that much up here on Capitol Hill, but I'll give it a whirl.

But one of the things that wasn't a surprise, the two people who are very highly regarded and expected to be promoted before the Bo Xilai scandal, who were closely associated with Bo Xilai, were, in fact, not

elevated to the Central Military Commission, both Liu Yuan, the political commissar, as well as Zhang Haiyang, the political commissar of the Second Artillery.

But we've seen a wholesale shift in this PLA leadership, although I would say that what we continue to see is the continuing professionalism of the people getting these positions rather than a retrogression back to a more political age.

Just a couple of highlights about some of the individuals, and as I said, in my written testimony, there's a lot more gory details. The two new vice chairmen, Fan Changlong--it's difficult for many of us to figure out how he got this position considering he had to make what's called a "two-grade jump," which we previously had thought was impossible in senior Chinese military appointments. But in the articles that came out afterwards, apparently he actually distinguished himself in his management of both the 1998 flood management that the military was involved in in China, as well as in the military's response to the 2008 earthquake.

The other new vice chairman, Xu Qiliang, is now the highest-ranking Chinese Air Force officer of all time. Not a very political person, which is surprising, because that second Vice Chairman position is traditionally associated with being a political officer, although one of our self-criticisms is, in fact, that that was a mistake all along, and that if you go back and really look at those guys, most of them weren't really all that political.

The new Minister of Defense is a man named Chang Wanquan. He actually hasn't been appointed Minister of Defense yet because that's a state position, and so he won't get that position until the March National People's Congress. So he's listed as a Central Military Commission member now without portfolio. But to people who know what they're looking at, they say, well, that must mean he has to wait five months to be appointed Minister of Defense.

Fang Fenghui is the new Chief of the General Staff. He spent his entire career out in the Lanzhou Military Region, out in the northwest, probably putting down separatist revolts, and probably has a very keen understanding of the volatile separatist situation out there.

He was also in charge of the 60th anniversary parade for the Communist Party. So it meant he got to spend a lot of time with the Party boss, which probably helped him get this new position, making sure that the six months that everyone was marching in a straight line.

And Ma Xiaotian, our old friend from the military-to-military relationship, who is an Air Force officer but a very joint person, former Deputy Chief of the Staff for Intelligence and Foreign Affairs, the U.S.'s primarily interlocutor in the mil-mil. I've met with him a number of times, as has Roy. He's a tough guy. He has memorized the U.N. Convention on the Law of the Sea from front to back and likes to lecture from it at length, and he is a formidable person to deal with.

Finally, just to mention a number of our self-criticisms. We had

previously believed it was a norm in the Chinese military that you could not make a jump of two grades, not ranks, but grades in position. But the elevation of Fan Changlong to be one of the vice chairmen after having never served on the Central Military Commission shatters that norm.

We had always believed that one of the vice chairmen positions was a political officer, but if you go back and look at the previous people who have held the position, like Chi Haotian and Liu Huaqing and other people like that, you realize, in fact, we were mislabeling them.

We expected Wu Shengli, the Commander of the Navy, to be elevated to Minister of Defense, and that didn't happen. The speculation is that this is because what the Navy is doing right now is so important, and he's so charismatically associated with it, that they didn't want to actually move him from that position so he's one of the two guys who ended up staying.

We expected these changes to signal a dramatic reform of the military region structure, perhaps even its abolition in favor of more of a joint command system, but the fact that almost all of the elevations were former ground force military region commanders rather than the more joint guys we associate with the deputy chiefs of staff suggest that that's not going to happen.

And, then, finally the X-factor that I would offer for you that could potentially upturn this applecart over the next couple of years is this very serious effort at doing a corruption purge within the Party, but there are significant amounts of smoke coming out of the military right now about the extent of senior military officer corruption, and we continue to see the outlines of the evidence of that, and so expect, I think, over the next year or two some very significant senior people taken down for corruption.

Thank you.

**PREPARED STATEMENT OF DR. JAMES MULVENON
VICE-PRESIDENT, INTELLIGENCE DIVISION, DEFENSE GROUP, INC.**

February 7, 2013

“The New Chinese Central Military Commission”

Testimony of

James C. Mulvenon, Ph.D.
Vice-President, Defense Group, Inc. Intelligence Division
Director, Center for Intelligence Research and Analysis

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

“China’s New Leadership and Implications for the United States”

INTRODUCTION

Thank you, Mr. Chairman and the other members of the U.S.-China Economic and Security Review Commission for the opportunity to take part in the hearings you are holding today on the topic of “China’s New Leadership and Implications for the United States.” My remarks will focus on the personalities of the new Central Military Commission.

Every five years, the advent of a Party Congress heralds a significant turnover of senior military officers on the Central Military Commission. Every two Congresses since the early 1990s, speculation about whether the CMC chairman will step down after two five-year terms or hold on for a “decent interval” becomes rife, and outside analysts pore over the military appointments to look for evidence of “factional” influence. The 18th Party Congress did not disappoint on either account. In mid- to late October 2012, eight out of ten of the uniformed members of the leading Central Military Commission were replaced. Moreover, the Party’s new general-secretary Xi Jinping, who had been the only civilian CMC Vice Chairman since 2010, also replaced Hu Jintao as CMC Chairman, defying expectations that the latter would stay on for an additional two years. This article examines the reasons for Xi’s “early” promotion and profiles the new members, exploring their backgrounds and possible clues as to their preferences and outlooks.

Surprise, Surprise: Xi Takes Over the CMC

In what even official Chinese media described as an “unusual twist to China’s leadership transition,”²⁴¹ Xi Jinping was named chairman of the Central Military Commission at the first plenary session of the 18th CCP Central Committee, ending months of speculation about whether Hu Jintao could or would retain the chairmanship for a “decent interval” after passing the CCP general-secretary position to Xi.² The argument in favor of Hu staying on was primarily historical precedent, since both Deng Xiaoping and Jiang Zemin had maintained leadership of the military for approximately two years after stepping down from their Party positions. Yet Xi had powerful advantages over Hu, including his pedigree as the son of a legendary communist guerrilla (Xi Zhongxun), his longstanding princeling ties to senior military leaders, and his experience as a uniformed *mishu* to Defense Minister Geng Biao in the late 1970s and early 1980s, accompanying Geng on visits by official military delegations to Europe and the United States.³ Structurally, the move will be supported by those who felt that the “two centers” approach introduced unnecessary ambiguity in the chain of command.⁴ Chinese official media went so far as to praise Hu for “voluntarily” leaving the post, and Xi magnanimously offered

Notes

¹ Yan Hao, “Xinhua insight: Hu praised for voluntarily resigning from top military post,” *Xinhua*, 17 November 2012.

² “Xi Jinping named Chairman of CPC Central Military Commission,” *Xinhua*, 15 November 2012.

³ Keith Richburg, “China’s other transition: military to be led by new generation,” *Washington Post*, 23 October 2012, accessed at: http://www.washingtonpost.com/world/asia_pacific/chinas-other-transition-military-to-be-led-by-new-generation/2012/10/23/a8fd9504-19e5-11e2-ad4a-e5a958b60a1e_print.html.

⁴ James Mulvenon, “Party-army relations since the 16th Party Congress: The battle of the two centers?” in Andrew Scobell and Larry Wortzel, *Civil-military change in China: Elites, institutes, and ideas after the 16th Party Congress*, Carlisle, PA: Strategic Studies Institute, Army War College, 2004, chapter 2, pp.11-48.

that Hu's decision "embodies his exemplary conduct and nobility of character."⁵ Even though Xi is taking the helm of the CMC from Hu Jintao, the head of the latter's office, Chen Shiju, has reportedly been appointed head of the CMC General Office,⁶ suggesting some latent Hu influence over the body's activities.⁷

After Xi assumed the chairmanship, Hu and Xi presented a common front to the troops. They addressed an enlarged meeting of the Central Military Commission on 16 November, "urging continuous efforts to advance army building and to fulfill the historic missions shouldered by the military."⁸ Hu lauded Xi, assuring the assembled generals that he could "shoulder great responsibilities of being chairman of the Central Military Commission while uniting and leading the commission to fulfill the great historic missions."⁹

China's New CMC Leaders

In official protocol order, the new members of the CMC are Fan Changlong, Xu Qiliang, Chang Wanquan, Fang Fenghui, Zhang Yang, Zhao Keshi, Zhang Youxia, Wu Shengli, Ma Xiaotian, and Wei Fenghe.¹⁰

General Fan Changlong, Vice Chairman

Of all of the promotions to the CMC, General Fan Changlong's is the most surprising, because it violates what had previously been considered an ironclad norm in the PLA against "skipping a grade," in this case moving from MR leader to CMC vice-chair and without pausing at the CMC member grade.¹¹

Fan Changlong has experienced a typical Army career, rising through the ranks as an artillery officer before moving to national command.¹² He was born in May 1947 in Dandong, Liaoning Province, and worked on a commune before joining 3rd Company, 122nd Artillery Battalion, 16th Artillery Corps in the Shenyang Military Region in January 1969. Fan joined the Party in September 1969, and spent the next thirty years moving systematically up the ranks of 16th Corps, serving in political positions in the 1970s and regimental command positions in the early 1980s. For ten months in 1975 he attended an artillery academy, and between 1980 and

⁵ Yan Hao, "Xinhua insight: Hu praised for voluntarily resigning from top military post," *Xinhua*, 17 November 2012.

⁶ The CMC General Office is a Military Region deputy leader-grade organization, which means that Chen now has the same grade and holds the rank of lieutenant general or major general. It is an unusual step to place a civilian in a military billet. Hat tip to Ken Allen.

⁷ One strange anomaly noticed by Ken Allen: the CMC's General Office is concurrently MND's General Office. It is a Military Region Deputy Leader-grade organization, whose director is either a lieutenant general (primary rank) or major general (secondary rank). But as John Corbett points out, having a civilian in the job is not unprecedented. Jia Tingan moved from Deputy Director of the Shanghai party committee General Office—working for Jiang Zemin—to be Deputy Director of the CMC General Office as of 1994 with the rank of Major General. Jia then went on to be promoted to Deputy Director of the General Political Department in December 2007, undermining the argument that he was simply a paper-pushing apparatchik. Hat tip to both of them.

⁸ "Hu, Xi urge army to fulfill historic missions under new leadership," *Xinhua*, 16 November 2012.

⁹ "Hu, Xi urge army to fulfill historic missions under new leadership," *Xinhua*, 16 November 2012.

¹⁰ "List of Chairman, Vice Chairmen, Members of CPC Central Military Commission," *Xinhua*, 15 November 2012.

¹¹ For the definitive treatment of the critically important PLA grades and ranks system, see Ken Allen's chapter in *The People's Liberation Army as organization: Reference volume v1.0*, Santa Monica, CA: RAND, 2001.

¹² Fan's official bio can be found here: http://news.xinhuanet.com/english/china/2012-11/04/c_131950268.htm, accessed 4 November 2012.

1982 he was a student at an Army academy. In September 1985, he moved to division-level headquarters and was promoted to deputy commander of the 48th Division, then commander of the 46th Division in September 1990. Fan was elevated to the 16th Corps headquarters in February 1993, serving two years as chief of staff and then five years as Corps commander. In 1998, he came to the attention of senior military leaders with his actions during the military response to flood fighting.¹³ He became chief of staff of the Shenyang Military Region in December 2002, where he served for three years before moving to Beijing as an Assistant Chief of the General Staff in December 2003. Before becoming Vice-Chairman, Fan's last position was commander of the Jinan Military Region, where, because of his political officer background, he also served as head of the MR Party Committee. While serving in Jinan, he showed a keen interest in military agriculture, including prescribed fertilizers and biological control for plant diseases and insect pests.¹⁴ He led important unit experiments in joint logistics, command structures, and training methods.¹⁵ Fan also reportedly played a key role in the PLA response to the May 2008 earthquake in Sichuan, personally leading 20,000 troops from Jinan to the scene of the disaster that killed 80,000 people.¹⁶ According to the *South China Morning Post*,

General Chen Bingde, the Chief of the General Staff, revealed in a memoir published in 2010 that he bypassed routine procedures and called Fan at 9.34 pm on May 12, seven hours after the quake struck, ordering two army corps from the Jinan Military Area Command to prepare immediately for a disaster relief mission in the quake zone and "await orders to set out at any time."¹⁷

Politically, he was an alternate on the 16th Congress Central Committee, a full member of the 17th Party Congress Central Committee, and now a member of the 18th Party Congress Politburo.

*Fan Changlong's bio highlights the weakness of foreign PLA leadership analysis, since nothing in the raw details of his career explains his meteoric rise to CMC Vice-Chair, except perhaps the recognition of his leadership during both the 1998 floods and the May 2008 earthquake relief effort. In a PLA striving to fulfill the goals of the "New Historic Missions," these types of achievements may have equal or greater weight than performance of traditional military tasks, and "increasingly serve as proxies for combat experience."*¹⁸ Fan also overlapped with Xu Caihou and Liang Guanglie when the former commanded the 16th Group Army and the latter commanded the superordinate Shenyang Military Region. Yet Fan will be

¹³ Hat tip to Daniel Tobin, Kim Fassler, Justin Godby, "Parsing the selection of China's new high command," *China Brief*, Volume 12, Issue 22, 16 November 2012.

¹⁴ "Sun Huangtian, others attend PLA agriculture S&T meeting," *Jiefangjun bao*, 26 July 2012, p.1.

¹⁵ Hat tip to Daniel Tobin, Kim Fassler, Justin Godby, "Parsing the selection of China's new high command," *China Brief*, Volume 12, Issue 22, 16 November 2012. For examples of the experiments, see Liao Xilong, "Personally experiencing Jinan Theater's major joint logistics reform," *Jiefangjun bao*, 16 December 2008; and Huang Chao and Xu Hu, "Combine troops level by level, conduct multi-level joint training—an armored division under the Jinan Military Region Tests and perfects new operational methods by using actual troops and real equipment," *Jiefangjun bao*, 11 November 2008.

¹⁶ One of the main tasks of the Jinan Military Area Command, thanks to its ability to mobilize quickly and deploy airborne troops, is to serve as a supporting force for military or emergency missions. See Choi Chi-yuk, "General Fan Changlong tipped for top post in China military commission," *South China Morning Post*, 22 October 2012.

¹⁷ Choi Chi-yuk, "General Fan Changlong tipped for top post in China military commission," *South China Morning Post*, 22 October 2012.

¹⁸ See Daniel Tobin, Kim Fassler, Justin Godby, "Parsing the selection of China's new high command," *China Brief*, Volume 12, Issue 22, 16 November 2012.

past mandatory retirement age at the 19th Party Congress and therefore will likely serve only a single term as CMC Vice-Chair.

General Xu Qiliang, Vice Chairman¹⁹

Xu Qiliang is a career Air Force officer and pilot. He was born in March 1950 in Linqu, Shandong Province, joining the PLAAF as a student in July 1966 at the PLAAF 1st Aviation Preparatory School. He is the son of late Lieutenant General Xu Lefu, a former Deputy Political Commissar of the Air Force.²⁰ Xu briefly served as a “basic trainee” in the 335th Regiment, 112nd Division, 38th Army, before joining the Communist Party in July 1967. He entered the PLAAF 8th Aviation School in Liushuquan, Xinjiang²¹ in December 1967, graduating from the 5th Aviation School, Wuwei, Gansu, in November 1968 with a senior technical (associates) degree.²² Xu was first posted as a pilot to the 77th Regiment of the 26th Air Division in August 1969, rising quickly to be a deputy commander and finally commander of the 26th Division’s Independent Flight Group (battalion) in May 1976. His promotions continued within the division, including being one of the deputy commanders in September 1980 and the commander in May 1983, interrupted by a six-month attendance in the Senior Course at the Air Force Command College between March and October 1982. From the 26th Division,²³ Xu continued to serve in logical command positions; he was selected as a deputy commander of the 4th Air Corps in Shanghai in May 1984 and then served as chief of staff of the renamed Shanghai Command Post from August 1985 to August 1986.²⁴ In an appropriate move for his grade and position, he left command to attend the National Defense University’s (NDU) Basic Course as a student from September 1986 to June 1988. After his stint in the classroom, he returned to the PLAAF as an acting deputy commander of the 8th Air Corps in Fuzhou, Fujian, before becoming the chief of staff in July 1989 and finally commander of the unit in June 1990. At this point, Xu moved to Beijing, assuming duties in January 1993 as one of the deputy chiefs of staff in PLAAF Headquarters and then chief of staff beginning in October 1994.²⁵ Twice during his headquarters stint he attended short courses at NDU, first as a student in the Campaign Refresher Course from September to November 1994 and then as a student in the National Defense Research Department from July to October 1998. In February 1999, Xu concurrently became commander of the Shenyang Military Region Air Force and one of the deputy commanders of the MR itself, which is an MR deputy leader-grade billet. From March to July 2001, he took the “generals course” at NDU. In June 2004, Xu was appointed as one of the Deputy Chiefs of the General Staff, which is an MR leader-grade billet, and was promoted to full general in July 2007. Three months later, he was appointed as the PLAAF Commander and a concurrent Central Military

¹⁹ The details of Xu’s bio can be found here: http://news.xinhuanet.com/politics/2012-11/04/m_113600838.htm, accessed on 4 November 2012. Special thanks to Ken Allen for the link, and for the detailed footnotes on PLAAF organizational history.

²⁰ Choi Chi-Yuk, “China’s leadership transition feature series—Xu Qiliang; aviator looks set to climb,” *South China Morning Post*, 16 October 2012.

²¹ The 8th Flight School was created in 1967 by merging part of the 5th Flight College and 3rd Flight College. In 1972, it was merged back into the 5th Flight School.

²² The 5th Flight School was founded in Jinan, Shandong Province, but moved to Wuwei, Gansu in early 1966.

²³ The 26th Air Division was created in 1953 at Liuzhou, Guangxi, but it moved at some point to the Chongming District of Shanghai

²⁴ The 4th Air Corps was renamed the Shanghai Command Post in 1985.

²⁵ Xu made a lateral transfer from being an air corps commander to become the chief of staff. They are both grade 5 positions, but the latter has greater responsibilities.

Commission member. Politically, Xu's memberships in leading Party bodies paralleled his military promotions. He was an alternate member of the 14th and 15th Party Congresses in 1992 and 1997, respectively, rising to become a member of the 16th and 17th Party Congress Central Committees in 2002 and 2007. Finally, with his elevation to the vice-chairmanship, Xu became a member of the 18th Party Congress Politburo.

Xu Qiliang now holds the highest position achieved by an air force officer in the post-Mao era.²⁶ But this move also allows us to discard the popular shibboleth that the second CMC Vice-Chairmanship is reserved for a "political officer." The most recent Vice-Chair, Xu Caihou, did follow a typical political officer career path, but the previous occupants (Liu Huaqing, Cao Gangchuan, Chi Haotian, et al.) were not. Even if the leadership had wanted to further the Xu Caihou example, none of the three top political commissars in the PLA (General Liu Yuan, 61, of the General Armament Department; General Zhang Haiyang, 61, of the Second Artillery Force; and General Zhang Yang, 61, of the Guangzhou Military Region) were members of the CMC and were not senior enough to succeed Xu Caihou as CMC vice-chairman. However, Fan Changlong's two-step grade elevation to Vice-Chair would seem to undermine that thesis, unless it was simply impossible to contemplate two two-step promotions at the same time.

General Chang Wanquan, expected Minister of Defense²⁷

Chang Wanquan was born in Nanyang, Henan, in January 1949, joining the PLA in March 1968 and the CCP later in the same year. After a few years of soldiering, he was promoted to chief of staff of the 140th Division's training section in July 1970, moving up to chief of staff of the 47th Army's training bureau in the Lanzhou Military Region in March 1974. From February to September 1978, Chang served as chief of staff of the Lanzhou MR Headquarters' Operations Department (second section), and then became the *mishuzhang* of the MR General Office *mishu* section. In February 1980, he returned to the 47th Army, serving as one of the deputy chiefs of staff and then chief of the Headquarters Department's Training Bureau. From May 1983 to September 1985, Chang was promoted to chief of staff of the 47th Army's 140th Division, and then one of the deputy division commanders until August 1990. For the next two years, he headed the Lanzhou Military Region Operations Department, and then assumed command of the 61st Division. From November 1994 to June 1998, he served as chief of staff of the 47th Army, leaving to head the National Defense University's Campaign Education and Research Department. Chang returned as commander of the 47th Army in October 2000, rising to chief of staff of the Lanzhou Military Region. In December 2003, he became chief of staff of the Beijing Military Region, and one year later was promoted in grade to command the Shenyang Military Region. Chang became director of the General Armament Department in September 2007. Politically, he was a member of the 16th, 17th, and 18th Party Congress Central Committees.

Chang Wanquan's appearance on the official CMC protocol list without an assigned position guarantees that he will be appointed Defense Minister at the National People's Congress in March 2013. He is widely credited with the successes associated with the country's manned space program, which is administered by Chang's General Armament Department. Outside analysts predicted before the Congress that Chang would be promoted to the Vice-Chair

²⁶ Hat tip to Daniel Tobin, Kim Fassler, Justin Godby, "Parsing the selection of China's new high command," *China Brief*, Volume 12, Issue 22, 16 November 2012.

²⁷ <http://baike.baidu.com/view/325385.htm>

position that was ultimately awarded to Fan Changlong, but instead he was moved “up” to Defense Minister.

General Fang Fenghui, Chief of the General Staff²⁸

Fang Fenghui was born in April 1951 in Xianyang, Shaanxi. He joined the PLA in 1968, and served for 34 years in the Lanzhou Military Region, primarily in Xinjiang. Among his positions was chief of staff of the Xinjiang Military District and commander of the 21st Group Army. In December 2003, Fang was appointed chief of staff of the Guangzhou Military Region, and was promoted in 2007 to be commander of the Beijing Military Region and elected to the 17th Party Congress Central Committee. In 2009, he was in charge of the 60th anniversary National Day parade in Beijing, accompanying Hu Jintao in reviewing the troops.

Fang is young enough to serve one five-year term as Chief of the General Staff, then potentially follow past patterns and move up to CMC Vice-Chair in charge of professional PLA affairs. His service in three different military regions casts him in a positive light compared with competing officers.

General Zhang Yang, Director, General Political Department²⁹

Zhang Yang was born in August 1951 in Wuqiang, Hebei. From 1996 to 2000, he served as the political commissar of the 163rd Division. In 2000, Zhang was appointed director of the 42nd Group Army’s Political Department, and was elevated to political commissar. He was elected as a deputy at the 10th National People’s Congress in 2003. From 2004 to 2007, Zhang served as director of the Political Department of the Guangzhou Military Region, eventually rising to political commissar and election as a member of the 17th Party Congress Central Committee in 2007.

Zhang’s career is a bit unusual for a GPD Director, since he has only served in political positions in units and has never done a tour in Beijing at GPD headquarters. At age 61, Zhang Yang could serve two terms on the CMC, first as GPD Director and possibly one as CMC Vice Chairman in charge of political affairs.

General Zhao Keshi, Director, General Logistics Department³⁰

Zhao Keshi was born in November 1947 in Gaoyang, Hebei, and joined the PLA in 1968. Until 1988, he moved up the system as an apparatchik in the Army Headquarters training command. Between 1990 and 1994, Zhao served as deputy director and then director of the Nanjing Military Region Training Department. From 1994 to 1999, he served as chief of staff of the 31st Group Army. From 1999 to 2001, he was one of the deputy chiefs of staff of the Nanjing

²⁸ Fang Fenghui’s bio was cobbled together from multiple sources, including: Li Xiaokun and Zhao Lei , “Military reshuffles its major positions,” *China Daily*, 26 October 2012, accessed at: http://www.chinadaily.com.cn/2012-10/26/content_15847863.htm; and <http://baike.baidu.com/view/1032917.htm>.

²⁹ Zhang Yang’s bio was pieced together from multiple sources, including: Li Xiaokun and Zhao Lei , “Military reshuffles its major positions,” *China Daily*, 26 October 2012, accessed at: http://www.chinadaily.com.cn/2012-10/26/content_15847863.htm; and <http://baike.baidu.com/view/41979.htm>.

³⁰ Zhao Keshi’s bio was assembled from multiple sources, including: Li Xiaokun and Zhao Lei , “Military reshuffles its major positions,” *China Daily*, 26 October 2012, accessed at: http://www.chinadaily.com.cn/2012-10/26/content_15847863.htm; and <http://baike.baidu.com/view/1033044.htm>

Military Region, moving to command the 31st Group Army from 2001 to 2004. Zhao then returned to the Nanjing Military Region as chief of staff in 2004 and assumed command in 2007.

Zhao will be 70 at the 19th Party Congress in 2017, strongly suggesting that he will only be able to serve one term on the CMC.

General Zhang Youxia, Director, General Armament Department

Zhang Youxia was born in July 1950 in Weinan County, Shaanxi, and also joined the PLA in 1968. He is the son of Zhang Zongxun, an original Marshal of the revolution who reportedly fought alongside Xi Jinping's father during the Revolution.³¹ In the 1970s and 1980s, he participated in various episodes of the border war and subsequent skirmishes with Vietnam, and was reportedly wounded.³² He was a division commander in the 13th Group Army, then deputy commander of the 14th Group Army, and then commander of the 13th Group Army in Chengdu Military Region.³³ In 2005, Zhang was appointed one of the deputy commanders of the Beijing Military Region, and then assumed command of the Shenyang Military Region in 2007. In 2009, he was quoted in *People's Daily*, the Communist Party mouthpiece, as saying: "The fires of war are burning throughout the world. In this area, the gap between the Chinese military and foreign militaries is growing by the day. This is a real problem."³⁴ In his position at GAD, Zhang takes over the responsibility of improving the PLA's weaponry and technology.

At age 62, Zhang Youxia could serve two terms on the CMC.

Admiral Wu Shengli, Commander, Navy³⁵

Wu Shengli was born in August 1945 in Wuqiao, Hebei, joining the PLA in 1964. He first attended the PLA Institute of Surveying and Mapping, and joined naval units after graduation. During his navy career, Wu commanded a destroyer zhidui (flotilla), served as chief of staff of the Fujian base, was commandant of the Dalian Naval Academy, served as one of the deputy commanders of the East Sea Fleet, and concurrently commanded the South Sea Fleet as one of the deputy commanders of the Guangzhou Military Region. He became one of the Deputy Chiefs of the General Staff in 2004. In August 2006, Wu became the PLAN commander when Zhang Dingfa died, and did not receive his third star until July 2007 (after he met the time-in-rank criteria); however, he did not become a CMC member until the 17th Party Congress in October 2007. He was the only officer who retained his original position in the changes accompanying the 18th Party Congress. Politically, he was a member of the 17th and 18th Party Congress Central Committees

³¹ Li Xiaokun and Zhao Lei, "Military reshuffles its major positions," *China Daily*, 26 October 2012, accessed at: http://www.chinadaily.com.cn/2012-10/26/content_15847863.htm; and Jeremy Page, "China reaches accord on military makeup," *Wall Street Journal*, 26 October 2012, accessed behind a paywall at: <http://online.wsj.com/article/SB10001424052970203897404578077844219771274.html>

³² Jane Perlez, "New leaders of military in China announced," *New York Times*, 25 October 2012, accessed behind a paywall at: http://www.nytimes.com/2012/10/26/world/asia/china-names-new-military-leaders-as-transition-nears.html?_r=0

³³ See the usually reliable Xilu.com biography website: <http://club.xilu.com/xinguancha/msgview-950389-104372.html? PHPSESSID=a78cb23ead24848375566c5fb016e7db>

³⁴ Zhu Sixiong, "New revolutions in military training in new period (high-end interview)—from tough, strict, and live combat and training crack troops through sharpening and smelting—detailed account of this paper's exclusive interview with Shenyang Military Region Commander, Zhang Youxia," *Renmin ribao*, 20 November 2009, p.19.

³⁵ <http://baike.baidu.com/view/676987.htm>

Outside analysts were surprised that Wu Shengli remained in place and did not become defense minister, but it may be that the current PLAN modernization, which is strongly associated with Wu, is too important right now to be placed in other hands.

General Ma Xiaotian, Commander, Air Force³⁶

Ma Xiaotian was born in Gongyi, Henan, in August 1949, joining the PLA in July 1965 and the CCP in July 1969. His PLAAF career began as a student in the Air Force 2nd Aviation Preparatory School, and continued with his education as a pilot at the 12th Aviation School. After graduation in May 1968, Ma returned to the school as a flight instructor. From December 1970 to January 1972, he was a student at the 5th Aviation School, then left to join an aviation unit where he served successively as a pilot, squadron leader, deputy regiment commander, and regiment commander. In May 1985, Ma became one of the deputy commanders of an air division, and was promoted to division command in the early 1990s. From May 1993 to April 1994, he attended the Basic Course at National Defense University. After graduation, he was elevated to chief of staff and then command of the 10th Air Corps. A Hong Kong magazine asserts that Ma served as a commander during the joint drill of the three services in the Taiwan Strait in 1996.³⁷ In March 1997, Ma moved to Beijing as one of the deputy chiefs of staff at PLAAF headquarters, and was then promoted in August 1998 to chief of staff of the Guangzhou Military Region Air Force. From June 1999 to January 2001, he concurrently served as commander of the Lanzhou Military Region Air Force and one of the deputy commanders of the military region itself. From January 2001 to July 2003, Ma held identical positions in the Nanjing Military Region. In July 2003, he moved back to Beijing as one of the deputy commanders of PLAAF headquarters, and then assumed the position of National Defense University commandant in August 2006. From September 2007 to October 2010, Ma was one of the deputy chiefs of the General Staff for foreign [affairs?] and held the affairs and intelligence portfolio that included managing the military-to-military relationship with the United States.

Ma Xiaotian is in many ways the model of a modern PLA leader, commanding units in his service, serving in regional and service headquarters, and successfully performing in “joint” positions in national PME and the general staff. While he was eminently qualified to lead the PLAAF, Ma also made a name for himself as an articulate and tough strategic interlocutor in military-to-military relationships with the United States, as well as a globally savvy officer guiding the PLA’s increasingly complex foreign interactions. Yet his age prevents him from spending more than one term on the CMC.

General Wei Fenghe, Commander, Second Artillery³⁸

Wei Fenghe was born in March 1954 in Liaocheng, Shandong, joining the PLA in December 1970 and the CCP in January 1972. For 20 years he moved up the ranks within a Second Artillery brigade, pausing from 1982 to 1984 for education at the Second Artillery Command College. Between 1990 and 2001, Wei successively served as chief of staff and then

³⁶ For a much more detailed biography of Ma Xiaotian, see James Mulvenon, “The “Dawn of Heaven”? A New Player in Sino-U.S. Mil-Mil,” *China Leadership Monitor* 24, March 2008.

³⁷ Yu Qianli, “Profiles of the key personnel in the CPC’s war against Taiwan,” Chien Shao, 1–31 December 2007, No. 202, pp. 54–57.

³⁸ <http://baike.baidu.com/view/1551471.htm>

commander of a brigade, leaving in July 2001 to become the chief of staff at the 54th Base. From December 2002 to December 2004, he commanded the 53rd Base, moving to Beijing for a position as one of the deputy chiefs of staff and then chief of staff of Second Artillery headquarters. In December 2010, Wei was promoted as one of the deputy chiefs of the general staff. Interestingly, Wei was the only officer elevated to the Central Military Commission in October 2012 who was not a full general, but was quickly promoted on 23 November.³⁹ This sequence was not unprecedented. According to John Corbett, “The timing and process—promotion of the lone LTG [lieutenant general] to full general about one week after the Party Congress by the newly elected Chairman (or re-elected in 2007) mirrors the 2007 promotion of Chang Wanquan to full general after he was put on the CMC as General Armament Director.”⁴⁰

Wei Fenghe’s career path, commanding a Second Artillery brigade and then a base, is very similar to his predecessor Jing Zhiyuan.⁴¹ At age 58, Wei is also young enough to serve two complete five-year terms on the CMC.

CONCLUSION

The 18th Party Congress witnessed the largest-scale change in PLA leadership in years, but analysts remain divided over the reasoning behind individual choices. Perhaps the only consensus involves the dogs that did not bark; namely, the strong suspicion that GLD political commissar Liu Yuan and Second Artillery political commissar Zhang Haiyang did not advance because of their tainted relationship with disgraced official Bo Xilai. Regarding the winners, however, explanations are still bogged down in outdated notions of faction and loyalty. Specifically, outside analysts were quick to identify five or more of the CMC appointees as loyal to Hu Jintao, based primarily on the rationale that their previous grade and rank promotions had been signed by Hu as CMC Chairman or they had served in the same geographic proximity as Hu or Jiang Zemin sometime in the last 20 years. These logical fallacies are compounded by the resurrection of “field army” explanations for personnel groupings, and the expected but tiresome false dichotomies of “hardliners” versus “moderates.” Yet it is striking that five of the officers chosen for the CMC, like the majority of the new Politburo Standing Committee, can only serve one five-year term before reaching mandatory retirement age, suggesting that some of the choices were short-term compromises.

Although the appointment of Fan Changlong as a CMC vice chair came as a surprise because he skipped a grade, the remaining candidates came from a narrow pool of officers who had moved up the career ladder and met the required time-in-grade and time-in-rank criteria in key staff officer and leadership billets. In the end, however, there is always some horse trading that occurs based on *guanxi*.

³⁹ http://news.xinhuanet.com/english/china/2012-11/23/c_131994985.htm

⁴⁰ Corbett

⁴¹ Hat tip to Daniel Tobin, Kim Fassler, Justin Godby, “Parsing the selection of China’s new high command,” *China Brief*, Volume 12, Issue 22, 16 November 2012.

**OPENING STATEMENT OF ROY D. KAMPHAUSEN
SENIOR ADVISOR FOR POLITICAL AND SECURITY AFFAIRS
NATIONAL BUREAU OF ASIAN RESEARCH**

MR. KAMPHAUSEN: Thank you. It's a privilege to be back before the Commission and thanks to our hearing co-Chairs for this opportunity.

Many of the comments that I'll offer today are really the result of the work that we've been in partnership with at NBR with Army War College as we've helped to sponsor the Carlisle PLA Conference for the last seven years, and had the benefit of experts like James participating in that event, and resulting in the edited volumes, the six that are now out as a result of those conferences.

We've dovetailed our approach in the oral testimony, I think, to focus on different things. I'd like to focus on three questions that the staff has asked us to look at.

The first is to make some comments about the changing, potentially changing relationship between the PLA and the Party. And the short answer is, in my judgment, there is no fundamental change that's taking place, but this goes well beyond the assertions that the PLA makes about itself being a Party Army.

In fact, there are structural components to this that make it unlikely that that relationship will change in any fundamental way.

A couple of key points, and, then, as James said, more detail is in the written statement. First, PLA leaders themselves are senior Party leaders by virtue of their status as full members of the Central Committee or, in some cases, as alternate members. They are senior Party leaders. And in some cases, we can actually predict or forecast who might be a next-generation PLA leader by understanding more about the cohort of PLA officers who are members or alternates on the Central Committee.

For instance, Xu Qiliang, as James said, first Air Force Vice Chair of the CMC, was first made an alternate member of the Central Committee in 1992, full member in 2002. He became a CMC member in 2007, and Vice Chair in 2012. His Party leadership predates his senior military leadership.

The second piece of this, the structural piece that makes a fundamental break between the PLA and the Party unlikely to occur, is the very nature by which officers in the PLA and political and Party leaders rise to central leadership positions.

They do it by earning their credentials in the provinces and for the military by their experience in the military regions. This experience and this exposure creates interactions between Party and political leaders and their military counterparts at much earlier points in their careers, and this, I think, lends to coherence between the Party and the PLA that's notable.

As James said, it's not particularly important that there is not a new Vice Chair on the CMC who does not come from a commissar background. It's not always been the case that we've had a political Vice Chair, and in fact, it doesn't say that the PLA is becoming less political because there is no political commissar Vice Chair.

The second point I'd like to address is the PLA's ability to influence Politburo Standing Committee deliberations on national security issues as well as other issues. First, over the last 20 years, we've seen a declining ability at the structural level for the PLA to have inputs. There is no longer a PLA member who's a member of the Politburo Standing Committee. For the last ten years, there has not been a CMC Vice Chair who sits on the Central Committee's Secretariat, which is the structure that runs the Party's day-to-day affairs. So we've seen somewhat of a retrenchment from the PLA in those key roles.

There are three remaining ways in which they can influence, at a structural level, the interaction and development of policy.

First is through their interactions, the uniformed PLA's interactions, with the CMC Chair, Xi Jinping himself, in the CMC setting. We know they meet regularly, perhaps as much as once a week, and they also accompany him on his military related visits around the country. That's one important way that they can shape the thinking of the top leadership on military issues.

The second is through the two members of the CMC, the two Vice Chairs that James talked about, who are members of the larger Politburo. This is a structural way that the PLA can influence the top leadership deliberations.

And the third is through the PLA participation in leading small groups--foreign affairs, national security, and so forth.

However, that's the structural piece. The PLA has great autonomy in the execution of national security plans and operations, and this autonomy, this absence of a mandate to coordinate with other elements of the Chinese government, can lead to a phenomenon that sometimes is observed by the outside as a PLA that's out of control, or a "rogue PLA."

This presents huge challenges to the political leadership, particularly in their dealings with other regional players, as they want to convey an image of a China that's peacefully rising, on the one hand; on the other, they have a PLA that acts with great autonomy.

Well, these civil-military relations issues and interactions, I think, will manifest themselves in two important modernization and reform issues that lie before this new CMC.

The first is the likely imperative to reform the military region structure. Now, the military regions were set up to conduct national defense, defend China's sovereignty at a time when China was under great threat on nearly all its borders. Those days have gone by. The borders are demarcated. Confidence-building measures have replaced uncertainty, and we have a new regional security structure, not new, but a regional security

structure in central Asia that has replaced the Soviet threat.

The imperative to have military regions from a national defense perspective has gone away, but the imperative to keep the military regions from a civil-military relations perspective remains, and this introduces a tension that the leaders of the CMC will have to address.

The final issue to put on the table for your consideration--perhaps we can discuss--is the degree to which the interaction between the services will be manifested in civil-military relations as it pertains to who gets bigger budgets, who gets more priority, and who actually succeeds in going forward in a global environment in which the PLA's interests are becoming much more global in nature.

The PLA remains an Army-dominated force. Fifty of the top 60 generals or admirals come from the Army. Sixty percent of the budgets and structure and people are in the Army, but the Army is not going to be the force of choice to help defend China's national security interests, as they occur around the world, and so there is a tension there, and that tension will manifest itself, I think, in aspects of civil-military relations.

Thank you.

**PREPARED STATEMENT OF ROY D. KAMPHAUSEN
SENIOR ADVISOR FOR POLITICAL AND SECURITY AFFAIRS
NATIONAL BUREAU OF ASIAN RESEARCH**

USCC Hearing
China's Military Transition
February 7, 2013
Roy Kamphausen
Senior Advisor, The National Bureau of Asian Research

Introduction

This statement is submitted to the U.S.-China Economic and Security Review Commission to address issues related to the transition to the new top military leadership in China. The statement addresses the composition of the new Central Military Commission, important factors in the selection of the leaders, and highlights salient elements in the backgrounds of specific leaders. The statement also addresses important factors of civil-military relations, including the relationship of the People's Liberation Army (PLA) to China's top political leadership, potential reform of the military-region structure of the PLA, and the likely competition for budget resources.

Composition of the China's New Central Military Commission

As expected, new Chinese Communist Party general secretary *Xi Jinping* was appointed in November 2012 as the Central Military Commission (CMC) chairman. Additionally, army general *Fan Changlong* and air force general *Xu Qiliang* were promoted to positions as vice chairmen of the CMC—Fan from Jinan Military Region commander and Xu from PLA Air Force commander. Other members of the new CMC include General *Chang Wanquan*, who will become the next Minister of National Defense when that position is confirmed in early spring 2013; General *Fang Fenghui*, chief of the General Staff Department (GSD), who previously had been Beijing Military Region commander since 2007; General *Zhang Yang*, director of the General Political Department (GPD), who comes to the job from the Guangzhou Military Region political commissar position and is the first new GPD director in at least twenty years who was previously not a GPD deputy director; General *Zhao Keshi*, director of the General Logistics Department (GLD), formerly commander of the Nanjing Military Region; General *Zhang Youxia*, who is director of the General Armaments Department (GAD), the former commander of the Shenyang Military Region, and the son of a famous Chinese general who had served with Xi Jinping's father, making Zhang a "princeling"; Admiral *Wu Shengli*, commander of the People's Liberation Army (PLA) Navy, retained the same position on the CMC

despite expectations that he might become a CMC vice chairman; General *Ma Xiaotian*, commander of the PLA Air Force and formerly the deputy chief of general staff in charge of intelligence and foreign affairs; and General *Wei Fenghe*, commander of the Second Artillery, China's missile force. No civilian vice-chairman was appointed, but if past practice holds, China's 6th generation paramount leader could be appointed as a vice chair of the CMC at a future party Congress plenum.

Changing Relationship Between the PLA and China's Communist Party?

The PLA remains firmly a "party army" in that the loyalty of China's military is pledged to the Chinese Communist Party (CCP). In many respects, the close relationship between the PLA and the Chinese Communist Party reflects the reality that the PLA *is* the Party, or at least is comprised of senior Party leaders. Almost all officers above company grade are Party members. Moreover, throughout their careers, PLA generals and admirals have directed or been central to the party committees that exist at every level of command. Perhaps most importantly, all CMC members – as well as more than fifty of the next top sixty military leaders – are full or alternate members of the Central Committee of the CCP. The military is a large "bloc" within the Central Committee; over the last four Party Congresses PLA members have consistently been about a quarter of the total number of Central Committee members. Central Committee membership often is an indicator of future promotion for those in the deputy military region grade position. For instance, although he just became a vice chair of the CMC in November 2012, General Xu Qiliang was already an alternate Central Committee member in 1992 at the 14th Party Congress; he became a full member a decade later at the 16th Party Congress in 2002 when he was a deputy military region grade officer as the Shenyang Military Region air force commander.

PLA leaders in regional command and leadership positions have ample opportunities to interact with local party and government leaders through the various civil-military interactions. Additionally, China's top military leaders usually command or serve as a political commissar in a different military region from the one in which they spent the bulk of their career, thereby increasing the opportunities to interact with local political leaders. (There are exceptions, of course. Zhang Yang spent his entire career in the Guangzhou Military Region, ultimately rising to the position of military-region political commissar. And Zhao Keshi was in the Nanjing Military Region for his entire career before becoming the military region commander.) Because the political and military promotion systems both funnel successful cadres to central leadership roles in Beijing, relationships formed at earlier points in a career often translate into more partnerships at senior levels.

Outside observers overlook this dynamic when they emphasize the loyalty that a new three-star full general must feel toward the general secretary that pinned on his last star,

suggesting that PLA officers are “politicized” at the point of promotion. In fact, the nature of the Chinese system serves to ensure that political-military relationships are formed and strengthened at much earlier points in an officer’s career. By the point in his career that a PLA officer becomes a member of the CMC, he will have had extensive personal and professional interactions with a variety of political and Party leaders, and he is himself, by virtue of his Central Committee status, a Party leader in his own right.

In this regard, it might be inconsequential that neither of the two new vice chairmen comes from a political commissar background (although according to his biography, General Fan did fill a tour as a company level commissar early in his career.) While the CMC has had vice chairman with “political” backgrounds during parts of the past twenty years, it is difficult to ascertain that one portfolio is necessarily “political.” It is likely a mistake to conclude that the absence of an officer with a strict political commissar background as a vice chairman of the CMC means that the PLA has become less of a Party organization.

Did Xi Jinping’s ascension to CMC Chairmanship differ from that of his predecessors?

To be sure, some aspects of the leadership change in the PLA caught observers unawares. Perhaps the biggest news was that Hu Jintao did not follow the practice of Jiang Zemin and retain his CMC chairmanship after relinquishing his role as general secretary of the Communist Party and ranking member on the Politburo Standing Committee, the highest collective leadership body in China. Whether this was the result of a back-room deal to limit the influence of retired top political leaders such as Jiang Zemin—either because Hu Jintao saw the wisdom of avoiding the “twin centers” problem in military leadership that he himself had faced or because Xi Jinping built an effective coalition to prevent Hu from remaining on—we don’t know. We do have a sense, however, that consolidating authority under Xi might help avoid some of the civil-military challenges that plagued China in the early years of Hu’s CMC chairmanship.

Xi Jinping does have experience, albeit limited, with the PLA before becoming CMC chairman. He spent time as a junior staff officer in the CMC General Office as a mishu (essentially an aide-de-camp) to then minister of defense Geng Biao from 1979-1982, and this no doubt provides him with perspective on the activities of the CMC at its highest levels. Additionally, in his various party roles, Xi has supervised PLA units and served on joint party-army committees. However, while he certainly exudes more charisma than the reserved Hu Jintao, the degree to which Xi is able to personally impact PLA priorities and modernization programs will remain difficult to assess, especially in these early days.

Xi Jinping’s activities and initiatives after he became civilian vice chairman of the CMC in October 2010 at the fifth plenum of the 17th Party Congress do not shed a great deal of light on what his priorities might be as Chairman. For instance, he met with military

chiefs of the Shanghai Cooperation Organization countries in Beijing in April 2011; joined CMC Chairman Hu Jintao in a promotion ceremony for officers promoted to general in July 2011; and traveled to Tibet and inspected army troops in July 2011, among other activities.

How does the PLA influence Politburo Standing Committee deliberations and decisions? Does this apply for issues that are not strictly military in nature?

Since the venerable Admiral Liu Huaqing retired in 1992, the uniformed PLA has not had direct representation on the Politburo Standing Committee (PSC). Additionally, beginning with the 17th Party Congress in 2007 there is no longer representation of the PLA in the Secretariat of the Central Committee, which manages the daily workflow of the Party. Absent those two direct points of access, today there are two structural means by which the PLA can influence PSC deliberations and decisions: 1) through their regular interactions with Xi Jinping in his role as CMC Chairman, 2) via the uniformed members of the CMC who are members of the larger Politburo (Generals Fan Changlong and Xu Qiliang are both Politburo members) and 3) through PLA participation in PSC-level leading small groups (including foreign affairs, national security).

As a Party organization subordinate to the PSC, the CMC does not have a mandate to interact and coordinate with other elements of the PRC governmental structure. To be sure, China's Ministry of National Defense (MND) does sit on the State Council, and coordinates with other ministries of the Chinese government on issues such as conscription, mobilization, education and demobilization, among others. But little to no coordination appears to occur on issues related to national security policy and operations. Consequently, many analysts have concluded that the PLA generally regards itself as accountable only to the top party leadership, perhaps even only to the party general secretary, who is also CMC chairman. The absence of a mandate to coordinate – the notion of a Chinese-style inter-agency process remains a far-off possibility – has resulted in high degree of autonomy for the PLA in the execution of defense and national security-related operations and policies. Typical of this approach would be the response of then CMC vice chairman and army general Guo Boxiong to criticisms about the PLA's anti-satellite launch in January 2007. Guo downplayed the event's significance and waved off any risk of space debris, in essence conveying that reactions to the launch were overwrought in the West. In the process, General Guo displayed a surprising lack of regard for the second- order consequences of seemingly autonomous PLA decisions, such as the thousands of pieces of space debris created as a result of the operation, as well as an apparent lack of appreciation for these decisions' impact on other states.

The autonomy in execution that the PLA appears to possess has been construed in some corners to mean that the PLA that has “gone rogue” or is out of control of the Party. I don't believe this to be the case, in large part due to the symbiotic relationship of the top

Party and military leadership I described earlier, but the impression alone creates a problem for the political leadership that seeks to downplay regional concerns of a China threat.

The PLA does not appear to have the ability or inclination to shape the deliberations and decisions of the PSC on issues other than on defense and national security.

Priorities for the New Leadership to Consider

What are the issues that face China's new military leadership and how might their strategic direction differ?

To be sure, a transition to new military leadership suggests the possibility of new approaches, but many of the issues that confront the new leadership remain the same as before. Nonetheless, some aspects warrant highlighting.

First, the composition of the CMC is more “joint” than ever before. General Xu Qiliang is the first air force general to be a vice chairman. When his successor as Air Force chief, General Ma Xiaotian, is added to PLA Navy commander Admiral Wu Shengli, the number of non-Army officers on the ten person CMC increases from two to three, the most ever. At one point prior to the transition before it became known that Admiral Wu would remain as Navy commander, it appeared that two of the top three positions in the PLA would be held by non-Army leaders. (Some informed speculation has suggested that Fan Changlong was “helicopter promoted” from Military Region command precisely so that an Army general would remain in one of the CMC vice chairs.)

The increased number of air force and navy representation on the CMC notwithstanding, the PLA remains an army-dominated force, especially at the top leadership levels. Seven of the ten CMC leaders are army generals, all general department directors are army generals, and all seven military-region commanders are army generals as well. Indeed, nearly three-quarters of the fifty-odd top ranking officers in the PLA are army officers.

Second, the direction of PLA modernization likely will remain focused on the “goals and tasks of China's national defense in the new era” as outlined in the 2010 Defense White Paper. These goals are listed as:

- Safeguarding national sovereignty, security and interests of national development.
- Maintaining social harmony and stability.
- Accelerating the modernization of national defense and the armed forces, particularly to “attain major progress in informationization by 2020”.
- Maintaining world peace and stability.

While the new leaders are unlikely to reshape the aforementioned goals and tasks, they do bring their own particular background and experiences to these roles. For instance,

General Fan Changlong was widely regarded as a top-notch commander who led important military exercises, spearheaded the PLA's operational response to the 2008 earthquake, and achieved key modernization initiatives in the Jinan Military Region. Those experiences could add impetus to further operational and doctrinal reforms.

General Xu Qiliang has been an advocate for advanced concepts of air force deployment, and promoted a strong role for the PLA air force in China's space program. He could contribute to an evolving PLA aerospace capability and doctrinal development.

Additionally, both leaders have extensive background in Northeast China's Shenyang Military Region bordering North Korea. General Xu commanded the military region's air force and General Fan spent 30 years in the MR, rising to the position of military-region chief of staff before taking command of the Jinan Military Region in 2004. While we might be tempted to conclude that North Korea's uncertain prospects prompted China's top political leaders to promote two leaders with on-the-ground experience in Shenyang, this analytical approach might overlook other factors in the selection process, including a desire to balance the geographic origins of the top military leadership. For instance, five of seven military regions are represented on the Central Military Commission.

Modernization Issues with Civil-Military Implications

Even as the PLA continues its path of modernization, influenced and tweaked by the new leaders perhaps but not fundamentally altered, there are two additional issues that will have important bearing on the overall trajectory of PLA modernization. These are deliberations about 1) whether and how to undertake military-region restructuring and 2) the competition between the services for resources.

Military Region Restructuring

The impetus to undertake structural reform that goes beyond the tactical and operational-level restructuring of the last decade to address fundamental military-region structural reform is likely to grow in intensity. The current structure evokes the pre-modernization period in which PLA ground forces were essentially static garrison forces whose chief role was to carry out sectoral defense of Chinese territory and internal security and stability missions. However, China's regional security situation has changed dramatically from the 1950's: it faces no imminent military threat on its borders and the strategic challenge from the Soviet Union has been replaced with multilateral confidence building mechanisms such as the Shanghai Cooperation Organization and clearly demarcated borders. In short, the defense against external threats rationale for the current military region structure has largely gone away.

Reform of the existing structure would doubtless be a complex process, which would likely include an evaluation of strategic and regional security as well as the domestic security situation, assessments of the capabilities of existing units and structures, and alignment of units with the roles and missions that a modified structure might permit. The potential outcomes that might be considered range from reducing the number of military regions from seven to five (or less) all the way to consideration of an entirely functional capabilities structure.

An updated capabilities-based structure could more easily accomplish a variety of tasks, including the positioning of forces capable of responding to border contingencies and projecting land power around China's periphery. A capabilities-based structure also presents opportunities to reduce redundant or superfluous forces and organizational structures, allowing for resource reallocation or savings. And ground-force exercise patterns of the last several years have demonstrated that cross military region operations are increasingly becoming the norm, suggesting that fixed military region boundaries may become less relevant, which could be the first step in a restructuring process.

The outcome of this debate will have important ramifications for the degree to which the PLA, particularly the ground forces, becomes more expeditionary.

However, the debate will hinge on much more than a clear-eyed assessment of roles, missions and capabilities of the PLA in the new era because the military-region structure serves more roles than simply to help prepare for operational contingencies. Indeed, the military-region structure is a central feature of civil-military relations in China and would not easily be changed. The provincial military districts and their subordinate military districts and sub-districts perform critical civil-military roles related to mobilization for national defense, disaster relief, civil defense, conscription and demobilization and thus represent entrenched bureaucracies that might prove difficult to dislodge. And as mentioned above, it is at the provincial-military region level where important political-military relationships are often initially formed. Thus, any significant changes to the military-region structure are likely to be contentious events.

Nonetheless, the pressure from a purely military and operational perspective to begin reform will likely intensify during this CMC's tenure. Although five new CMC members come directly from military-region commander or political commissar postings, it might be hasty to conclude that they are either solid supporters of the status quo or ardent reformers. In any case, their recent experiences as military-region commanders will doubtless inform their thinking.

Second, related to but distinct from military-region restructuring, we may also see intra-PLA struggles between the land forces, surging navy, Second Artillery, and air force over resources and priorities. This dynamic would intensify in future years if downward budget pressures on defense expenditures come to pass. The land forces still constitute the bulk of the PLA (some 60% of manpower, units, resources), serve as the Communist

Party's link to its revolutionary past, and are charged with the fundamental national security missions of defending China's sovereignty and the rule of the Communist Party. Yet, as we have seen, the number of ground forces in place to carry out these missions is outsized for the tasks themselves, suggesting an opportunity for further realignment of forces. This realignment, or "rebalancing" between the army, navy, air force, and Second Artillery, becomes more justifiable as the PLA looks to secure China's national security interests on a global scale.

In many respects, the allocation of resources between the services will provide insight into how expeditionary China's CMC hopes the PLA will become. An outsider can easily conjure up a variety of scenarios and approaches through which a future PLA might seek to project power—for instance, from a modest regional power- projection posture in which land forces still play a significant role, all the way to a full-scale global capability in which a blue water navy and robust air force and Second Artillery (the latter of which might be promoted to a full service) are more prominent. Will we see a more joint orientation? Will the regional air forces and fleets come out from under their subordination to the military regions, perhaps adopting an "expeditionary force" model of air strike groups with a mix of fighters, bombers, and early-warning aircraft? Moreover, might the PLA Air Force contest for a role in managing China's space mission, currently controlled by the GAD and GSD, as the country seeks to pursue its aerospace strategy of "integrated air and space operations, being prepared for simultaneous offensive and defensive operations"?

There is good reason to believe these issues are being debated internally though there is limited evidence of the debate. But as with the case of military region restructuring, the ultimate outcome will be a result of much more than just a consideration of the military factors involved. Domestic politics and the competition between services, albeit if different in character from that of Western democracies, will play a huge, even decisive role in the final determination of programmatic requirements and budgets. And we can expect that the competition between the services will manifest itself in the tenor of civil-military relations in coming years.

China's new military leaders attitudes toward foreign powers and international experience.

At this early juncture, it is difficult to ascertain the specific views that new leaders might have toward foreign powers, especially the United States. We know that CMC Chairman Xi Jinping apparently has fond memories of his visit to Muscatine, Iowa in the 1980's, memories that were warmed during his return visit last year. The two new vice chairman also have had some exposure to the U.S. Fan Changlong made an official visit to the United States in September 2011 as the leader of the Jinan Military Region delegation. General Xu Qiliang visited the US in 1997 as Chief of Staff, PLA Air Force. As

commander of the PLA Air Force, he was supposed to visit the US in 2008, but that trip was cancelled due to the Sichuan earthquake. (The last PLA Air Force commander official visit to the U.S. occurred in 1995; the U.S. Chief of Staff of the Air Force visited China in 1998.) More recently, General Xu met with a delegation of retired US admirals and generals in December 2012.

The degree to which these visits resulted in positive views toward the U.S. is even more difficult to know, and may not matter a great deal, because of the degree to which the individual views of top leaders are constrained within China's collective leadership model. While positive views of the U.S. would be nice, we should also be looking for a clearer understanding of the U.S. that would inform their views articulated in internal "debates" or "discussions" to the extent they take place among CMC members.

What impact will the domestic political corruption scandals in the last year have on the CMC and the PLA?

As a political structure that is subordinate to the Party, the political corruption events of the past year will inevitably have an impact on the PLA. Already, we have seen the promulgation of new regulations that limit the ability of PLA leaders to engage in extravagant activities at banquets or during travel. While largely symbolic, the new rules suggest a more restrictive environment for military leaders. Moreover, the widely publicized intra-PLA anti-corruption efforts like those led by General Logistics Department Political Commissar Liu Yuan imply that the PLA leaders are under scrutiny like their political counterparts. What will be interesting to watch is whether the anti-corruption efforts make headway against some of the pernicious "pay for promotion" schemes that are allegedly rampant within the PLA.

The much-discussed "princeling" phenomenon may also be relevant to this issue. Military princelings, the children or in-laws of current or former political or military leaders, were "born red" after the founding of the People's Republic of China (PRC), and are often well connected with political cadres of similar lineage. Of the new slate of CMC leaders, CMC vice chairman Xu Qiliang is the son of the late air force lieutenant general Xu Lefu; PLA air force chief Ma Xiaotian is the son of Ma Zaiyao, former dean of the Political Institute of the PLA; and the new GLD director, Zhang Youxia, is the son of General Zhang Zongwun, a revolutionary general. But not all eligible princelings were promoted. For instance, neither General Liu Yuan, political commissar of the General Logistics Department and the son of former state president Liu Shaoqi, nor Zhang Haiyang, political commissar of the Chengdu Military Region and the son of legendary general Zhang Zhen, was selected to become director of the General Political Department, despite both being highly rated candidates. While some candidates might suppose that their princeling connections with deposed Chongqing leader Bo Xilai doomed their prospects for promotion, other factors may have played a role as well. In

General Liu's case, for instance, the zeal with which he pursued a high-profile anti-corruption campaign, which resulted in the sacking of Lieutenant General Gu Junshan, deputy director of the GLD, may have alarmed some leaders enough to prevent his promotion. The reality is that not everyone can be promoted to a limited number of positions, and a candidate's princeling connections appear to be only one of several determining factors in how new leaders were selected.

Do you foresee a changing role for the Ministry of National Defense?

In short, I do not anticipate fundamental changes to the functions of the Ministry of National Defense (MND). Rather, I see an evolution of functions and inclusion of new roles in keeping with the traditional externally-focused role of the MND. The PRC's Ministry of National Defense has always been the "face of the PLA" to foreign militaries and the outside world. Its traditional roles have centered around the management of the PLA's international relations, via the MND Foreign Affairs Office. These include high-level interactions, functional military professional visits, strategic dialogues, and so on. In recent years the MND has added an Information office /spokesperson office which manages the public image of the PLA and disseminates periodic multi-lingual information updates (the office is staffed by former MND Foreign Affairs Officers) and a Peacekeeping Center which manages China's participation in UN-sponsored peacekeeping missions. Both functions are essentially in line with the historic foreign affairs functions of the PLA in that they manage some international aspects of the PLA.

Within the PLA branches and services, have there been any leadership or organizational changes with particular strategic significance?

The most interesting development was that Admiral Wu Shengli retained his position as Commander of the PLA Navy, and as a result, remained a CMC member, rather than become one of the two uniformed vice-chairman of the CMC. The speculation as to why he did not move up includes several possibilities such as his contentment with continuing to shape the development of the PLA Navy, or that the bureaucratically entrenched and ground force-centric PLA was unable to contemplate two non-Army CMC vice chairmen.

PANEL III QUESTION AND ANSWER

VICE CHAIRMAN SHEA: Thank you, both, for your very interesting testimonies.

I guess I'll start off with a question. There's a recent report that a Japanese vessel near in the East China Sea was painted by, I believe, a Chinese Coast Guard vessel with fire radar, which the Japanese insist was a provocative act.

Your understanding of the Chinese chain of command, and you mentioned, Mr. Kamphausen, about the great autonomy of the PLA, do you have any sense of how that type of decision to actually lock on your radar in a very tense situation involving disputed islands would be decided? Is this something you think was done autonomously by the Army? Do you think there was political input, political authorization, or maybe a decision at a low level within the Chinese military without higher-ups knowing about it? What's your sense and what implications do you draw from your conclusions?

DR. MULVENON: Well, Roy is a very good person to talk about this because of his experience when he was on active duty running the Military Maritime Cooperation Agreement, which was supposed to handle our discussions with the Chinese about this issue.

I would say that at a strategic level, when people ask me the question about rogue PLA, I often say that I don't think that the PLA is necessarily acting rogue. What we identify as the behavior over the last ten years or so that appears to be at variance with what the Foreign Ministry is saying is in some ways a reflection of the fact that the modernization of the Chinese military has allowed it to expand the geographic scope of what it regards as normal patrolling behavior and normal military activity.

And it has expanded beyond the traditional mechanisms that the Party had to actually govern the use of military forces. And the military says, you know, why should we have to go back to you every time, "Mother, may I?" This is what normal modern militaries do. We're just pushing farther out.

But the problem was they began chafing up against U.S. and Japanese and other regional navies and air forces along their periphery. As early as the 2001 EP-3 crisis, I think we began to see that phenomenon.

And up to a couple of years ago, in the South China Sea, there was real concern that the Chinese had set up these State Oceanic Administration ships primarily to allow them to harass our USNS ships and other things while not making a military encounter. But they had some unfortunate incidents down there. I believe that we have seen evidence that the Chinese political civilian leadership has begun to reassert an ability to not only have a pretty tactical level of understanding of what's going on down there, but to also set up rules of engagement and to manage that knowing that it can become a real strategic crisis; and so there's a significant

amount of reporting, for instance, that Xi Jinping is managing a leading group that is dealing with these maritime disputes.

And so, given the advancements that we see in Chinese military intelligence and surveillance and reconnaissance, which gives the leadership the ability to have a much better understanding of what's going on down there than they would have previously, combined with the fact that I think the leadership now understands that they were engaging in uncoordinated behavior, and it was potentially very escalatory and very dangerous means that they are exercising much greater control down there than they have in the past.

VICE CHAIRMAN SHEA: Mr. Kamphausen.

MR. KAMPHAUSEN: A couple points. First, they were, in fact, PLA Navy vessels, two frigates, two different frigates of the East Sea Fleet, and this is concerning. It raises questions about what their rules of engagement are, and perhaps more importantly, at a strategic level, whether there's an appreciation for the degree to which this was a very escalatory act.

It's not unknown to navies. I'm an army guy, but navies engage in it. It was a big problem we had with the Soviets during the Cold War. It was a provision of the INCSEA agreement that we reached with the Soviets, and it's not clear the Chinese have an appreciation of the actions that the ship that is being painted, if you will, must take in response. You don't have a choice to make a determination that you believe they're just not going to shoot, even though I believe they're not going to shoot, because I think they understand the implications of that.

The second part of it is this took place well away from the Senkakus, between a hundred and 150 kilometers away. The Japanese themselves apparently are not convinced that it's related, and they've said-- some of their own statements that have been not particularly helpful in defusing the crisis when they've talked about warning shots and that sort of thing.

So I think your chief question was, though, who approved it?

VICE CHAIRMAN SHEA: Right.

MR. KAMPHAUSEN: And the Japanese are not convinced that it took place above the East Sea Fleet level. I think the problem with giving an excuse is that the people that we hold accountable are the ones we interact with, and so at a national level, you're accountable; you're responsible. Whether the exact order was given or whether lax rules of engagement were permitted to be formed, I think we have to hold the leadership accountable irrespective of whether they issued the order.

VICE CHAIRMAN SHEA: Well, the system is at fault then.

MR. KAMPHAUSEN: That's essentially the point I would make. And the details of the event matter, but in the end the system has to take accountability for what has taken place.

VICE CHAIRMAN SHEA: Thank you very much.

Commissioner Fiedler.

COMMISSIONER FIEDLER: I have some smaller questions, but

I actually want to get into a larger question of decision-making coordination. James, you sort of lost me, or you dropped it at one point. Let's just take a step back. The CMC is supposed to be the ultimate military body, right?

DR. MULVENON: Uh-huh.

COMMISSIONER FIEDLER: They're supposed to be the ultimate coordinating body within the military?

DR. MULVENON: Within the military.

COMMISSIONER FIEDLER: Within the military.

DR. MULVENON: Right. The problems we're discussing, though, have a lot to do with the lack of coordination with the Ministry of Foreign Affairs.

COMMISSIONER FIEDLER: No, I--well, I've always viewed, I mean that's a similar problem here.

DR. MULVENON: Right.

COMMISSIONER FIEDLER: I mean we may have a National Security Council, but that functions differently in every administration.

DR. MULVENON: Right.

COMMISSIONER FIEDLER: It gets structured internally. I have a very rudimentary understanding of their decision-making process and coordination. I don't know if we have any more sense than I do how much time Xi Jinping spends in a day dealing with national security issues? I have no sense of, in his position as head of the CMC, whether he has large staff, small staff, he beefed it up, he toned it down, who's on it. This begs the question, I mean, in time, this becomes a more dangerous situation for us if we cannot make these decisions knowledgeably.

And I don't want to get into mil-mil transparency whining, but we don't really understand the decision-making process; is that fair?

DR. MULVENON: Well, that's definitely true. I mean it's less of a black box than it used to be, but it's still far too dark for my taste. I will say that the conventional wisdom, which I largely ascribe to, is that Xi Jinping by virtue of his stronger relationship with the Chinese military will be better positioned to be able to actually manage and government and the PLA as Chairman of the CMC than some of his predecessors had who had very little personal knowledge coming in, and therefore could be frankly--

COMMISSIONER FIEDLER: Easily conned.

DR. MULVENON: --ruled a little bit by the military. Now, the problem is, and you diminish the National Security Council issue. Most people who look at this think that that's actually a critical problem, that they--

COMMISSIONER FIEDLER: Oh, no. I'm not diminishing the problem; I'm actually saying they don't have a National Security Council.

DR. MULVENON: Yeah.

COMMISSIONER FIEDLER: Maybe, I'm not saying they should have one like ours.

DR. MULVENON: Right.

COMMISSIONER FIEDLER: Okay? But they don't have

anything even closely resembling a coordinating structure outside of some black box in the CMC.

DR. MULVENON: Well, no, they recognize they have a coordinating problem. They've been working for ten years through various crisis management studies and things to try to figure out where to put a box in the org chart that wouldn't gore somebody's ox about this kind of coordination, and we have been hearing that they have set up ad hoc bodies in the last couple of years to help them with this coordination, and we haven't really seen the same kind of uncoordinated behavior that we saw, for instance, with the 2007 ASAT test or with EP-3--

COMMISSIONER FIEDLER: Right.

DR. MULVENON: --as a recognition, I think, of the fact that they have this problem.

COMMISSIONER FIEDLER: But, Roy, you were discussing the sort of leading small groups. Leading small groups traditionally within the Party are all issue oriented. Well, unless you can anticipate the issue, you then, you're creating the structure to deal with the issue after it's blown up in your face.

So what is our recognition in the government about this as a problem in knowing who to deal with and when?

MR. KAMPHAUSEN: In the U.S. government?

COMMISSIONER FIEDLER: Yeah. I mean, look, we sat here and listened to all kinds of testimony during the ASAT test. The White House said that it was rogue. The Pentagon said, no, it wasn't rogue. And so what are we to think? How is our government supposed to know who to deal with really on these issues beyond Xi Jinping?

MR. KAMPHAUSEN: Well, the opacity of their system is not our disadvantage in the sense that we have counterparts at the top leadership level who, as I said earlier, are accountable for the actions that take place of their subordinates.

If you recall at the time--I'm a big fan of his--but our National Security Advisor said after the anti-satellite launch, he said it's not clear to me that Hu Jintao knew.

COMMISSIONER FIEDLER: Yeah, I know.

MR. KAMPHAUSEN: I think that's a very unhelpful thing for an American leader to say. Whether he did or he didn't, it's not our problem. He is accountable for what took place, and we need to, I think, address it at that level.

COMMISSIONER FIEDLER: In other words, you just hold them accountable whether he knew or he didn't? I agree with that.

MR. KAMPHAUSEN: Oh, I mean--

COMMISSIONER FIEDLER: I agree with that. No, no, no.

MR. KAMPHAUSEN: I don't think it's up to us to figure out the belly button in the system that we have to talk to in order to get the right answer.

COMMISSIONER FIEDLER: No, but whether or not we're

nervous is whether we understand that they have a predictable, dependable decision-making system.

DR. MULVENON: Right. But if we hold them accountable for something very significant that happens that they weren't actually coordinating or monitoring well, it encourages them the next time--

COMMISSIONER FIEDLER: To have a better system.

DR. MULVENON: Yeah.

COMMISSIONER FIEDLER: I agree with that.

MR. KAMPHAUSEN: You know one of the things I learned from Larry in my days when I worked for him was--a museum--

COMMISSIONER FIEDLER: You just blew all the credibility--

[Laughter.]

MR. KAMPHAUSEN: Did I have any to start with? I mean--

[Laughter.]

MR. KAMPHAUSEN: There's a museum we went to in Tianjin that talks about the operations of the PLA during the Beijing Tianjin campaign, which was one of the three big campaigns at the end of the Revolution. And one of the things that Larry remarked to me at the time, and I've remembered it ever since, is that the Party and the military structure were writing doctrine in the midst of one of the three greatest campaigns that the PLA ever conducted.

His point was let's not underestimate the durability and flexibility of that system to produce in a crisis. And so your point touches on that. Your question touches on that. To the degree that we worry that our inability to understand their system means they're not going to be able to reach good outcomes that we can live with, I think that's a fair concern, but let's not worry more about their system than they worry about it.

COMMISSIONER FIEDLER: I got the point.

VICE CHAIRMAN SHEA: Okay. Commissioner Wessel.

COMMISSIONER WESSEL: Thank you, gentlemen, and we all learn from Larry everyday.

[Laughter.]

COMMISSIONER WESSEL: Question as to what does all this mean, you know, the question of the decision-making structure, et cetera? Looking at the recent changes in leadership and what preceded that in terms of fairly dramatic platform development in terms of naval, air and other capabilities, the rise in cyberwarfare activities or electronic recon, whatever you want to call it, what expectations, if any, do you have of a change?

As we look at China, even though we've talked a bit about the decision-making structure, should we expect any changes? Are the risks diminished, increased? How do you view it going forward over the next several years?

Both, please.

MR. KAMPHAUSEN: Couple thoughts to start. People matter, but I think it's a particularly Western orientation to place more emphasis on the individuals than maybe is warranted.

If Xu Qiliang is the first Air Force Vice Chair of the CMC, he cares about the PLA Air Force getting a piece of the space mission. He's going to weigh in on that, to be sure. He has already prior to becoming Vice Chair.

But his personal influence is perhaps less relevant than the broader interaction of the collective leadership structure. Similarly, Fan Changlong, as James said, is notable for the degree to which he gets things done in an operational setting. He's highly regarded as a military leader, as a commander, as someone who gets things done.

And so he will certainly put his personal imprimatur on things, but the degree to which the fundamental direction of the Chinese modernization, military modernization reform might change with all these new leaders, I don't think we can see for a period of time, and I'm doubtful that much will take place.

DR. MULVENON: I'm struck at the next level up by the significant amount of criticism that we're finding among Chinese commentators and other people about Hu Jintao's weaknesses, about how he was largely a lowest common denominator leader, who hid behind the collective leadership, didn't assert his own leadership, didn't put his own stamp on it, and allowed China to drift for ten years, and that Xi Jinping, by contrast, and you have to, you have to obviously correct for the fact that you know some sources are pro Xi, and some are not, that he's much more comfortable in the position.

He's much more comfortable being "primus inter pares," first among equals, and he believes that he and his princeling cohort have a right to rule, and that he is going to be a more assertive leader, and that the Chinese military and the progress they've made over the last 15 years, the revolutionary progress they've made over the last 15 years, gives him a set of tools with which he can, in fact, be a more dynamic, assertive leader where we can actually associate individual policies with him.

And if you map that onto the behavior that we've seen in the maritime disputes, I do think that that is a recipe for a much more--what's a good Washington word--"challenging" environment for us to be dealing with, one in which the Chinese are more assertive, are more risk acceptant rather than risk averse, particularly when it comes to challenging claimants to various territories and things below the level--I mean frankly the aggressiveness they've shown towards the Japanese given the clarity with which we have articulated the terms of the mutual defense treaty have been striking to me.

It bespeaks a level of willingness to take on risk, even if it involves the United States, that I think is relatively unprecedented.

COMMISSIONER WESSEL: Thank you.

In one of the earlier panels, we heard about stability and nationalism having--the interaction of those two issues. To what extent do you think the new leadership as it looks at some of the economic challenges, threats, whatever word you want to use, is going to rely more on the import

of the military/the strength of the military to impart nationalism and therefore enhance stability?

DR. MULVENON: Well, I mean to the earlier question, I think Xi Jinping actually spends very few hours in his day working on military affairs and largely leaves that to the staffs because Xi Jinping and the civilian leadership face a dozen structural challenges in China, the size of which any one of which would bring a well-functioning Western democracy to its knees, and they've got a dozen of them, and so I do think they spend the vast majority of their time focused inwardly on stability issues.

And the military are clearly--still, despite the flood fighting and the 2008 earthquake and all of the heroic things that they did, they still do not want to be involved in these kinds of domestic affairs, and even though under the new historic missions, one of those is humanitarian disaster relief, that most of the new historic missions for the PLA are much more externally focused, and so they continue to talk about the failures of the government to build a force, whether it's the People's Armed Police or other forces, that can take care of these domestic issues and let them focus on what they're supposed to be focused on.

COMMISSIONER WESSEL: Thank you.

VICE CHAIRMAN SHEA: Okay. Now, I'm going to see how smart he is. Commissioner Wortzel.

[Laughter.]

DR. MULVENON: Roy and I have too many stories about him. He's not going to pull--

COMMISSIONER WORTZEL: I'm not going to do anything bad with these guys. They know everything.

The conventional wisdom is that Xi Jinping is very close to Liu Shaoqi's son, Liu Yuan, and to Zhang Zhen's son, Zhang Haiyang. Both of them have a long publication record or speaking record of being pretty strident against the United States, and of course both were sidelined and didn't get what we thought they would get on the Central Military Commission.

But Liu Yuan is increasing the most senior and major spokesman taking a strident anti-American and anti-Japanese position on the East China Sea and the Senkakus. And he still is arguably pretty close to Xi Jinping, and Xi Jinping is running the leading group to deal with the Senkakus and the East China Sea.

So I'd like to get your views on the extent to which these personal articulations of strong positions from a very high-ranking officer of the PLA may actually reflect the position of Xi Jinping and the leading group in the CMC.

DR. MULVENON: Right. Well, Larry, you know that one of the real challenges of being a China watcher is that there are a lot of loud voices of people wearing uniforms in China. Most of them are what we call "barbarian handlers," people like Luo Yuan, Zhang Zhaozhong, you know, Yang Yi, these guys, people are politically vetted, sent to conferences to

hang out with people like Roy and me, give us the message. They're trusted, but they don't really in many cases have the operational experience or the real military background that gives us the confidence that they're anything other than articulate spokesmen of a certain line.

But Liu Yuan and Zhang Haiyang and those guys who don't come to foreign conferences and chat with us, but instead were very public articulators of this idea of a stronger China, of an anti-American bent, almost a neo-Maoist ideological agenda, I take those much more seriously. I know that I'm not reading something that I'm supposed to be reading because it's published in English on the PLA Web site, and given their political credentials, they're also--and their princeling backgrounds--they're also fairly immune from significant consequences for their behavior.

So when Liu Yuan came out a year or two ago and very stridently called for anti-corruption measures within the Chinese military, and then immediately took down a Deputy Director of the General Logistics Department, Gu Junshan, people were afraid because they thought he had the mode to actually make things happen, and his political fall from grace means that he won't have more of a military career, but I think he would be a very significant advisor and voice internally that is very significant for us to watch.

MR. KAMPHAUSEN: If I could add to that, they are two sides of the same coin, I think, that James has alluded to. He's exactly right we need to pay attention and understand the message that we are to receive from those very strident voices.

But the other part of it is the degree to which he has that external message so that he can carry out some of this internal work. That there's a domestic piece to it. And at least in Liu Yuan's case, the anti-corruption efforts are really striking close to home for many top leaders of the PLA. And so the degree to which he can have an externally-oriented message that has a very strident message for the United States and Japan to some degree provides some cover for some of the things he needs to do domestically, specifically to the PLA itself. And so I think they're in some respects related to each other.

COMMISSIONER WORTZEL: You're not helping me here. My implication is I infer from that that Xi Jinping and the leading group are very happy with the message he's delivering.

DR. MULVENON: Well, I mean he could be a useful idiot for them. You know, he could be someone that is saying things that allow him then to tack to the moderate middle and go, well, I'm not that, I'm not crazy like that guy, you know.

But I do think--and I do think that we find that Xi Jinping, for instance, we have him on record in Mexico as saying some very strident things about the United States to an audience that he didn't think was going to get publicized on the outside in Chinese. So it's not unknown even here in Washington for leaders to have different messages for different audiences.

But I think that Liu Yuan has a lot more credibility with that

message than some of the TV commentators that unfortunately get a lot of play into our system.

MR. KAMPHAUSEN: As Admiral Dennis Blair said once in response to an outburst from Zhu Chenghu, sometimes it's useful for your adversary to know or think you have a wild dog in the house, and I think there is some merit to that. I don't think we're going to say that he's speaking for Xi Jinping, but his message hasn't been squelched at least, and we should draw some conclusions from that.

VICE CHAIRMAN SHEA: Commissioner Slane.

COMMISSIONER SLANE: Thank you all for both coming today. It's been very, very helpful. I have been reading a lot of or some alarmist articles about the Senkakus situation, and later on this year, we're going to Tokyo, and we're meeting with Japanese government officials.

I'm interested in your views on where you think this is going to go, the impact that the PLA may have on the problem, and what we should be focused on?

MR. KAMPHAUSEN: Well, I guess a couple of points. First, the story starts in the Philippines and a new model of an opportunistic kind of behavior that changes the status quo on terms that are more to the liking of Beijing was tested there, and so we are seeing, I think, evidence that that model is, there's effort being made to apply it in the Senkakus, even though some of the basic dynamics are different. Certainly, Chinese calculations have been complicated by American assertions of the degree to which our treaty with the Japanese applies.

But we're seeing enormous pressure to change the status quo, and, in fact, the status quo has changed. We're not going to go back to the status quo ante in any meaningful way.

The challenge for the Japanese is to not give the impression that they have lost administrative control. At that point--and Chinese pressure, I think, is intended to convey that meaning both to Japan and to the international community. The point at which that line is crossed, then we see both the introduction of the ability on the Chinese part to escalate militarily at that point, and we see international legal remedies that China could potentially pursue because, if Japan doesn't have control, then who does, and then we need to see an effort to actually have it declared as a Chinese controlled territory. So I think those are some of the important dimensions for us to think about.

DR. MULVENON: I agree with Roy. Scarborough Shoal is an exemplar for this, you know, really this new Chinese strategy of not invading a possession but basically changing the administrative sort of aspects of it. So, you know, from this point forward, there will be a Chinese presence around Scarborough Shoal. They've roped off the entrance to it. For all intents and purposes, the Filipinos have lost control of that possession, and the status quo of it has changed.

I think that the interesting wrinkle on the Japanese case is that the Chinese, first and foremost, want the Japanese to simply acknowledge

that there is a dispute at all. And there is a great debate amongst ourselves as to whether now it's too late for the Japanese to actually play that card and say, okay, we can tone this down if we simply admit that there is a dispute because maybe too much has happened already.

There was an opportunity to do that a month ago that they didn't take. But the difference here is that the Japanese, for them to continue to assert their administrative control, given the overflights of the Y-8, given the other issues that they're having, I think the potential here for even an inadvertent escalation is very high, and there are no good mechanisms bilaterally or trilaterally to step this down.

And this is why people are engaged in all kinds of discussions right now about communications to the Japanese and what are the modalities under which they would respond and how would we separate the combatants, and what's the role of PACOM, and there's just a tremendous amount of ambiguity and uncertainty about this that is considered by most people to be very dangerous.

VICE CHAIRMAN SHEA: Commissioner Cleveland.

COMMISSIONER CLEVELAND: You feel less alarmed or more alarmed?

COMMISSIONER SLANE: No, I don't feel that. I feel more alarmed.

DR. MULVENON: Yeah.

COMMISSIONER SLANE: Is that a fair statement?

DR. MULVENON: I'm very concerned about it. I watch that situation pretty closely.

MR. KAMPHAUSEN: I guess my concern in this case is that there are, it's not inevitable that it will result in conflict.

DR. MULVENON: Right.

MR. KAMPHAUSEN: In fact, there have been some de-escalatory steps that both sides have taken, perhaps beginning with Yamaguchi's visit to Beijing a few weeks ago.

That said, the structural change that occurred is that the Chinese believe there's a model now for asserting control over a territory that they previously didn't control. That, in my mind, is the more alarming development, and I personally don't think we'll see shots fired in the Senkakus. I think we will see a de-escalation.

It will be enormously challenging for the Japanese to maintain their presence there. It will be increasingly costly. The Chinese will keep the pressure on. I doubt that will lead to conflict. I think the bigger issue is this new model that has emerged that we'll see tested potentially in other areas.

COMMISSIONER CLEVELAND: Thank you.

I'm struggling with how to pose this question. So bear with me. In your written testimony, Mr. Kamphausen, you talk about the shift in the understanding of the regional military structures, and you say that there is no military threat on the border, the strategic challenge is abated, and borders

are clearly demarcated.

Therefore, the national defense rationale for the current military regional structure has largely gone away.

And I'm wondering, if it has gone away in a security sense, but in an economic sense, it's begun to change? When you talk later about struggle for resources, anti-corruption efforts striking close to home in the PLA, I'm thinking particularly of Burma and the encroachment into northern Burma by military corporations, for lack of a better word, and I'm wondering if we view this regional structure strictly through the military prism, indeed, there's no need for any kind of change, but I really wonder about military expansion in a very different sense, through that economic prism.

Is that clear? I'm interested--

MR. KAMPHAUSEN: I think so. The point I'm trying to make with the current structure is that it has outlived its usefulness, and a new structure will afford the flexibility to deal with emerging issues in far more robust ways, that you don't need fixed stationary forces to defend your borders with Russia or Central Asia the way you did 20 years ago. And if you restructure--this is the military imperative to it--if you restructure, you cut costs, reduce structures, introduce more flexibility; you're actually better prepared to respond to some of these crises.

The point I was also trying to make is that brings with it civil-military baggage, that these structures themselves are entrenched bureaucracies, that they're the ways in which the PLA gets troops into the PLA, it responds to civil disaster, civil defense, it responds to disasters, it demobilizes, and you take that structure away, there will be fundamental changes that occur in the dynamic of civil-military relations, but you are better able to respond to some of the crises that emerge.

COMMISSIONER CLEVELAND: And setting aside the military purposes for the structure, how do you see the military maneuvering on its borders, and I don't mean in a military sense, but operating on its borders to support their economic interests individually or as groups?

MR. KAMPHAUSEN: I guess there are a couple of areas in which PLA activity is supporting economic activity, and perhaps the principal one is in Tibet where PLA contributions to infrastructure development are, on the one hand, enhancing the local economic environment in ways that are leading to economic development, but on the other hand, enabling the potential future movement of forces to the border regions, especially with India.

Now, that's a contribution that the PLA has made. The PLA has always been involved and continues to be involved in national development. They have a role in laying fiber-optic lines and developing and building roads and that sort of thing, and that role continues, particularly in the difficult, hard-to-reach areas on China's periphery.

And so it's not necessarily new, but perhaps the areas where it's taking place are different than ever before. What you may be asking, and if I'm wrong, then stop me, but the degree to which PLA activities are

facilitating direct economic interactions with Chinese neighboring countries?

And we don't really see that at a macro level. I'm certain it occurs at a micro level in the localities, that there are PLA units that are involved. We've all seen in years gone by PLA license or PLA military-licensed trucks carrying commercial goods. And those days have largely gone by, but I think we'd be foolish to conclude that they have ceased all together.

DR. MULVENON: Yeah. I feel like it's *deja vu* all over again for me because it was--what--18 years ago, Jeff, when you and I were doing PLA incorporated stuff, and I wrote my dissertation on the Chinese military's business empire, and they did a lot of trans-border business in there, and that largely was officially ended in 1998 when they divested from the economy, but the feeling was/is always that Chinese military businesses were divested, maybe one step removed, to the brother-in-law and the cousin and the nephew, and that was sort of the political bargain.

This recent push about PLA corruption has brought all of this back to the surface again, and you see a tremendous amount of sort of thrashing around in the water, trying to understand 12 years later who actually owns those military businesses, to what extent are they still related to units, to what extent do units still commercially benefit from those businesses, and that is a significant complicating factor for foreign relations with some of those countries, particularly in Burma and other places where you have these construction companies that not too many years ago were official military construction companies and obviously still had very close ties because with the rebels in Burma, they have to be defended.

So there's all these sort of para-military looking people defending these construction companies, and you have to ask yourself where did those guys come from, and I think that's an open question right now.

COMMISSIONER CLEVELAND: That was the question I was asking. Thanks.

VICE CHAIRMAN SHEA: Okay. Commissioner Bartholomew.

COMMISSIONER BARTHOLOMEW: Thank you very much, Mr. Chairman, and thank you to our witnesses, both for appearing today, and I was going to say, and dare I say, for your decades of contribution to the field, but Dr. Mulvenon, since you invoked 18 years ago, I don't feel quite as bad saying that. Sometimes I'm amazed at the issues and how we're still talking about some of them.

Mr. Kamphausen, could you, you said that there's no longer a structural way for the military to influence leadership deliberations; correct? Did I get that correct?

MR. KAMPHAUSEN: There are fewer structural ways.

COMMISSIONER BARTHOLOMEW: Fewer structural ways. I was just wondering how that ties into or could encourage rogue PLA activities because sometimes if you can't accomplish what you think you want to accomplish within the system, you do something outside that forces an issue. Do you see that as a dynamic we should be concerned about? Both

of you?

MR. KAMPHAUSEN: I don't particularly, but let me elaborate a bit. First, at the earlier points in time when the PLA had direct representation on the Standing Committee, they were intimately involved in a whole range of issues, including domestic policy issues.

So part of the reason they are not part of a direct representative-- have direct representatives on the Standing Committee is because the leadership wanted them out of those deliberations and sort of pushed them towards a more professional military-focused activity. So it's a consequence of a series of decisions that they are not; it's intentional on the part of the leadership.

But the second part, or your question then says, doesn't that introduce the possibility that the autonomy creates a lack of accountability, and I don't believe that's the case. I think the evidence to support it is always invoked at the time of a crisis, and those are really not times to make great judgments about the degree to which the military is autonomous or not.

I think the presence of these other structural means that still do endure and the fact that it is known and expected that the PLA will have autonomy in execution of national security plans and operations does not necessarily imply that they are out of control. The control exists at the point of approval, and then execution is decentralized. And I think we would see a reining in of the PLA if they crossed a line that they weren't supposed to.

So I'm not as concerned about the absence of role/the absence of presence in the top deliberative body somehow then leading to an out-of-sight/out-of-mind situation in which they can get away with murder. I don't think it really plays out that way.

COMMISSIONER BARTHOLOMEW: Dr. Mulvenon.

DR. MULVENON: I spent too much time reading Chinese military writings about command and control, and one of the interesting things is that one of the dilemmas and one of the things that they struggle with the most is what they refer to as "the edge." In other words, the units operating on the edge and whether or not they are completely under control because those are the ones that are bumping up against the Japanese Maritime Self-Defense Force and things like that.

You know, Beijing, as a rule, is among one of the world's greatest control freaks when it comes to this sort of thing. But it's interesting the role that technology has played in ameliorating this problem. The Chinese over the last 15 years have implemented a very sophisticated command and control infrastructure, and an intelligence and surveillance and reconnaissance infrastructure. It has led to the same kind of perversions we have in our system where instead of pushing jointness and flexibility and initiative to lower levels, it just gives higher echelon the temptation to have tactical control of the battlefield.

And the Chinese complain about the fact that they have that problem. Its senior leaders in Beijing now have the ability to see at a tactical level what's going on and have a common operational picture of

what's going on in these exchanges at the lower level, and therefore they're intruding into it. So I think the Chinese military's complaint is that the center is getting too involved in their business, not that they're not getting involved enough.

And they're still trying to work out that dynamic. I think that the civilian leadership, particularly in the wake of the EP-3 crisis and other things, also made it priority that they themselves had access to that information, to know what was going on at the local level because they didn't want to be surprised again about a chain of events that led to an escalatory spiral with the United States or with Japan that they weren't prepared for, and so in a sense, they have been trying to use technology in a variety of ad hoc leadership groups in order to deal with that very situation you're describing. But they themselves recognize it as a problem, and they struggle with it.

COMMISSIONER BARTHOLOMEW: Okay. Mr. Chairman, if there's a second round, I might have another question.

VICE CHAIRMAN SHEA: Sure. Thank you.
Commissioner Tobin.

COMMISSIONER TOBIN: I want to thank both of you for the information you've brought forward today, and I don't have a question as of this day, but later this spring, Commissioner Brookes and I will be leading an in-depth review, and we'll probably be tapping you, talking with you about the China Seas issue. So please watch it closely so we can hear a few months from now further.

Thank you.

VICE CHAIRMAN SHEA: Great.

COMMISSIONER TALENT: Mr. Chairman.

VICE CHAIRMAN SHEA: Sure. Commissioner Talent.

COMMISSIONER TALENT: Mr. Kamphausen, I really appreciated your discussion of the local regional structure of the military and how that bears on the issue of whether the PLA is becoming expeditionary, but I want to make sure I did understand your ultimate conclusion to be that they can and probably will move in a more expeditionary direction even if they are not able to reform that structure? So I want to make sure I understand your opinion properly. You're not saying that unless we see that structure, organizational structure reforming, they're not going to move in an expeditionary direction? You're saying they can, but it will be more difficult, or am I incorrect about how I read--

MR. KAMPHAUSEN: No, Commissioner, you heard me correctly. The degree to which the military region structure reforms directly affects the degree to which the ground forces become more expeditionary.

The Chinese ground force exercise activity of the last several years has demonstrated they're increasingly comfortable operating across military region borders, having forces from one military region exercise in the one adjacent or even two away, and this suggests that even within their own planning, the military region structure is not meaningful as they think

about how they deploy forces within China.

But it does inhibit their ability to think about how they deploy those ground forces up to and perhaps even over their borders, and a new structure creates more flexibility that makes that process an easier one, especially for the ground forces.

Now, that's not the only answer. They've got real challenges in mobility that they have to address as well in terms of air transports and helicopters, in particular. It's not the great answer to the problem or the only answer, but it certainly has bearing on it.

COMMISSIONER TALENT: And one more. Have they undertaken a more or less formal series of protocols or reforms to try and encourage jointness? I know they talk a lot about jointness, but are they doing the kind of things that we began doing, you know--what--I guess 30 years ago moving officers through different kind of joint assignments throughout their career or making abilities in jointness sort of a determinant of promotion? Have you seen any of that, or are they still at sort of the discussion levels of all that?

MR. KAMPHAUSEN: James, I hope, comments as well. My sense is it's still very early in that process. It's been excruciatingly slow, and it suggests that they have a different idea about jointness than we do, that perhaps the most they are aspiring to is either sequential or coincidental operations by different services at the same time, same place, but perhaps not as part of a joint command structure.

The ground forces, you know, 60 or the top 70 ranked officers in the PLA are ground forces.

COMMISSIONER TALENT: Right.

MR. KAMPHAUSEN: I mean we went from two to three members of the CMC who are non-ground force officers. It's still a ground force dominated entity, and the movement towards something that looks more joint has been excruciatingly slow.

Now, reform of the military region structure provides a hint about a degree of seriousness. Right. If they undertake that, it opens up opportunities for the creation of, if not a joint structure, perhaps one-off joint task forces to respond to particular challenges. But that's for them to figure out. There are some steps they have to take before that, and it just has been a very, very slow process.

COMMISSIONER TALENT: Yeah, I raise the point, and then I'll yield back, Mr. Chairman, because I think that's a major--they're obviously trying to grow their capabilities. You all discuss that. I just wonder how big an obstacle that's going to be to them really being able to use these capabilities on the periphery or under these circumstances, and whether they realize how big an obstacle that's going to be? Because it sounds to me like they're very embryonic in terms of that kind of development, and the nature of these modern, modern warfare confrontations makes a significant degree of jointness, which is not easy to develop, just necessary.

DR. MULVENON: I mean the Chinese military joke about

jointness was different services were going to come to the same place and then exercise separately.

[Laughter.]

DR. MULVENON: So they are at a very early stage. Now, we, you know, small signs. We see Air Force and Navy officers wearing their own service uniforms at the National Defense University, whereas in the past, they would all wear Army green. The Deputy Chiefs of the General Staff are showing up representing different services, and then a number of years ago, each of the service branch commanders was elevated to a Central Military Commission member slot.

Those are all very slow, small, positive signs, but they have a long way to go, and I agree that it actually acts as an impediment. It suboptimizes the advanced military equipment that they've acquired.

VICE CHAIRMAN SHEA: I have a second round question. I'm going to go off the schedule here a little bit and talk--because we have Dr. Mulvenon here who is an expert on cyber, and I thought I would take an opportunity to ask a question on that if that's okay.

About a year ago, three distinguished Americans, Michael McConnell, Michael Chertoff, and Bill Lynn, Democrat, Republicans, signed an op-ed called "China's Cyber Thievery is National Policy and Must be Challenged." They say that China has a state strategy to advance its economy technologically through intellectual property theft and cyber theft.

It says it's costing the United States millions of jobs and billions of dollars, and then they say the United States needs to respond with all the diplomatic, trade, economic and technological tools at our disposal.

My question to you is, is the United States responding to this threat, which I assume you share? You agree?

DR. MULVENON: Yeah.

VICE CHAIRMAN SHEA: Are we responding with all the diplomatic, trade, economic and technological tools at our disposal, and if not, what more should we be doing?

CHAIRMAN REINSCH: And what are the tools?

DR. MULVENON: Right. Well, I will say that I've participated in nearly every round of the Track 1.5 dialogue we have with the Chinese on cyber issues, and at the last round here in Washington, I addressed the Chinese side, and I said, I said as a political scientist, I said I want to say that China has achieved something quite remarkable, and, of course, the Chinese all sat up in their seats and said, you know, is it our manned space program, you know, is it the Olympics? You know, what was it? I said, no, I said the scope and scale of your intrusion set has been so brazen in its scale and scope, that you've done something that most political scientists thought was impossible: you've actually motivated a whole of government response from the U.S. government.

Entire departments of the U.S. government who just had their head in the sand on the issue are now mobilized on the issue, particularly on the economic and trade side, and the reason is, is because until about 2006,

the intrusion set was largely focused on dot-gov and dot-mil and classified defense contractors like me, and to be honest, to a certain extent, all is fair in love and war. But in '06, when they started going after the heart of the American innovation economy and started exfiltrating out irreplaceable intellectual property from some of our most advanced companies, it was only then that I saw the movement within the U.S. government to say this is something we have to do something about.

For a long time, we had an attribution problem. We don't have an attribution problem anymore, and over the last two years, most of the focus has been now that we don't have an attribution problem, what do we do about it? And a lot of looking at what works and what doesn't. Clearly, our demarching of the Chinese didn't have the desultory effect that we desired.

But you may have seen a variety of things across those tools, to Commissioner Reinsch's point. DOJ is going to begin indicting individuals and companies in China as part of this commercial confederated cyber espionage empire that they're running. Universities that are involved in this activity are going to be put on entities lists, and as such they can't get visas; they can't come here for academic exchanges.

On the State Department side, a lot of what we're doing on the global Internet governance agenda is very much focused on setting in place a norms regime that governs this kind of behavior, and then there's a lot of, you know, potential other tools that we have, which would be sub rosa.

VICE CHAIRMAN SHEA: How about economic tools?

DR. MULVENON: Economic tools is more difficult although I would say that I was very struck two years ago, two years ago December, when 30 different European and American trade associations came out complaining about the indigenous innovation policies, the mid-to-long-range S&T plan, and basically saying after 30 years, it's now increasingly difficult for us to make money in China, and it's increasingly obvious to us that you have a national strategy to compel technology transfer from our companies to national champions that you've designated, who have unfair advantages, who have WTO violation advantages, and then you're going to push multinationals out of the China market, and then you're going to compete with them globally, and cyber espionage has been a core element of facilitating that indigenous innovation strategy.

And the only analytic dilemma we have is there's still not a clear enough set of examples of companies where the source code was exfiltrated, given to a Chinese national champion, which then reverse engineered it and marketed it and demonstrable loss of U.S. market share. That's really all that remains to be proven is that that is, in fact, happening.

VICE CHAIRMAN SHEA: Okay. Sure.

CHAIRMAN REINSCH: There is one case of that that was litigated, and they settled. You don't happen to know the details of the settlement; do you?

DR. MULVENON: I wish. But I would define it more broadly. I'd put Nortel in that category. There's a lot of companies that I think are

going out of business for reasons that have a lot to do with the combination of the Chinese structural environment in which they were forced to operate combined with intellectual property theft.

CHAIRMAN REINSCH: In the example you cited, it's a good example, and we have some powerful tools here through the use of the U.S. judicial system, and even if you don't win a judgment, even if you don't ever collect a dime, you can cause a world of pain to the other party.

It's been little used, and as I said, in the one case I'm aware of, which is a big one, billions of dollars in damages alleged, it was settled very quietly without any fanfare, and I'm trying to figure out what that means. Maybe we can confer afterwards.

VICE CHAIRMAN SHEA: Well, just listening to the tools, they don't seem--I mean indicting a few people, denying some visas doesn't seem very strong to me. That's my personal view.

Jeff. Commissioner Fiedler.

COMMISSIONER FIEDLER: At the risk of interrupting that fascinating conversation, I want to get back to a quick factual thing on the People's Armed Police. Who is controlling the People's Armed Police today?

DR. MULVENON: Day-to-day control of the People's Armed Police falls under the Ministry of Public Security, and in crisis, it falls to the General Staff Department of the PLA.

COMMISSIONER FIEDLER: And in terms of rough numbers, in the last five years, what was the increase in the manpower in the PAP?

DR. MULVENON: I don't have that at my fingertips. All I would say is there continues to be a lament that despite whatever manpower levels they have, their training is insufficient to deal with the internal crises they have.

COMMISSIONER FIEDLER: They used to be the dumping ground--a better way to say that is the demobilization trough for the PLA. Is that still true?

DR. MULVENON: Yeah, it is, and as you know, during divestiture in '98, the most corrupt elements of the Chinese military economy were, in fact, passed to the People's Armed Police.

COMMISSIONER FIEDLER: We have had testimony at various times that the state security budget, public security budget, and presumably combined with the PAP budget, exceeds that of the military. Do we know sort of roughly how that's divided? I mean at least what the PAP is getting? That would give us a sense of the number.

DR. MULVENON: The PAP budget is broken out in the state statistics. I don't have it at my fingertips, but you're right. The Chinese themselves are the ones who said that the internal security budget now exceeds the announced military defense--

COMMISSIONER FIEDLER: Yeah, I don't think it does, in fact, but I mean--

DR. MULVENON: But to me, it's remarkable that they would say such a thing out loud.

COMMISSIONER FIEDLER: That's right.

DR. MULVENON: Because it really is the manifestation of their greatest fears about internal stability.

COMMISSIONER FIEDLER: So in terms of national crisis, national domestic crisis, the General Staff takes over the PAP?

DR. MULVENON: Yeah, that's--yeah.

COMMISSIONER FIEDLER: So they're just using different shooters than before?

DR. MULVENON: Right.

COMMISSIONER FIEDLER: Yeah.

DR. MULVENON: The Chinese military still wants desperately to avoid another Tiananmen-like situation in which front-line troops have to engage in controlling civil unrest.

COMMISSIONER FIEDLER: But they're still controlling the disposition of those troops.

VICE CHAIRMAN SHEA: Commissioner Wortzel has a comment on this subject and then Commissioner Wessel.

COMMISSIONER WORTZEL: I just sort of did some research on these numbers, and if you believe the Defense White Paper published in 2011 in the International Institute of Strategic Studies, the People's Armed Police dropped from about 1.2 million after Tiananmen, and is now down to a 660,000. I don't know where the other people went.

VICE CHAIRMAN SHEA: Commissioner Wessel.

COMMISSIONER WESSEL: I left one of the earlier discussions a little confused so I'm hoping you can help me. The discussion about the Philippines and the fact that with the rope, et cetera, at the end, that the Chinese were viewed as having won that episode, shall we say.

And then I thought I heard you say that Japan, in part to reduce the scope of the tension, should similarly accept the status, question the status and agree to that. Please, go ahead.

MR. KAMPHAUSEN: I didn't mean to infer that. I think what James said was that one of the ingredients of the crisis is the Japanese position that administrative control is not in dispute.

COMMISSIONER WESSEL: Right.

MR. KAMPHAUSEN: And that at an earlier point, there was a sense that a willingness on the part of the Japanese to acknowledge that a dispute occurs might have de-escalated tensions, but that we are now past that point.

COMMISSIONER WESSEL: Okay.

MR. KAMPHAUSEN: And even if they were to do that, it would have perhaps much more limited effect, and I don't think either of us is--I won't speak for James, but I know him pretty well--I don't think either of us is arguing that the Japanese need to take the steps to unilaterally to de-escalate the tension.

And so if--

COMMISSIONER WESSEL: Okay. You've cleared that up.

Okay.

DR. MULVENON: Yeah, I mean a core structural difference-- I'm not an international lawyer, but the core structural difference is that our treaty with the Filipinos did not require, did not cover territories, the maritime territories that were disputed outside of the Philippines themselves. The Mutual Defense Treaty covers areas under Japanese administrative control, and the Senkakus are under administrative control and therefore fall under the treaty. So that is a fundamental difference between the two situations as to how the U.S. reacts and the sort of automaticity of our response related to that.

So that's why there wasn't pressure to automatically respond to Scarborough Shoal. We've been much clearer about the automaticity of our response to an issue involving administrative control of Senkakus.

COMMISSIONER WESSEL: So is the de-escalation, though, going to be viewed by the Chinese as a win and transfer escalatory--the challenge, as you noted earlier, a threat to being born more by the U.S.?

DR. MULVENON: I think at this point if the Japanese did come out as a de-escalatory measure and somehow diluted their standing on administrative control, then the Chinese would interpret that as a successful execution of this new strategy; and that's precisely why Abe is not considering doing that.

COMMISSIONER WESSEL: Okay. Thank you.

VICE CHAIRMAN SHEA: Well, that concludes our panel. I want to thank both of our witnesses for their very interesting and helpful testimony and appreciate your participation today.

We will recess until 2:15pm so that's ten minutes from now.

PANEL IV INTRODUCTION BY VICE CHAIRMAN SHEA

VICE CHAIRMAN SHEA: Good afternoon. Our final panel of the day will discuss policy implications for the United States.

We're honored to have Lieutenant General Gregson provide testimony on the subject. General Gregson is currently Senior Director of the China Program at the Center for the National Interest. He previously served as Assistant Secretary of Defense for Asian and Pacific Security Affairs, following a long and distinguished career in the U.S. Marine Corps. And I want to thank you, General Gregson, not only for being here but for your service to our country.

We also have Dr. David "Mike" Lampton, who is a Professor at Johns Hopkins SAIS and serves as the Director of China Studies there, and he's also a military veteran, as I understand. So thank you as well.

Dr. Michael Auslin is a Resident Scholar in Asian Studies and the Director of Japan Studies at AEI. And we won't hold this against him. Previously, he was an Associate Professor of History at Yale.

We'll begin with General Gregson.

**OPENING STATEMENT OF
LTGEN WALLACE ‘CHIP’ GREGSON, JR. (USMC, RET.)
SENIOR DIRECTOR, CHINA AND THE PACIFIC
CENTER FOR THE NATIONAL INTEREST**

LtGEN GREGSON: Mr. Chairman, Vice Chairman, thank you very much, and thanks for the opportunity to speak before the Commission. I supplied written remarks. I assume they'll be entered for the record.

VICE CHAIRMAN SHEA: Yes, they will, sir.

LtGEN GREGSON: I'll be very brief in my introductory remarks. In the last few decades, hundreds of millions of people in Asia rose from poverty to higher standards of living, largely, but not solely, due to the growth of the Chinese economy.

The liberal economic order largely underwritten by the United States enabled that growth. The United States, all of our friends and allies in Asia, and our other friends around the world also had strong and important economic relationships with China.

China's economy, well-connected around the world, is vital to the global system. At the same time, China is rapidly increasing the size of their military forces and making rapid advances in military capabilities. China has resolved nearly all of the issues on their 14 land borders, yet many unresolved issues remain, particularly seaward.

Conflict with China would create catastrophic consequences. Likewise, U.S. inability to support our interests, as well as those of our allies and friends, would also be catastrophic and would threaten peace and stability. Clarity of U.S. policy and strategy is critically needed if we are to achieve that balance.

Other U.S. issues may seem more urgent, but none are more important. The security or military component is essential but not sufficient. We must lead with diplomatic, economic and trade components. Maintaining or enhancing stability in Asia promises benefits across the world. On the other hand, a rise of tensions can lead to very severe consequences.

Thank you.

**PREPARED STATEMENT OF
LTGEN WALLACE ‘CHIP’ GREGSON, JR. (USMC, RET.)
SENIOR DIRECTOR, CHINA AND THE PACIFIC
CENTER FOR THE NATIONAL INTEREST**

**Testimony before the U.S.-China Economic and Security Review
Commission 7 February 2013**

**China’s New Leadership and Implications for the United States
Panel V: The U.S. “Rebalance” to Asia**

**Wallace C. Gregson; Director, China and the Pacific, Center for the
National Interest**

Mr. Chairman, members of the Commission, thank you for the opportunity to appear before you today to discuss the U.S. “Rebalance” to Asia in the context of developments in China and implications for the United States.

Our allies and friends in Asia enthusiastically welcomed our president’s announcement that Asia will be a top priority for our security mission and presence. They welcomed our secretary of state’s “pivot” announcement calling for increased diplomatic, economic, and security investment. Well aware of the political and economic conditions in the U.S., they await implementing actions – with some worry.

Our policy announcements were the beginning of our work, not the product. Incredible opportunities – economic, trade, and otherwise – beckon across the region, but tensions, disputes, and threats increase. Prompt U.S. action is required on many challenges, but most urgently on economic matters, trade agreements, and security. All must be done in close consultation with our allies, friends, and yes, China. Our policies and strategies must be regional in orientation to fulfill the intent of the announcements. Any specific China considerations must be integrated within the broader policies and strategies.

In very broad terms, three things are needed: a strategic concept, resources, and an organization that can effectively and efficiently apply resources to implement the concept. We need a national strategic concept describing what we’re doing, how and why. It must win support in the region, and here at home. Support by the American people is essential to secure the resources needed for implementation. Any concept that cannot win the support of the electorate is destined to fail. An organizational structure with all necessary authorities must be created within the government to ensure leadership, resource stewardship, efficient implementation, and oversight.

The United States, our allies and our friends have unique and complex relationships with China. These are mixtures of cooperation, competition and conflicting interests. Asia bears many enduring, bone-deep historical grievances, territorial disputes and clashes over access to seabed

resources. Military forces, naval forces and armed law enforcement agencies of all nations operate in close proximity. U.S. strategic clarity, including a publicly discussable U.S. military strategy focused on defense of our allies provides assurance, clarifies alliance roles and missions, guides U.S. force shaping, and avoids unnecessary provocation and miscalculation.

In the past, our security policies and strategies were clearly focused, and publicly debated. The story goes that as the Soviet Union was collapsing the Chairman of the Joint Chiefs of Staff summoned his Chairman's Study Group – his personal think tank. This 4-person group consisted of three carefully-chosen colonels and a Navy captain representing each service. The Chairman had a simple question: “What do we do now that we've lost our best enemy?” The massive U.S. national security establishment that emerged to win the Cold War had accomplished its mission without another world war or nuclear conflagration. As the USSR climbed down from the ramparts, our national security structure's single organizing principle was collapsing, and with it our old models and conventions. They did not work anymore.

In many ways we are still looking for a new “best enemy” – a single organizing principle. Life was much simpler for our bureaucratic functions when we had a single, well-defined villain, right out of central casting. The villain is gone. China is most definitely not the new answer. We have a vital economic relationship with China, as do our friends and allies in Asia and as does Europe and the rest of the world. Most important, not one of our allies or friends wants us to pick a fight with China – but they do want us to maintain security and stability, and protect allied vital interests.

The U.S. needs China to be a successful contributor to the international system. That's settled policy from the time we championed their accession to the World Trade Organization in 2001. At the same time, we need to work with our allies and friends and support their interests, many well beyond those considered “traditional” security interests. We have many fundamental disagreements with China. We need to have as many positive conversations and cooperative programs with China as possible to provide a proper context for our disagreements. Every one of our allies and friends wants to have a productive relationship with China. They need the United States to play a different role than we did when the world was bi-polar, and we were the quarterback of the “Free World” team. Our challenge is developing a compelling strategy for Asia that supports our interests and those of our allies and friends without a declared enemy.

The U.S. is coming to grips with the importance, and the unique nature, of our Asian challenges. President Obama declared: “As we end today's wars, I have directed my national security team to make our presence and mission in the Asia Pacific a top priority.”¹ Secretary Clinton described our new approach as a “pivot” or “rebalancing” toward Asia. This remains the most enduring description to date of our emerging policy in Asia and the Pacific. She said we stand at a “pivot point” as we prepare to withdraw from Iraq and Afghanistan, that we have to be smart and systematic about where we invest our time and energy, and that “One of the most important tasks of American statecraft over the next decade will therefore be to lock in a substantially

¹ “Remarks by President Obama to the Australian Parliament,” Parliament House, Canberra, Australia, November 17, 2011, available at <www.whitehouse.gov/the-press-office/2011/11/17/remarks-president-obama-australian-parliament>.

increased investment -- diplomatic, economic, strategic, and otherwise -- in the Asia-Pacific region.”²

In short order, and in an atmosphere of Continuing Resolutions without actual resolution, imminent fiscal cliffs, potential national default, unknown budget allocations, and transition of key Asian policy-makers, we began discussing our future Asia and Pacific force posture. Secretary Gates introduced the concept of a “widely distributed, operationally resilient, politically sustainable” forward presence. U.S. and Japanese force realignments that began years before in the Bush administration – the 2005 Alliance Transformation and Realignment Agreement and the 2006 “Roadmap” Agreement – were quickly appropriated to symbolize our new policy and strategy.

The Services are now being asked what their contributions might be to our newly declared priority. Each service is responsible to “provide forces trained and equipped” for employment by the regional unified commanders in support of the national security interests of the United States. The development of national strategy as well as the national military strategy – critical assumptions; ends, ways and means coherence; priorities; sequencing; and theory of victory – is above the Services’ pay grade, as they say. We need a declared strategic concept for our forces that supports our Asia and the Pacific policy and national strategic concept. Then we can shape the composition, locations, and activities of the joint force.

“Asia and the Pacific,” the subject of the president’s announcement and the object of our rebalancing and realignment, stretches from the Indian sub-continent to the western shores of the Americas, north and south. It spans two oceans that are increasingly linked by shipping, energy, trade, and strategy. It includes five U.S. treaty allies. It includes sovereign U.S. territory, one island nation in Covenant with the United States that is treated like a territory, and three island nations in Compacts of Free Association with the U.S. It includes the world’s most populous country, and its future most populous country. The world’s largest and second largest Muslim populations within single national boundaries are in this region. It’s home to three maritime straits – the Malacca, the Sunda, and the Lombok – that permit the easy passage of well over 1100 fully laden supertankers per year, most passing on into the South China Sea bringing energy to China, Japan, the Republic of Korea, Taiwan, and other countries.

This body of water is bounded by China, Vietnam, the Philippines, Brunei, Malaysia, Indonesia, Taiwan, and Singapore. Many nations have competing claims to various islands and reefs in the South China Sea, and thus competing claims to fishing grounds, sea-bed resources, and exclusive economic zones. Fifty percent of the world’s seaborne commercial tonnage and 1/3 of the world’s value in trade traverses this sea. If the world has a critical commercial intersection, this is it.

Traditional international law, as favored by the United States and our allies, calls for freedom of navigation and peaceful settlement of disputes. This is being increasingly challenged by China’s claim of historical rights to the entire South and East China seas.

² “America’s Pacific Century” Foreign Policy Nov 2011, available at: http://www.foreignpolicy.com/articles/2011/10/11/americas_pacific_century

China today is pulled in two divergent directions by continental and maritime interests on a truly trans-regional scale. Fourteen land powers share terrestrial frontiers with China while six maritime countries together enclose the entire Chinese coastline. Of these twenty neighboring states, six rank among the world's top ten in population, eight rank among the top twenty-five in military forces, and four possess nuclear weapons.

China settled twelve of fourteen land border disputes. China no longer has any natural enemies on her borders, but neither does she have any natural friends. The closest "friends" might be North Korea and Pakistan. A few months ago Burma would have been included, but things have changed. It's not obvious sharing borders with North Korea and Pakistan provides any advantages. Neither does China have any natural seafaring partners among the six nations on her seaward frontier.

The East China Sea and South China Sea merit special attention. Beginning in 2009 and accelerating in 2010 and 2011, China began exerting ever more pressure on these seas as evidenced by its expanding territorial claims, the more brazen actions taken by its fishing vessels and its unilateral claims to potentially lucrative seabed drilling rights. These seas bathe the areas that are home to China's industry, economy, and wealth. The GDP per capita in the greater coastal region area is seven to ten times higher than it is inland. In no other place in the world do the critical interests of so many states overlap. China would accrue immense strategic benefits if these became the equivalent of inland seas. The offshore states would face correspondingly great disadvantages. This region must be very carefully managed to ensure continued peace and tranquility.

The Asia and Pacific region as a whole has many built-in stresses that can cause conflict. Some of the more dominant, or powerful, include demographics, energy, food and agricultural, and fresh water. All are interrelated, as numbers of people and their movement affects food security, water availability and purity, and energy production and use. These goals often conflict. For example, the use of hydropower to produce energy often reduces the availability of agricultural land and fresh water.

The world will add nearly 60 million people per year, reaching over eight billion by the 2030s. Most growth will be in developing countries. The United States, alone among developed countries, is expected to add 50 million people. Europe, Japan, Russia, and Korea will join those in absolute population decline. Welfare systems in developed countries are based on assumptions of moderate economic and population growth. Aging and declining populations will stress support systems.

China will add some 170 million, but the population will be aging, and predominantly male. India, in contrast, will add 320 million people, becoming the world's most populous nation before 2030.

Remittance flows are essential parts of the economies of many states. In 2007, the top three recipients of emigrant remittances were India, China, and Mexico. Disruption or alteration of these flows due to failing governments, war, pestilence, natural disaster or other phenomenon can generate uncontrolled population movements and damage peace and stability.

India will continue to grow, risking tension between the rich and the poor, as well as among Hindus, Muslims, and Buddhists. The Maoists in much of eastern India are India's most important security challenge, according to the Indians themselves.

Rapid development in China, India, and other countries creates a relentless drive to assure adequate and secure supplies of fuel to sustain growth, maintain satisfaction, and prevent internal strife and chaos. Multiple disputes over access to seabed resources in the South China Sea regularly fill the news. Massive additional production and refining capacity is needed to avert resource shortages as world population grows. Japan is currently coping with energy shortages caused by a complex natural disaster, illustrating the fragility of energy infrastructure. One bright spot in the otherwise troubling energy picture is the most recent International Energy Agency's annual report. It states that the world's energy map "is being redrawn by the resurgence of oil and gas production in the United States". According to this agency, the U.S. has the potential to surpass Saudi Arabia and Russia in oil production by 2020.

Every fresh water system on the east, southeast, and south Asian littoral is under heavy pressure from pollution. The search for affordable energy invites upstream countries to build hydroelectric dams on rivers coming out of their mountains. Ungoverned, this can cause devastation to downstream nations and cultures that depend on nutrients in the rivers to sustain their food security.

Ocean fish stocks are already under pressure from over-fishing and illegal fishing. Without some agreement, some code of conduct on fishing and effective enforcement means, many species, and nations, are in danger. One such dispute caused the death of a Korean Coastguardsman at the hand of a Chinese fisherman.

Nuclear issues, both weapons and power generation, are a reality in Asia. The United States, Russia, and China essentially balance and deter one another. But another relationship is that among China, India and Pakistan.

China keeps a careful eye on India's nuclear arsenal. Meanwhile, Pakistan is rapidly building its arsenal. If India decides to increase its arsenal, this would likely put pressure on China to react. If China thinks it must increase its arsenal to maintain deterrence that is likely to affect the US-China-Russia balance, with unknown results.

Weapons programs involving nuclear weapons and missiles in China and North Korea are matters of concern for our allies and friends. Many Asian voices call for independent nuclear capabilities. U.S. presence and strong involvement is essential to support our guarantees of extended deterrence and to prevent an arms race.

And then there is the threat from the global trans-national terrorist movements and associated criminal networks. Terror networks and their sponsors are already present in Asia. They gain support from financial flows, both formal and illicit. There are reports of technology cooperation in terms of weapons and material. Other countries struggle with elimination of safe-haven and transit operations supporting terror networks. We may be realigning or rebalancing our presence to favor Asia and the Pacific, but we're hardly likely to be done with this particular threat. The threat is most assuredly not done with us.

North Korean leadership is only too willing to sell anything to those with cash. They are widely suspected to be in league with Iran's nuclear ambitions. Narcotics, sophisticated counterfeit currency, and weapons material round out their offerings.

In support of our national and alliance efforts to meet all these challenges, we are realigning, or rebalancing our forces across the Asia and Pacific region. It has become far more discussed than understood. One particular airfield in Okinawa, Japan – Marine Corps Air Station Futenma – captures most of the commentary. It's merely one part of an overall initiative within Japan that involves a number of successful, and continuing, major initiatives involving both U.S. and Japanese forces. Future U.S.-Japan initiatives may include more joint basing, U.S. and Japanese forces together on the same bases.

A few principles should be stated to put our forward presence in context.

We deploy forces overseas to operate in support of the policy and strategy of the United States, including most importantly the defense of our allies. More broadly we help to assure peace and stability across the region. We do this with the active cooperation and support of our allies and friends.

Military and naval bases overseas are very useful things. They make a profound political statement long before they make a military statement. Any presence of foreign forces in another country requires a compromise of various principles of sovereignty on the part of both countries involved. Any such presence is a strong validation, at some cost, of commitment to common security goals.

Bases are also very useful, and cost-effective, means to develop, train, and maintain forces. Bases support alliance training and development. Bases provide valuable deployment platforms and support for forces operating throughout the region. Whether one fights from these bases in conflict, or from other locations, is a different question driven by a number of factors. But to fight early, you have to be there.

Our forces overseas have an important deterrent role. But if that was all they did, their role would be a very expensive and unprofitable undertaking. The role of our forward deployed forces is far broader and more constructive than simply waiting for someone to turn the master arming switch on. Broad, active, widely distributed presence throughout the theater dampens sources of instability, deters conflict, gives substance to U.S. security commitments, and ensures continuing American access to the region. The presence and the efforts of our forces helps shape the regional geopolitical climate, and they remain immediately available to respond if needed.

Our bases in Asia and the Pacific are concentrated in Alaska, Hawaii, Korea, and Japan. Diego Garcia is a very important facility in the Indian Ocean, but it is not a base in the traditional sense. After a long period of decline following Vietnam, our force presence in Guam and the Commonwealth of the Northern Mariana Islands is again growing. These are traditional bases supporting personnel on long tours with their families. As a result, they have schools, commissaries, exchanges, movie theaters, hospitals, dental clinics, recreational facilities, and so on. Our concentration in Japan and Korea reflects the enduring, and urgent, threat of North Korea, our historic obligation to Taiwan, and our Cold War history.

This model of presence will be changing, with forces deployed far more often away from our traditional bases. As mentioned earlier, Secretary Gates introduced the concept of a “widely distributed, operationally resilient, politically sustainable” forward presence. This signals recognition of the importance of South East Asia and the Indian Ocean area. The concept expands the geographic distribution of our forces, and the geographic reach and distribution of our alliances. In all the rhetoric and discussion of our alliance transformation and realignment agreement with Japan, very few observers note the U.S. promise to provide for the continuous presence of Japanese forces and their training in Guam. This is already underway, and it will be increasing. This establishes the presence of Japanese forces on U.S. soil, an appropriate counterpart to our presence in Japan. This is an expansion of the U.S.-Japan alliance to Guam, the Commonwealth of the Northern Mariana Islands, and in the future to the Compact States. It is a major strategic step forward designed to rapidly increase the efficiency and effectiveness of our alliance forces when we are operating together in high-intensity, modern operations.

Our presence guidance also calls for a more lean, agile, and expeditionary posture. Expeditionary in this sense means self-sustaining, stepping lightly on the local infrastructure, making do with things as they are. It means making do with conditions that we find, not building “Little America” on foreign soil and enclosing it inside a fence line. It’s tough to win friends when we are living better on deployment, including in combat, than our hosts do at home.

Our presence guidance signals increased emphasis on robust, continuous, bi- and multi-national training, accomplished through expansion of the U.S. and Australian synthetic training environments. These systems, already in place, permit combinations of live, virtual, and constructive forces arrayed in an interactive, hyper-realistic simulation system that replicates faithfully the uncertainty, friction, fog and stress of high-intensity air-land-sea-space-cyberspace integrated operations and combat for commanders and their staffs.

The Marine presence in Australia is, along with Guam, a big first step to these goals. It is a training presence, not a base. The force there will be an immediately deployable, combat-capable combined arms air-ground force. It will be expeditionary, self-sustaining, and self-contained. One mission will be to work and train with forces from Australia, and in the future Japan and other friends and allies. They will be supported by pre-positioned ships and amphibious ships. Mobility will be supported with Joint High Speed Vessels, and commercial High Speed Vessels, as well as organic aircraft, including FA-18, MV-22, KC-130, and F-35B in the future. Combined deployments with Australian, and eventually other forces, are possible.

Our policy for Asia and the Pacific is pretty well defined, if not so well understood. Our forces are in place. The posture, operational employment, and presence will be much improved over the coming months and years.

The missing component is a declared strategy to complement, and implement, our policy. We must develop, and discuss with our allies as well as our own public, a viable strategy to support our goals. A proper strategy includes critical assumptions, ends-ways-means coherence, priorities, sequencing, and a theory of victory. While many official documents include the word “strategy” in the title, few include the specificity and the discipline to take us beyond aspirational statements.

Other voices call for increased definition of our strategy in Asia and the Pacific. The Center for Strategic and International Studies (CSIS) recently completed a critical assessment of our Pacific posture for Congress. CSIS concluded, in part:

“There are clear connections between shaping actions and contingency preparation. Given rapid advances in Chinese military capabilities, the consequences of conflict with that nation are almost unthinkable and should be avoided to the greatest extent possible, consistent with US interests. It is therefore critical to achieve the right combination of assurance and dissuasion and to maintain a favorable peace before conflict occurs. At the same time, the ability of the United States to work with allies and partners to achieve those peaceful ends will depend on the perceptions, both of allies and partners and of China, of the U.S. ability to prevail in the event of conflict. U.S. force posture must demonstrate a readiness and a capacity to fight and win, even under more challenging circumstances associated with A2AD and other threats to U.S. military operations in the Western Pacific. Demonstrating such capacity is not automatic; one way to undercut dramatically the regional confidence in the U.S. commitment and the American ability to shape decisions and preserve peace would be to adopt a posture that pulled back from the Western Pacific and focused only on the survivability of U.S. forces and reductions in annual costs of forward presence. Forward presence and engagement are not simply helpful to shaping the environment and setting the stage for effective responses to contingencies – they are indispensable for minimizing the likelihood of larger conflicts.”³
(Emphasis in the original)

The resources available for defense, including engagement operations, are certain to be more limited. We’re headed for a fleet of 246 ships, significantly short of the 346 called for by the bipartisan Quadrennial Defense Review independent panel. This is important because, no matter how capable the ship, it can only be in one place at a time. And power projection that stays is about ships.

Our defense budget will be capped based on national need, not on military requirements. The reduction is not just in terms of the amount of the nation’s treasury allocated to defense. We face another reduction, more serious, from the resources required per weapon. The costs of vehicles, aircraft, ships, munitions, and personnel continue to rise at a rapid rate. Presence requirements will be faced with increasing unit costs, increasing flying hour, driving hour, and steaming hour costs. We are certain to be much smaller, and on an inevitable path to very small indeed. Solutions do not come readily to mind.

Our policy calls for a renewed emphasis on air and naval forces while sustaining ground force presence. Along with the calls for rebalancing we will no longer size ground forces for long-term stability operations. The number of ships will be reduced by stretching out new ship programs while retiring others early. Tactical fighter programs will also be reduced.

Already we hear from friends in Asia that they fear this budget reduction will be like the last such force reduction episode in the 1990s. In their memory, we reduced our presence in Asia

³ U.S. Force Posture Strategy in the Asia Pacific Region: An Independent Assessment. Center for Strategic and International Studies, 10 July 2012 pages 17-18.

then, and called it an improvement, because individual weapons systems were better. Our own documents call for preserving readiness over more force structure. Smaller but better, in other words. Increased readiness is good, of course. But at some point, quantity has a quality of its own.

We have a pressing need for forward presence and extensive engagement operations, confronted by severe budgetary pressures. We need a coherent strategy to efficiently apply our resources and our alliance resources to our overall goals. Such a strategy must address the reality of nuclear weapons and the history of confrontations between nuclear armed states. It must define and expand “engagement” and its connection to contingency plans. While conflict is unlikely, *every* strategy must take into account the likelihood that *any* conflict will be a long war, and not assume, as we often do – and as Europe did in 1914 – that wars will be short. Any worthy strategy must also take a cold-blooded look at the new warfare domains of cyber and space, and their effect on escalation.

We had a public understanding of the tenets of our strategy in NATO during the latter days of the Cold War. We need that level of public understanding again. Most important, we must have a strategy that achieves some compatible relationship between ends and means. An incoherent competition for declining resources will confuse our own public, alarm our allies, and waste the resources we have.

Of paramount importance to the U.S. are the security of our homeland and the security of our allies. Other important objectives flow from that. A public strategic concept that calls for defense of the territory and the interests of our allies and friends avoids unnecessary demagoguery of our intentions, reassures allies and friends, helps to rationalize roles, missions and responsibilities across our alliances, and provides our own citizens with a rationale for defense resources.

Chief U.S. Policy Goals in the Asia Pacific:

- Peace, stability, and prosperity
- Be a stabilizing military influence and economic partner in the Asia Pacific
- Strengthen relationships across the region
- Ensure U.S. access
- Promote regional security through enhanced military-to-military cooperation
- Focus on regional institutions to advance clear and shared objectives
- Expand economic opportunity and growth
- Promote democracy and human rights

Actions in the region that achieve those goals:

- Senior official attention and participation

- Force realignment initiatives
- President Obama attendance at events:
 - o APEC 2009, 2010, 2011
 - o EAS 2011, 2012
- Established the Strategic and Economic Dialogue with China (April 2009)
- Established Comprehensive Partnership with Indonesia (November 2010)
- First non-ASEAN country to establish a dedicated Mission to ASEAN in 2010.
- Revised missile agreement with South Korea increasing the payload and range

Successes of those policies:

- American exports to Asia have increased approximately \$87 billion since 2008
- Burma opening up, releasing political prisoners, lifting of sanctions
 - o U.S. eases import ban on most Burmese goods
 - o U.S. lifts sanctions on leading Burmese officials which blocked assets and wouldn't let them participate in transactions with U.S. nationals
 - o U.S. lifted ban on U.S. investment in Burma
- KORUS FTA (approved November 2011, came into force on March 15, 2012)
- New security initiatives with Australia, Japan, South Korea, Thailand and the Philippines
- Japan relaxed its ban on military exports to allow it to take part in the joint development and production of arms with other countries and to supply military equipment for humanitarian missions. Now, Japan's defense budget should stretch much further.
- American presence in the region reassures our friends and allies, providing a stabilizing force as powers rise and countries continue to grow and develop.

Shortcomings/Challenges Ahead:

- Lack of implementing action on the "pivot"
- TPP stalled
- Failure to resume or replace the Six-Party talks
- North Korea's weapons programs continue
- Need to renew the Compact of Free Association with Palau, reassure the Pacific Islands that the U.S. is not abandoning them

- Human rights abuses are still challenging

How is China reacting to recent developments in U.S. policy?

Similar to here in the United States, there is no monolithic “Chinese view” on U.S. policy in the region. Rather there is a range of views and reactions depending on which official you are speaking to, which governmental agency they represent, etc.

The general attitude of Chinese officials could be overall thought to be rather muted and restrained. The Hu administration wanted to avoid any serious deterioration in U.S.-China relations. For example, Xi Jinping has stated he wants to “Control and manage the differences (*guan kong fenqi*)” and State Councillor Dai Bingguo has said, “Major Powers like China and the U.S. should focus their Asia-Pacific policies and interactions on regional peace, development and cooperation.”

Official Comments on Specific Issues

- TPP - Chinese Assistant Minister of Commerce Yu Jianhua: “TPP has set very high benchmarks; whether or not all these members will reach that high benchmark we’ll have to wait and see.”
- Deployment of U.S. Marines in Australia - Ministry of Foreign Affairs spokesman Geng Yansheng: “Any strengthening and expansion of military alliances is an expression of a Cold War mentality.” He added that the U.S. had stated many times that it welcomes a strong, prosperous and stable China and has no intention to contain China, saying that “We hope the U.S. does what it says.”
- South China Sea - Wen Jiabao: “[South China Sea disputes] ought to be resolved through friendly consultations and discussions by the sovereign countries directly involved. Outside forces should not use any excuses to interfere.” MFA spokesman Liu Weimin: Territorial disputes should be handled bilaterally and that “foreign intervention will not help settle the issue but will complicate it instead and is not conducive to peace, stability, and development of the region.”
- U.S. arms sales to Taiwan - Rear Admiral Yang Yi: “We are going to give a lesson to the U.S. government that harming others will harm yourself.”

Commentator and Scholar Reactions

- Chen Xiangyang, deputy director of the Institute of World Political Studies at the China Institutes of Contemporary International Relations (CICIR): The real intention of the U.S. in getting involved in the South China Sea issue is to “sow discord between China and ASEAN” and promote its new Asia-Pacific strategy.
- Li Xiguang, Director, at the Center for International Communication Studies at Tsinghua University: “The aim of the new U.S. Asia policy is to isolate and encircle China.”
- Shi Yinhong, professor at People’s University, advised the Chinese government to “think about the reason why the [US] is suddenly so popular in the region.” “Is it because China has not been good enough when it comes to diplomacy with its neighboring countries?”
- Zhu Feng, professor at Beijing University, called for China to “stop blaming the United States, Japan, Vietnam or the Philippines, and reflect first on its own diplomatic blunders.”

**OPENING STATEMENT OF DR. DAVID M. LAMPTON
PROFESSOR AND DIRECTOR OF CHINA STUDIES
JOHNS HOPKINS UNIVERSITY
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DR. LAMPTON: Thank you for having me here to share my views, and I look forward to the interaction.

Let me start by saying that with respect to my two colleagues' written testimony, it appears that I agree with them on what I would take to be three major points: One is that the United States needs a clearer strategy in Asia. Point two, resources are a severe problem for the policy we have; and, three, U.S. domestic gridlock and governance problems are a bad message to the Asia-Pacific and to the rest of the world. So it seems to me we see some of the same problems--all three of us.

The rebalancing or pivot policy was intended to achieve a balance in the region, but initial implementation could have been stronger and further development is needed. The altered foreign policy leadership in Washington, combined with what will soon be a completed team of counterparts in China, offers an opportunity for those adjustments and more self-consciously moving toward cooperative balance.

Achieving cooperative balance in Asia presents both Washington and Beijing with a Rubik's cube of challenges and tradeoffs. How do both China and the United States make prudent hedges against downside possibilities without producing an upward spiral in military competition? Can China's new leaders consolidate power at home without provocative acts abroad? How can the United States be supportive of treaty allies and other regional friends without seeming, in Chinese eyes, to be bent on what they would call "containment"? How do we reassure our allies without providing them a blank check to pursue goals that are not ours? What is the appropriate mix of military, economic, diplomatic and cultural instruments that we ought to employ to achieve balance? And what is the fitting and feasible allocation of financial resources to the Asia-Pacific, to other regions, much less the resources that need to be devoted here at home?

I would note, for example, that today Vice President Biden is reported to have said Europe is the cornerstone of our engagement with the world. It's that basic. Nothing has changed. Well, the theme of this Hearing belies this--something has changed. So that's what I mean. We need some strategy here at a very basic level.

Will the Middle East, Central Asia, North Africa, and other hot spots cool down, thereby providing the respite that rebalancing presupposes?

My recent trips to China make it clear that there is a debate occurring in China skewed toward those who see Washington's rebalancing policy and actions as containment. But there are more balanced and cosmopolitan voices in China, as well.

Xi Jinping faces an immediate need to consolidate his power, a requirement that places great importance on winning the support of the People's Liberation Army and playing to domestic nationalistic passions. At the same time, I believe, that in the not-too-distant future, this is going to give way to what I believe are his first, second, and third priorities; these are mainly domestic issues, economic and organizational issues, in China that the last panel talked about.

All of the priorities that are first, second, and third to Xi Jinping are domestic in character, I believe. The point is that Xi Jinping is walking a tightrope. On the other hand, he is consolidating domestic power, in part through muscular external policy, which means standing up against Japan and for sovereignty. On the other hand, Xi does not want to agitate the external environments to the degree that he engenders a countervailing coalition and has to divert major attention to external crises.

As part of this effort, Xi is also improving relations with Russia and his initial trips abroad in his first year may well be designed to send the message that the United States is less important to China than it used to be. But once this transitional phase is completed, I expect to see him assume a posture more aligned with what all knowledgeable Chinese continue to say, namely, that the United States is China's most important relationship.

This suggests that the question for the United States, therefore, is how do we get through this awkward transition period with the least possible damage? Now, it's fitting at this moment to reassess and modify the mechanism of dialogue between Washington and China. The Strategic and Economic Dialogue annual meetings have come to involve hundreds of persons. Getting the right handful of leaders with clout on a given issue in the room is worth more than a cast of hundreds.

Beefing up military-to-military exchanges and strategic dialogue has been done, but more needs to be done. The development of regular meetings between the Assistant Secretary-level of China's Foreign Ministry and the U.S. Department of State has been a good development and ought to be continued.

In a related vein, putting one very senior person visibly in charge of major policy in the relationship has worked in the past and something equivalent should be done again. Our two heads of state should get together as early as possible to articulate a compelling strategic foundation for the bilateral relations.

In the economic realm, local leaders in both China and the U.S. often are the most predisposed towards cooperation and building the interdependencies that will moderate conflict. More vigorous effort should be made to encourage Chinese investment in the United States and, vice versa, in part by fostering state, province and local level cooperation.

Finally, America's friends and third-parties can in their zealous pursuit of their own society's interests and concerns drag the United States into confrontations that are not in America's interest.

Thank you.

**PREPARED STATEMENT OF DR. DAVID M. LAMPTON
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February 7, 2013

HEARING: "China's New Leadership and Implications for the United States"

David M. Lampton

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Studies

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

"Cooperative Balance in Asia"

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

INTRODUCTION:

Hearing Co-Chairs Reinsch and Shea, and Members of the Commission:

Thank you for inviting me to share my views with you today.

Whether America and China cooperate or have high levels of conflict in the years to come will be a principal determinant of whether or not peace, prosperity, and stability can be achieved in the Asia-Pacific. The best approach to trying to achieve the best outcome is by pursuing a policy of Cooperative Balance. This involves the major powers not seeking absolute dominance; cooperating to minimize and manage crises; building integrating economic and security structures and supportive norms; increasing regional and bilateral economic interdependence; and, building mechanisms of effective multilateral and bilateral dialogue.

The “Rebalancing” or “Pivot”¹ policy was intended to achieve balance in the region, but initial implementation could have been stronger and further development is needed. The altered foreign policy leadership in Washington, combined with what will soon be a completed team of counterparts in China, offers an opportunity for those adjustments and more self consciously moving toward Cooperative Balance.

Achieving Cooperative Balance will not be easy and presents both Washington and Beijing with a Rubik’s Cube of challenges and tradeoffs: How do both China and the United States make prudent “hedgies” against downside possibilities, without producing an upward spiral in military competition that is corrosive of cooperation, both bilaterally and throughout the region? Can China’s new leaders consolidate power at home without engaging in provocative acts abroad and inflaming nationalism? How can the United States be supportive of treaty allies and other regional friends without seeming in Chinese eyes to be bent on “containment”? How do we reassure our allies without providing them a blank check to pursue goals that are not ours and could inflict great cost on America? What is the appropriate mix of economic, military, diplomatic, and cultural instruments that should be employed to achieve balance? What is the fitting and feasible allocation of financial resources to the Asia-Pacific, versus other regions, much less what resources must be directed to critical domestic needs? Will the Middle East, Central Asia, North Africa, and other hot spots cool down, thereby providing the respite that “rebalancing” presupposes? Finally, what are the benchmarks we should use to judge the success or failure of our policies?

With respect to the evaluation of policy, it should be judged by the degree of regional stability achieved, the degree to which it contributes to continued high-speed economic growth in the Asia-Pacific, and the degree of Sino-American cooperation on regional and global issues that develops. A pivot that is associated with lower economic growth, more big power friction in the region, and less cooperation on global issues ought not to be declared a success, using the rationale that the situation would have been even worse in the policy’s absence. With appropriate adjustments and seizing the opportunity that new foreign policy leaderships in both countries provides, there are reasons for cautious optimism.

U.S. POLICY GOALS:

There are several notable and commendable aspects of the current U.S. “rebalancing” policy: 1) It views Asia as a whole, putting U.S. policy vis-à-vis China into a broader Asian context. 2) It puts the strategic emphasis on maintaining balance among the major power centers in the region. 3) It emphasizes the importance of norms and international law in dispute resolution. 4) It seeks to reassure China’s smaller neighbors made nervous by a Chinese foreign policy that became notably less reassuring from about 2009 on. 5) It has focused additional diplomatic

¹ I use the terms “rebalancing” and “pivot” in this Testimony interchangeably simply because the word “pivot” was used initially by the first Obama Administration, because upon occasion the president and/or presidential spokesmen still use it, and because “pivot” conveys the sense of change most Chinese seemingly perceive. I prefer “rebalancing” myself.

and cultural resources on an area of ever-greater importance to America and, at a minimum, promises sustained security resources to a region that is divided by volatile nationalistic conflicts and deep distrust—one thinks of South Korea and Japan; Japan and China; North and South Korea; North Korea and everyone else; the Philippines and China; Vietnam and China; the Philippines and Vietnam; without even mentioning South Asia. Conflicting nationalisms in Asia is the central interstate challenge in the region.

Although the latest episode between Japan and China in the East China Sea is not over, at a critical moment Washington appropriately urged caution on Beijing and restraint on Japan. The combination of deterrence of the PRC and restraint of Japan offers a reasonable prospect for moving this conflict off the front burner, with a hopeful sign being the January meeting of Xi Jinping with Natsuo Yamaguchi of the ruling coalition in Japan and the note from Prime Minister Abe that he carried. Likewise, if China moves in the direction of restraining North Korea, as it appears to be trying to do lately, then both of these moves are constructive efforts to pursue a policy of Cooperative Balance. In short, Cooperative Balance involves both America and China throwing their weight in the direction of maintaining stability in particular cases, even if they don't agree in all respects.

CHINESE POLICY GOALS, PERCEPTIONS, AND CONSTRAINTS:

It also is important how Chinese leaders, citizens, and key interest groups (such as the People's Liberation Army, PLA) conceive of their own objectives and view Washington's rebalancing/pivot policy. The historical moment in which the Chinese polity currently finds itself shapes behavior.

My recent trips to China in September of last year and January of this year make it clear that there is a debate occurring in China, skewed (heavily) toward those who see Washington's rebalancing policy and actions as principally directed at Beijing—"containing China's growth and influence." Within the more cosmopolitan corners of the Chinese policy process and at its senior levels, however, there are individuals and groups that recognize there are several non-China-directed reasons for the United States to pursue "rebalancing," including: Growing U.S. economic interests in the world's most dynamic economic region; Reassuring U.S. allies and smaller neighbors that they will not be dominated by Beijing; Guarding against warlike North Korean behavior; Dampening proliferation and arms spiral pressures in the region; Securing the sea lanes of communication from a variety of threats; And, there is even recognition in Beijing that the budgetary competition in Washington requires big problems to justify big budgets. Not a few in China also candidly admit that the PLA uses the same tactics in Beijing's budget wars. Further, the level of alarm in Beijing is dampened by the belief among many observers in the PRC that instability elsewhere in the world likely will remain so high as to diminish Washington's ability to dramatically shift leadership attention and resources (from Central Asia, the Middle East, and new hotspots) to the Asia-Pacific. Still others think that, in financial terms, the pivot may end up meaning that the Asia-Pacific simply gets a somewhat larger fraction of a shrinking U.S. defense pie. In other words, "more U.S. emphasis" on the Asia-Pacific may be a relative, not absolute, concept.

While there are more and less skeptical PRC observers of the U.S. pivot/rebalancing, this debate is unfolding as China is transitioning from the era of Hu Jintao to that of Xi Jinping. Consequently, U.S. actions and policy are filtered through the lenses of domestic currents and domestic political needs in the PRC. Xi Jinping faces an immediate need to consolidate his power, a requirement that places great importance on winning the support of the PLA and playing to domestic nationalistic passions. At the same time that this is a pressing, short-term need, I believe and have been told that this will give way to the overwhelming first, second, and third priority of the new regime. Those priorities revolve around domestic issues—reducing the corrosive degree of corruption; building a new economic growth engine; addressing severe socio-economic inequalities; pushing ahead with restructuring of the State Council; and, accelerating economic reform. The point is that Xi Jinping is walking a tightrope. On the one hand, he is consolidating domestic power, in part through a muscular external policy (which means standing up against Japan, and for sovereignty), while, on the other hand, Xi does not want to so agitate the external environment that he engenders a countervailing coalition and has to divert major attention to external crises and security challenges. As part of this effort, Xi also is improving relations with Russia and his initial trips abroad in his first year may well be aimed at the BRICS, sending the message that he is not overly dependent on the United States.

Once this transitional phase is largely completed, however, I expect to see Xi assume a posture much more aligned with what all knowledgeable Chinese continue to say—the United States is China’s most important bilateral relationship. As for the United States, it is my understanding that the Obama Administration has concluded that Xi Jinping is a person with whom it can productively deal. Further, the concatenation of foreign policy leadership I expect to come out of next month’s National People’s Congress in Beijing, and (at this writing) the presumed new Secretaries of State and Defense in Washington, I believe will provide a reasonably strong basis to move positively forward. All this suggests that the question for the United States is: How can we get through this awkward transition period with the least possible damage? This brings us to the initial implementation of the “pivot” or “rebalancing” policy, a policy that the Obama Administration has been adjusting since its initial unveiling in late 2011.

THE ROUGH EDGES OF THE “PIVOT’S” INITIAL IMPLEMENTATION:²

The Obama administration’s rhetorical flourishes surrounding the initial launch of the “pivot” (“back to Asia” and “forward-deployed diplomacy”) obscured the facts that the United States never had departed the region and that key features of the effort date back to the presidencies of Bill Clinton and George W. Bush—namely reshaping the U.S.-Japan Alliance (not least with North Korea in mind), gradually enlarging military facilities and forces on Guam, emphasizing long-range strike capability, and improving relations with Vietnam and India. The newest, and very beneficial, part of the effort was the Obama administration’s seizure of the opportunity to

² This section draws very heavily from, David M. Lampton, “China and The United States: Beyond Balance,” *Asia Policy*, No. 14 (July 2012), pp. 40-44.

improve relations with Myanmar (Burma), afforded by hopeful indications of possible political change in that country.

To the degree that rebalancing has provided incentives for restraint and cooperative Chinese behavior—as appears to have been the case in some aspects of recent PRC policy toward North Korea and Iran—as well as renewed emphasis on soft power as an element of PRC statecraft, the policy has had upsides. The downside is that rebalancing as it initially was launched compounded mutual strategic distrust between Beijing and Washington. Further, there always is the fear in the region that Washington will go too far in hedging against Beijing and put China's neighbors in the unwelcome position of having to choose between the two powers, to choose between their economic and security interests.

In some areas where the new initiative represented or proposed genuine change, one could ask hard questions. Was it wise to place a small number of U.S. marines and air assets in Darwin and elsewhere in Australia on a rotating basis, given that these forces are located so remotely as to be largely irrelevant while at the same time signaling hostile intent to Beijing? Is the insertion of the United States more centrally into disputes over rocks and atolls in the vast South and East China Seas unwise (since great nations do not fight over rocks)? Does U.S. involvement incentivize Vietnam and the Philippines to stake out positions that are designed to align Washington (and U.S. energy companies) ever more closely with their claims? Quite frankly, none of the parties to these disputes have the best interests of the United States in mind. It was troubling when Secretary of State Clinton stood on the deck of a U.S. warship in Manila Bay and said, "We will stand and fight with you." President Obama's remarks in his October 22, 2012, debate with Mitt Romney referring to China as an "adversary" didn't help matters

Further, credibility is not simply a Cold War concept—it is the coin of the realm in international affairs. Given the pressures on the U.S. budget, and the defense budget in particular, is it credible to say that defense resources in the Asia-Pacific will be insulated from the pain that nearly every other corner of American life, and every other theater of military operations, is going to feel? Is it feasible to think that a Japan with rapidly rotating governments and a weakened economy will provide the resources for the significant levels of burden-sharing that the U.S. policy seemingly presupposes? In short, rebalancing is premised on U.S. resources that may not be available and on the provision of allied resources that may not fully materialize. The recent U.S.-Japan agreement to relocate 9,000 marines on Okinawa to Guam and elsewhere in the Asia-Pacific, even as Tokyo continues to be unable to deliver on earlier promises germane to Okinawa, is just one troublesome indicator of possible gaps between rhetoric and action. Further, the capacity of the United States to move resources from Central Asia and the Middle East to the Asia-Pacific presumes that those turbulent theaters to China's west will cooperate with Washington's plan. Turning to South Korea, governments come and go, and with each succession, how Seoul positions itself in the complex Washington-Beijing-Pyongyang triangle is subject to change. Although Washington had an unusually cooperative partner in the administration of South Korean president Lee Myung-bak (though the Japanese would have a

somewhat different view), his successor, President Park Geun-hye, may “rebalance Seoul” both on the Peninsula and vis-à-vis Beijing, while maintaining sound relations with Washington.

Another dimension of the rebalancing effort pertains to the genuine need for the United States to further strengthen its position as a free trade leader in the region. A great first step was the Korea-U.S. Free Trade Agreement (KORUS) that went into force in March 2012, brought to fruition by the Obama administration’s hard work and bipartisan support in Congress. However, the move in the rebalancing initiative to promote the Trans-Pacific Partnership (TPP) of generally modestly sized Pacific Basin economies (that now includes Mexico and Canada which participated in the 15th round of negotiations) seems weak compared to Beijing’s push for a free trade agreement with Japan and South Korea, and even to the PRC’s strengthening of free trade (and now currency) ties with Taiwan through the Economic Cooperation Framework Agreement (ECFA). It is unclear whether the major economic players in Asia (China, South Korea, and Japan) can or will ever join a TPP free trade area. The United States ought to be doing what it can to come up with feasible arrangements with the region’s major financial and economic players, not relying to such an extent on a “high-quality” arrangement with smaller economies, and in the process sending the message to Beijing that Washington is not interested in PRC participation except on U.S. terms. In this regard, one might also find it odd that Vietnam is in the TPP negotiating structure while China is not—are Vietnam’s free-trade practices of higher standard than China’s? It is fitting to note that Beijing, too, has been pushing alternative trade groupings designed to exclude Washington. Instead, the United States and China should forge a shared vision of a unified Pacific trading system, not a balkanized structure.

In short, to some extent there was less to rebalancing than meets the eye, though the increased senior U.S. leadership attention to, and travel in, the region has been striking and welcome. To the degree that there is substance to the policy, some of it is unnecessarily provocative, some of it may be infeasible, some of it is good, and some is well received in the region as long as the United States does not push too far. The military soundtrack was initially turned up too loud, while the volume on the economic soundtrack initially was too low. Some, perhaps much, of this has been recognized and partially addressed in the intervening year-plus and further adjustments in this direction are warranted, particularly if the East China Sea continues to move in the direction of what (hopefully) seems to be the back burner, at least for a while.

SO, WHAT ARE THE MOST PRODUCTIVE NEXT STEPS?

The central strategic challenge that the United States and China face is how to get along with each other so that each country can focus on rebuilding itself. Just as the anti-Soviet rationale provided a foundation for relations that proved durable in the 1970s and 1980s, and as economic mutual interest buttressed productive ties in the 1990s and up to the present, the shared imperative today is to rebuild our respective homelands—we are both societies in need of reform. Beijing’s and Washington’s commitment to those similar projects is the foundation for sound ties on which both should build, knowing that cooperation and competition will both be features of relations. Neither the United States nor China can afford to be at loggerheads if

we each wish to build better homes for ourselves and cooperate on pressing global issues such as climate change. I further believe that Xi Jinping and those around him have concluded that they cannot free-ride in the international system for ever, and that there is increasing consensus in Beijing that the PRC cannot remain a passive observer to ever more numerous situations in which its interests are increasingly engaged—we see China pledging to boost UN contributions,³ at the moment being modestly helpful regarding North Korea, and attacking climate change with arguably as much or more commitment than Washington. We will see, but there is reason for hope.

Another step that is needed is to gradually develop integrative economic and security structures in Asia that bring nations together, rather than divide them. A place to start in which the Chinese have expressed interest is a Northeast Asia Security Forum including China, Japan, the Koreas [North Korea obviously is a problem], the United States, and Russia. I would like to see the United States and China in the same organizations rather than building competing organizations in both security and economic domains.

Now is a fitting moment to reassess and modify the mechanism of dialogue between Beijing and Washington--the Strategic and Economic Dialogue (S&ED). Annual S&ED meetings have come to involve hundreds of persons. Getting the right handful of leaders with clout on a given issue in the room together is worth more than a cast of hundreds, though having working groups interacting frequently on key issues and projects is a feature of the current dialogue that should be preserved. Beefing-up military-to-military exchange and strategic dialogue also is essential, and the development of regular meetings between assistant secretary-level Foreign Ministry and State Department officials responsible for U.S.-China relations has been a good development. In a related vein, putting one very senior person visibly in charge of coordinating major policy in the relationship has worked in the past (e.g., Secretary of the Treasury Hank Paulson and Vice Premier Wang Qishan) and something equivalent should be done again. Our two heads of state should get together as early as possible to articulate a strategic foundation for bilateral relations that is compelling to our people, and durable.

In the economic realm, local leaders in both China and the United States often are the most predisposed toward cooperation and building the interdependencies that moderate conflict. More vigorous efforts should be made to encourage Chinese investment in the United States and vice versa, in part by fostering state-province and local-level cooperation. Governors-to-Governors forums of increased scope, duration, and frequency should be encouraged.

Finally, America's friends and third parties can, in their zealous pursuit of their own society's interests and concerns, drag the United States into confrontations that are not in U.S. interests. The George W. Bush Administration's experience with Taiwan's Chen Shui-bian and the recent experience in the East China Sea are suggestive in this regard. No one should be given a blank check to be filled out in American blood.

³ Cheng Guangjin, "Xi Vows to boost UN cooperation, equality," Chinadaily.com , updated December 28, 2012 (accessed January 26, 2013).

**OPENING STATEMENT OF DR. MICHAEL AUSLIN
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DR. AUSLIN: Chairman Reinsch, Vice Chairman Shea, members of the Commission, thank you for the opportunity to come again before you and talk a little bit about American policy in Asia. I know it's been a long day, it's the end of a long day, so I will try to emulate the General in the brevity of my remarks since I have submitted some comments for the record.

Very briefly, let me just run through an outline pretty much of what I submitted to you and talk about three things. First, the background to our policy, what it is, as I see it, in the Asia-Pacific. Second, where we're doing well; where we're doing poorly. And third, what are some of the bumps in the road ahead?

It's nice, as all of you are well aware who work on Asia and Washington, that it's one of the less contentious areas of policy most of the time.

[Laughter.]

DR. AUSLIN: And I think that's reflected in the national policy the United States has pursued in the region. I think successive Democratic and Republican administrations, and the Congress as well, have had broadly agreed upon goals for the United States for decades now. That includes ensuring economic growth, freedom of navigation, security of our allies and partners, so as to provide the prerequisite for stability that East Asia, and Asia more broadly, needs to continue its democratic and economic evolution.

On top of that, we layer our value system and promote liberalism, promote civil society and rules-based regimes throughout the region, both inside countries as well as for international relations in the region as a whole.

That policy has stayed remarkably consistent even as the region itself has changed and changed dramatically, mostly I would argue for the better. There was a rather static approach, I think, in the mind-set that we had to the region during the Cold War, and, in fact, I would argue Asia was seen largely as a subset of the Cold War centered on Europe.

But all that began to change. Historically, very interestingly, the moment the Cold War ended, the beginning of the rise of China, the popping of the Japanese bubble, and a search for a new American international identity, I would argue, drew us much more self-consciously to Asia for the past two decades.

If that was an intermediate period of trying to at least sense out what the landscape is, we're now moving into a new era where the parameters of how Asia is going to look, I think, are becoming clearer. I think from the economic perspective, we've done very well in terms of promoting our policies and helping our friends in the region as a whole rise up out of

poverty, establish successful and stable trading regimes, integrate into the world economy, and the like.

When you turn to the security side, as well, it seems as though we've been relatively successful. The region has not seen a systemic region-wide war since World War II, even though there have been numerous battles and wars, some of which we have been engaged in, of course. But if you think of stability broadly writ, and that is our security goal, I think again we've been largely successful.

I think the story is a little bit murkier when you turn to the political side. There we have seen progress, particularly in the 1980s with democratization sweeping through the region, but I would argue it was always individually. It wasn't a wave of democratization like the type that we saw, for example, in Eastern Europe, but rather it was very country specific and country dependent.

And so we have, I think, on balance, a good record, if somewhat mixed, in terms of seeing the evolution of liberal regimes, in essence, the inculcation of liberal and democratic values. And, of course, it is an ongoing struggle.

So where do we stand today in terms of what's working and what's not working? Again, because the policy has been stable, I think, in general, it is working as we define it now. If you take what successive administrations have said they want to see, then the policy is working. In that sense, I don't see that the Obama administration's rebalance, or pivot, whichever term you prefer, is materially different from the Bush administration or successive administrations before it.

The danger, of course, is that the actions will not match the words, that the rhetoric of the pivot, though laudable, I would add, does not match the resources we either devote to it or the results that come from when the pivot, the rebalance, has to meet specific issues. As I was walking in the door, I heard some of my other colleagues discussing with you the Senkaku issue. That may be the key test in terms of where the United States meets the road in this new pivot and engagement in Asia.

So that, I think, is actually where we run the danger of things not going as well, in that we raise expectations. We, in essence, make unmet promises to our partners that what we are going to be doing is somehow different from what we already have been doing. And maybe that's the debate that we need: is what we have been doing okay? Does it match what, in terms of strategy, ends and means, or do we have to have a fundamental rethink or not?

And with that, then, let me turn to some of the road bumps ahead, the landscape ahead, as I call it in my prepared remarks, that may lead us into a discussion of whether that strategy is successful and will be successful in the coming years?

I think there's a lot of things you could focus on. I just chose three. The first is the territorial disputes. Clearly, it's interesting. You know, look, let's be honest, it's good for business, so to speak, when things

get a little bit hairy in Asia; we all want to talk about it. We all get to go on CNN or Fox News or wherever it is, but I would say I'm surprised by the degree to which this has really ramped up rather dramatically over time, and where things in Asia, at least to me from a security perspective, were often very static. You know, we jump on small changes.

I think some of the changes we're seeing today are much more significant. The Japanese announcement of the actions the Chinese took last month in using fire control radar to target ships and helicopters is a material type of change, or at least potentially is a material type of change. So I think we have to be very aware of the significance of these territorial disputes in the East and South China Seas and the importance they have to our friends and allies.

Second is North Korea. Again, we're probably facing a third nuclear test in a matter of days or weeks. This, I think, over time is eroding the sense of confidence that Seoul and Tokyo have that the United States really has a plan for dealing with North Korea short of the fact that we know we could end that regime if we were so pushed.

But there's a long landscape in between where we are today and that, and I think the ongoing crisis is something that worries our friends and allies in the region.

And then, thirdly, and finally, to wrap up, it's what's happening at home. I mean all of us travel through Asia. We all know that people are paying close attention. They know what sequestration means. They know what budget cuts mean and they know what political dysfunction means. They worry that it will undermine our ability to have a clear policy to properly resource it and to have the political will to act on it when necessary. So those are the three things I think we should look at when we talk about strategy.

Thank you.

**PREPARED STATEMENT OF DR. MICHAEL AUSLIN
RESIDENT SCHOLAR AND DIRECTOR OF JAPAN STUDIES
AMERICAN ENTERPRISE INSTITUTE**

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

On “China’s New Leadership and Implications for the United States”

**Assessing the U.S. “Rebalance” to Asia: Trends and
Prospects for American Strategy in the Asia-Pacific Region**

Michael Auslin

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American Enterprise Institute

February 7, 2013

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Chairman Reinsch and Vice Chairman Shea, Members of the Commission:

Thank you for the opportunity to testify before you today on United States policy in the Asia-Pacific region and China's new leadership. As this panel is devoted more directly to the US rebalance to Asia, and because you have heard from a number of China experts earlier in the day, I will largely limit my remarks to the implications for US policy of the broad strategic trends in the region.

The next decade has the potential to be as transformative in world history as the decade of the nineteen-teens. One world order is struggling to maintain its viability in a rapidly changing environment, and a host of challengers for regional dominance are springing up around the globe. Meanwhile, the established powers that created the post-World War II system are dwindling in strength, failing at fundamental economic reform, and attempting to limit their ability to project power and exercise influence beyond their borders. Whether or not China, Iran, Russia, or Venezuela indeed become the most powerful players in their respective regions, there is little doubt that some of the certainties we have taken for granted over the past half-century, including the power balance of the international system and the attractiveness of the liberal international order will be increasingly called into question.

Perhaps nowhere is this reality more important than in the Asia-Pacific. The Commission knows better than most the centrality of the Asia-Pacific to the global economy, the potential threats it poses to regional and global stability, and also the opportunities it could afford for the expansion of peace and prosperity over the next generation. I find it difficult to credit any one ingredient with creating the Asia-Pacific and world that we know today. Yet there is little doubt that the positive role played by the United States, and its willingness to sacrifice national blood and treasure in the process, has been a significant element in the maintenance of regional stability and the rise to prosperity of Asia. That role, however, is increasingly at risk, and with it, the assurance of a peaceful and prosperous Asia-Pacific that we have taken for granted for so long.

A background to US policy in the Asia-Pacific

Successive presidential administrations, Republican and Democratic alike, as well as Congress, have agreed on the goals of US policy in the Asia-Pacific. Our broad, strategic-level objectives are to ensure economic growth, freedom of navigation, and the security of our allies and partners, so as to provide the prerequisite of stability needed for Asia to continue its evolution.

Additionally, our American sensibilities regarding the value of liberal democracy in promoting sustained economic and social development of any polity has led us to support democratic regimes, promote the rule of law, and encourage nations beginning their trek along the road of liberalization to stick with the often difficult choices that have to be made.

While the United States has been a Pacific power since the 19th century, it is the post-World War II international system with which we deal today. After the defeat of the Japanese Empire and the final decolonization of European-held territory throughout the Asia-Pacific, the emergence of nation-states in the struggle to secure stable political mechanisms while pursuing domestic development has been the hallmark of the last 60 years. The decades of the Cold War also split Asia into two ideological blocs, one capitalist and democratic and another authoritarian and centrally controlled. In addition, the Nonaligned Movement for a time attempted to provide a third way in opposition to both these systems, although without making a permanent political

impact on the region. The end of the Cold War was accompanied by a development that began about a decade earlier and has proven to be the single most important change in Asia's postwar history: the beginning of economic reform in China and the integration of the People's Republic of China into the world economy.

This development has shaped the past two decades of Asian economic growth, much as Japan's postwar recovery during the 1950s and 1960s set the stage for the growth of Asia's export-oriented economy through the 1990s. In a historically short period of time, China has become the primary economic partner for most Asian nations, as well as for the United States and many other nations around the globe. Along with the global free trade regime championed by the United States and multilateral agreements such as the General Agreement on Tariffs and Trade (GATT), Asia's economic development has lifted hundreds of millions of people out of poverty throughout the region. It has also promoted technology transfer between the West and Asia, as well as numerous intellectual exchanges that maintain a vibrant network of scientists, researchers, and businessmen. From this perspective, American policy to ensure the free flow of goods and open trade borders, underwritten by security guarantees of the US Navy to maintain freedom of navigation, has been a crucial ingredient in the transformation of the world economy, or what about a decade ago academics liked to call "globalization."

Yet the story has been murkier in relation to America's political goals in the Asia-Pacific. Our policy of ensuring stability, deterring aggression, and promoting democracy has had a more uneven outcome. In order to pursue these goals, American strategy since the 1950s has been to maintain a forward presence in the region of permanently deployed US Army, Navy, Marine Corps, and Air Force units. This presence has been structured by bilateral treaty alliances known as the "hub-and-spokes" system. The alliance with Japan (signed in 1960) has been the cornerstone of US presence in Asia, enabling the hosting of nearly 40,000 military personnel and their equipment throughout the Japanese archipelago. In addition, our security commitments to South Korea (signed in 1953) have kept around 30,000 US troops near the Demilitarized Zone on a combat footing for over half a century. In the early 1990s, America lost the southern anchor of its Asia-Pacific strategy, with the withdrawal of US military forces from the Philippines. However, access to Thai airbases and naval facilities in Singapore has allowed the US to maintain a presence in Southeast Asia, though much-reduced. In total, the United States maintains approximately 325,000 military and civilian personnel throughout Pacific region under the control of US Pacific Command (PACOM), headquartered in Hawaii.

Long-term deployment of hundreds of thousands of troops thousands of miles away from home under a series of half-century old alliances is nearly unprecedented in world history. Few would question their importance in bolstering allies or maintaining stability along the border separating North and South Korea. In addition, US Navy patrols of the Western Pacific and the East and South China Seas in partnership with other countries' naval forces have no doubt contributed to preserving freedom of navigation. The quick response capabilities of US Marines based in Okinawa and US Air Force units in Japan and on Guam have contributed immeasurably to humanitarian relief missions as well as provided a further layer of assurance that the United States would be able to come quickly to the aid of its allies or attempt to contain conflict in the region.

If Washington's goal after World War II was to prevent another regional war from erupting in Asia, its policy has been singularly successful. Despite cross-border wars between China and

India, China and Vietnam, and some smaller nations, not to mention the US wars in Vietnam and Korea, the region as a whole has been spared the type of devastation visited on it during the 1940s. Moreover, due to this stability, and even with the communist takeover of China in 1949, Asia was never split geographically into two blocs. Rather, the countries on Asia's peripheries, such as Japan, South Korea, Taiwan, and Singapore, were able to maintain economic growth even before mainland China embarked on reforms in the late 1970s. Southeast Asia began to catch up in the first decade of the 21st century.

The security environment in the Asia-Pacific, while largely benign since the 1970s, is nonetheless rapidly changing. The great catalyst of this change, of course, is China and its rapid modernization and expansion of its military forces. While China is still primarily a continental power, the major economies of the region are all maritime powers, and therefore react with great apprehension to Beijing's strides toward a blue water navy and its ability to maintain presence far off its littoral, in places such as the Somali Basin, as well as the beginnings of its power projection capability. China's military modernization, moreover, is a 360-degree effort, and includes the development of advanced air, space, maritime, and land forces. It is the only country in the Asia-Pacific able to undertake such a comprehensive military modernization program.

Predictably, however, China's growth has resulted in a reaction on the part of nations throughout the region, in both the military and political-diplomatic sense. Despite a decade of declining defense budgets that just last month was reversed by the new conservative Liberal Democratic Party (LDP) government in Japan, Tokyo has maintained its maritime and air capabilities, and has sought to partner even more closely with the United States on issues ranging from cooperation on ballistic missile defense to intelligence, surveillance, and reconnaissance (ISR) sharing and joint training. Partially in response to China's maritime growth, nearly every nation in the region, from Australia to Vietnam, is growing their submarine capabilities. Those that can afford it are also increasing their air capabilities by purchasing advanced jets; close allies of the United States, such as Japan, Australia, and South Korea, are either planning or expected to purchase the F-35 Joint Strike Fighter to enhance cooperation with the US on joint defense issues. From a security perspective, then, the guarantees that America extended to its allies (in the general sense of its ability to shape the security environment), have been maintained up to the present day, but the unique stabilizing role the United States has played over the past six decades is in danger of weakening as China grows and other countries step up their self-defense capabilities in response.

Yet if Washington's goal was to spread democracy and promote liberalism, then that is a struggle still being waged. There is no doubt that the great wave of democratization in Asia in the 1980s was due to domestic issues and nationalism in countries such as Taiwan, South Korea, and the Philippines. But one would be hard-pressed to say that the close relations each of those countries shared with the United States, and the potential of transmitting democratic knowledge and civil society norms, played no role at all. On the other hand, authoritarian regimes maintained their grip on power in China and much of Southeast Asia, at least until Indonesia and Malaysia began to experiment with more open political systems in the 2000s. Unlike in Eastern Europe, when the collapse of the Soviet Union and the end of the Cold War signaled the defeat of an ideology that held nearly a dozen countries in its sway, the more variegated political map of Asia meant that progress remained at the individual level of states, and not as a region-wide movement.

Moreover, as China gained both economic strength and confidence during the 1990s and 2000, it sought to increase its political influence, as well. Its “smile diplomacy” was employed alongside generous trade and aid packages to develop friendships and diplomatic support throughout the region, from tiny oceanic states to large countries. Beijing did not seem to be driven by any values, or desire to convert states to its style of governance. Rather its goals were transactional; namely, to gain support for China in regional and international forums. Yet in the zero-sum world of great-power politics, both Beijing and Washington (along with smaller players like Tokyo) saw each other’s actions as conflicting and designed to secure a more dominant position for each in the region.

For the historian and policymaker alike, identifying the results of US policy in Asia during the Cold War and after is as important to understand as it is impossible to answer. We cannot be certain an Asia without a US presence would have experienced another regional war; nor can we assume that Asian economic growth would never have happened without the stability underpinned by American power that the region enjoyed. Even so, if we accept that the United States was an important, perhaps crucial, element in Asia’s post-Cold War history, then at least we should be willing to admit that to have removed the US and its power from the regional mix would have altered the system to some unknowable degree or another. Similarly, to remove the United States today as an ingredient in Asia’s international relations would be to introduce extraordinary level of uncertainty into the system.

The current American approach: its success and weakness

Current American policy in the Asia-Pacific is therefore built on a decades-long tradition of alliance relationships, forward presence, and an unvarying set of principles. American involvement in the region has been deepened by the development of China as an integral part of the American economy, but it also is now beginning to be challenged by China’s emergence as an increasingly troubling military competitor in the region. Simultaneously, doubts about America’s long-term commitment to the region going forward are being fuelled by continually anemic economic growth as well as fears of a decline in US capabilities thanks to budget cuts. It is of no small historical significance and interest that what many perceive as America’s decline is happening precisely at the moment of China’s rise. It is this confluence, along with Asia’s general economic growth compared to other regions of the world that may set the stage in the coming decade or so for a tectonic shift in global power.

The Obama administration’s approach to the Asia-Pacific is not materially different from that of its predecessors. It has maintained close alliance relationships built on decades of common agreement. It has continually sought to deepen and expand the US-China relationship to create a greater sense of trust and working ties between the two largest economies of the world and perhaps its two most influential countries. It has followed the Bush administration’s lead by engaging China at the highest levels and establishing the Strategic and Economic Dialogue as a venue for meetings between Chinese and American principals. Furthermore, it has maintained America’s forward-based military presence, and allowed Pacific Command to respond to strategic uncertainty by deploying America’s most advanced military assets to the region.

Yet the Obama administration has also brought increased international attention to Asia by embarking on a strategic initiative to “rebalance” to the region. The ostensible reason for this initiative, according to the administration, is that the Asia-Pacific is increasingly crucial to America’s future, particularly from an economic standpoint. However, many observers have argued that the real impetus for the rebalance is the growing perception of a Chinese military and political challenge. A Chinese military that has benefitted from double-digit budget increases each year over the past decade is now fielding advanced naval and air weapons systems, and has continued the development of a credible anti-access/area denial suite of capabilities that could be used to prevent American forces from operating freely or intervening in a conflict between China and its neighbors. This development runs parallel with increasing Chinese assertiveness in its maritime claims in the East and South China Seas, which largely has been exercised through its paramilitary forces (though in recent weeks, Chinese air force planes have been sent to shadow Japanese Air Self Defense Forces jets over the Senkaku Islands). Should Beijing’s increased capabilities give pause to American decision makers, then US treaty guarantees to its allies would correspondingly become suspect. This, then, would lead inexorably to a diminution of American influence in the Asia-Pacific with greater consequences than a general adverse shift in the balance of power currently ongoing in the region.

The administration’s rebalance has been a topic of contention since it was announced at the end of 2011 by President Obama. While the administration has argued that it is a holistic approach, incorporating diplomatic, economic, cultural, and military elements, it is, not surprisingly, the last of those elements that has received the most attention. This is due, no doubt, to the military nature of our alliances in East Asia, and the continuing important role American forces play in providing security assurance in the region. Indeed, given the continuity of Asia policy under Republican and Democratic administrations, concern in both Washington and abroad that the United States was beginning to lose its qualitative military edge in the region seems the most parsimonious explanation for the pivot.

Administration officials at many levels have sought to explain the rebalance without precisely defining the policies that will make it a reality, aside from some changes that contribute to the security component of the rebalancing. Perhaps best known is the agreement between Australia and the United States to base up to 2,500 US Marines in Darwin on a rotational basis for training purposes. This would put American ground troops on Australian soil for the first time in the long alliance history between the two nations. In addition, Singapore and Washington agreed to base up to four new Littoral Combat Ships at the Changi Naval Base. Rumors about use by the American military of Subic Bay or the former Clark Air Base, have been unsubstantiated, but reveal the degree to which the Obama administration is believed to be attempting to disperse American forces throughout the region. In addition, speculation that the United States would attempt to deepen military ties with Vietnam have led some to see the possibility of more joint actions to follow the naval exchanges and exercises between two countries in recent years. Taken together, these moves are designed to balance out US forces in the Western Pacific, reducing the over concentration in Northeast Asia and attempting to increase the US military presence in Southeast Asia that was lost with the closing of Subic and Clark in the early 1990s.

In order to be present in Asia, the United States obviously must have matériel and personnel in the region. Yet one of the central criticisms leveled at the rebalancing is the difficulty, if not impossibility, of maintaining American presence in the Asia-Pacific region and increasing our

engagement (at least on a military level) with both allies and new partners if defense budget cuts reduce substantially the size of the American Armed Forces. Both the Budget Control Act and sequestration throw shadows on the future ability of the United States to maintain its overall regional presence and its credibility in fulfilling its various commitments. The Obama administration, while pursuing significant reductions in military auditing, has nonetheless assured allies and partners that any reduction in the size of the US military will not affect US operations or presence in the Asia-Pacific region. In response to specific concerns about what the pivot will mean for the future posture of the United States in Asia, Secretary of Defense Leon Panetta indicated that 60-percent of US Navy strength would be moved to the region by 2020,¹ while America's most advanced weapon systems, such as the F-22 and (when available) the F-35, would continue to be rotated in and out of bases in Japan and on Guam.

Despite the administration's assertions, however, my regular travel through the region has convinced me that many Asian nations neither understand the rebalance nor believe that it will materially change American presence. They are well aware of America's economic weakness and budget difficulties, and are surprisingly well-versed in the mechanics of sequestration. Perhaps even more significantly, they have watched Republican and Democratic administrations in the past fail to respond to Chinese provocations, and believe that the United States has either been too encouraging of China's rise to great-power status or has been too passive as the regional balance of power begins to shift. Admittedly, these opinions are voiced mostly by smaller nations that either have territorial disputes with China or long-standing grievances against China (like Vietnam), but such impressions are not unknown even among larger allies such as Japan. While it might be going too far to say that America, and the Obama administration, now has a credibility deficit in Asia, there is little doubt that the nations of Asia are looking carefully to see if Washington's deeds match its words.

Given such concerns, then, the administration is perhaps unwittingly setting up future disappointments on the part of our friends and allies, in the sense that expectations will not be met. That, however, is rather different from judging that the current American policy is not effective. Indeed, the United States continues to observe its treaty obligations through forward presence, conducts a multitude of exercises and exchanges each year (though the degree to which those will be curtailed due to budget difficulties is something that should not be overlooked), and in general maintains its presence in the air and on the sea as it has done for decades. Whether the maintenance of this status quo operational stance is effectively responding to the ongoing changes in the region is yet another matter for consideration.

The landscape ahead

Given the confluence of several factors—unchanging US policy goals in Asia, the rise of China and its effect on the Asian security environment, and the possibility of an enhanced American approach to Asia through rebalancing—what does the future hold? On balance, it must be recognized that Asia's security environment remains relatively benign at present. Despite warning signs, there is little prospect for large-scale conflict in the near future. Moreover, the threat of terrorism, particularly in Southeast Asia, is present, but is a comparatively lesser concern than in other areas of the globe. That does not mean, however, that all trends are

¹ Leon Panetta, "Shangri-La Security Dialogue," (speech delivered in Singapore, June 2, 2012), <http://www.defense.gov/speeches/speech.aspx?speechid=1681>.

necessarily positive, nor that the risk of miscalculation or accident could not lead to the outbreak some level of armed conflict. It is in the gray areas that United States policy is most likely to be challenged in the coming years. In particular, the US must focus on two potential threats and one source of uncertainty.

The first threat is the spate of territorial disputes in the East and South China Seas. Here, China finds itself at odds with many of its neighbors, including Vietnam, the Philippines, Malaysia, Taiwan, and Japan. Already, Chinese maritime patrol vessels and fishery enforcement vessels have confronted the coast guards and navies of these nations on a regular basis. Last year, in particular, China had face-offs with the Philippines over the Scarborough Shoals and Japan over the Senkaku Islands (known by China and Taiwan as Diaoyu). The multinational dispute over the Spratly Islands has compelled the Association of Southeast Asian Nations (ASEAN) to attempt to bring the disputants to the table for a multilateral solution. Beijing has rejected this approach, and has used its influence over Cambodia to scuttle any attempt to resolve the dispute multilaterally, as evidenced by the two ASEAN summits last year. China's preferred approach is to address all territorial disputes in the South China Sea on a bilateral basis, thereby giving it much greater leverage over its negotiating partners.

Of even greater concern is the dispute over the Senkaku Islands, located just northeast of Taiwan. Ongoing tensions between China and Japan first erupted in September of last year, when the Japanese government, then under the leadership of the Democratic Party of Japan (DPJ), purchased three of the Senkakus from their private owner. The potential to exploit the large reserves of undersea oil and gas first discovered in 1968 has caused China to dispute Japan's sovereignty claims. Although Japan has administered the islands since 1972, it had refrained from nationalizing them. Spurred by then-Tokyo governor Shintaro Ishihara, the DPJ administration announced its plans to buy the islands, sparking massive protests in China, a boycott of Japanese goods, and the regular dispatch to waters around the islands of Chinese maritime patrol vessels. Since then, the Japanese Coast Guard has routinely confronted Chinese (and Taiwanese) vessels, and both sides have now sent patrol planes and fighter jets into the skies above the islands.

Japan and China are one mistake away from an incident that would dwarf the significance and fall-out of the 2001 EP-3 accident that caused a minor crisis between Washington and Beijing. The level of mistrust between the two countries, the still-bitter feelings from Japan's invasion of China during World War II, and their nascent rivalry for leadership in East Asia, would tax the efforts of diplomats charged with maintaining peace and preventing the eruption of conflict. The United States would almost certainly be dragged into any conflict between the two nations, due to our 1960 security alliance with Japan. Tokyo could call for consultations with Washington or invoke Article V of the treaty, calling on US military assistance. Either action would be seen as highly provocative and aggressive by Beijing, thereby potentially increasing the likelihood the conflict.

So far, Washington has trod a fine line with the Philippines and Japan, both treaty allies, in their disputes with China. The US government refuses to take any stance on the sovereignty questions. While supporting the status quo, it has called publically on all sides to peacefully resolve the disputes. This stance may no longer satisfy our allies if they perceive that their effective control

over disputed territory is being ceded gradually to China; nor will it suffice if American allies actually come to blows with China. Moreover, even now, Washington's unwillingness to become more involved in the territorial disputes is raising questions about the reality of the pivot to Asia and raises the risk of undermining American credibility, given the Obama administration's rhetorical emphasis on the American role in Asia.

A second major policy concern is the ongoing North Korea nuclear and ballistic missile crisis. While this is an issue separate and independent on its own merits, it is also a factor in US-China relations. After two decades of negotiation with Pyongyang, under three different paramount North Korean leaders, the United States has failed in its major policy objectives—to prevent North Korea from developing a nuclear weapons program or a ballistic missile capability. Indeed, the successful December 2012 missile launch was a significant milestone in North Korea's development of weapons of mass destruction, and erased over half a decade of its prior failures. Should the regime of new leader Kim Jong Un conduct a third nuclear test, as is widely expected, it will underscore the inability of the US to effectively influence or pressure the North.

Nor has United States policy been reassuring to our closest allies in the region, South Korea and Japan. After Pyongyang sank a South Korean naval vessel in 2010 and shelled South Korean territory the same year, Seoul made clear that any further provocation from the North would result in an overwhelming military response. However, numerous off the record comments indicated that Washington put pressure on Seoul not to respond to these provocations. In addition, the seemingly low-key US posture during North Korea's missile and nuclear tests continues to worry Japan, which consistently urges a harder line against North Korea. North Korea's steady progress towards a viable ballistic missile capability and potential weaponization of its nuclear program is of the highest concern to both our allies, but they are consistently frustrated by the United States' unwillingness to put serious pressure on North Korea or to respond to provocations.

At the same time, Washington has repeatedly turned to Beijing as the one power it believes can put real pressure on the Kim regime in order to force it to the table for meaningful nuclear talks or punish it for provocations. Washington's reliance on Beijing has been as unrealistic as its expectations for breakthroughs in its repeated negotiations with the North. While Beijing joined in the last round of United Nations (UN) sanctions in January 2013, it has a long track record of refusing to employ any meaningful leverage on its ally. Nonetheless, Washington considers China to be perhaps the most significant player in the Six Party Talks. A number of US scholars, including longtime China watchers, believe that Beijing in reality has little if any functional influence over Pyongyang; others assume that Beijing has decided that the existence of an erratic, anti-American regime in control of the northern half of the Korean Peninsula is preferable for its geopolitical goals to other alternatives.

A final area of concern and great uncertainty relates to our current economic troubles and resulting budget cuts that will have an unknown effect on the US presence in Asia. While this is of concern to America's global posture, it may have a significant effect in the Pacific, and thus, will in some way shape American relations with China. Like other administrations before it, the Obama administration emphasizes the political and economic spheres of the US-China relationship. Yet America's ability to maintain influence in that relationship comes from its global leadership, and even then, as we have seen, Washington is often loathe to put any pressure on China that might result in a negative reaction. It is of no small concern what America's

diminished economic strength means for perceptions of US leadership abroad. The political influence Washington wields is proportionate and directly related to its economic vitality and its military power. As both of those decline, then, it is natural that rising powers like China will seek to take advantage of American weakness, whether real or imagined.

A China that is more confident in its own military strength is one that will continue to press its territorial claims in an assertive manner throughout the region; this will be magnified if it assumes that America will become less able to project power in the coming years, due to budget cuts and reductions in planned expenditures that may reach up to \$1.5 trillion since 2009 and through 2023. An America that is less sure of its ability to intervene when necessary will send an unmistakable signal to allies and competitors alike that the East Asian security equilibrium may be up for grabs. Many nations will watch China's continued military modernization with trepidation, and at some point have to make uncomfortable choices about whether they can ensure their own security or need to consider some type of security-based relationship with Beijing. As a side note, a militarily weaker America will undoubtedly spur North Korea to become more aggressive as well.

Such an environment would translate, as well, into less political influence for Washington. Its voice will be less heeded in multilateral councils, such as the East Asian Summit, ASEAN Defense Ministers Meeting Plus, and the like. Our allies would take cold comfort from Washington's protestations of support, and would instead question not only our military credibility but also the wisdom of following America's political lead. It would open up a space for China to regain some of the political influence it has lost in the past several years due to its bullying behavior over maritime disputes. A Washington whose dysfunction is on public display at home and abroad cannot be expected to inspire confidence in its ability to lead.

From that perspective, our Asia policy is in no small measure hostage to our larger national strength and the soundness of our policies. All discussion of a rebalance to Asia, commitments to allies, attractiveness to potential partners, and desire for a more mature working relationship with China will come to naught under conditions of continued economic weakness, political dysfunction, and straitened military budgets.

Thank you for the opportunity to share some thoughts on our current Asia and China policy in light of the leadership change in Beijing. I look forward to your questions.

PANEL IV QUESTION AND ANSWER

VICE CHAIRMAN SHEA: Well, thank you all for your very enlightening testimony and your written comments, which will all be put in the record.

I'll start. I know, Dr. Lampton, you mentioned that there's a lot of agreement among the three of you, but that's not the point. We don't want you to have a lot of agreement. We want to figure out what the differences are. So I'm going to start with something that you say in your testimony and see if the others agree.

You say that conflicting nationalisms in Asia is the central inter-state challenge in the region. And you cite a few examples, several examples--Japan and China, North and South Korea, the Philippines and China. I personally have trouble, for example, seeing how the Philippines and China is an example of conflicting nationalism. It seems as if it's an example of a country being pushed by a larger country, a more powerful country, not for nationalistic reasons, but perhaps for resources. I don't see that as an example of conflicting nationalism.

So my question to the others--and you did say in your remarks that we need a strategy at some basic level, which I think we all agree. I am imputing from your testimony that the strategy is to somewhat mitigate these conflicting nationalisms in Asia. That should be the U.S. strategy, which, one, am I correctly interpreting your remarks, and if so, I would appreciate the comments of the other two witnesses about that.

DR. LAMPTON: Do you want me just to elaborate first?

VICE CHAIRMAN SHEA: Sure. Yes.

DR. LAMPTON: I guess what my bottom line would be, rather than dividing the region, we ought to be seeking to build economic and security structures that bring people in, and I think I gave the example of a northeast Asia security structure.

VICE CHAIRMAN SHEA: Right.

DR. LAMPTON: Although I noted North Korea is a big problem in that concept. But maybe five members, not including North Korea, might not be. Then I expressed a dubious attitude toward the Trans-Pacific Partnership in the sense that it seems to me we want to build economic structures, if we can, that include China, the United States, Japan, and Korea, the big economies. So that's aspirational.

In fact, it's not going to be easy to do. But at the strategic level what I would like to be seeing is us put more attention to how we develop structures that bring these conflicting countries together in functionally important ways, either economically or strategically. That's the impulse, but I don't underestimate the difficulty in doing that.

VICE CHAIRMAN SHEA: Thank you.

General Gregson.

LtGEN GREGSON: I would agree with the strategy part and the fact that we need one. On the grander national strategy, I tried to indicate that the military component is necessary but not sufficient. We need to pursue those things that stitch the region together, despite the sometimes bone-deep historical disputes or historical matters that cause anxiety between different countries, South Korea and Japan being one example.

We need to lead with something like that so that it puts the other things that we do into context. We have a vital economic relationship with China, as do our allies and friends. One comment from a friend over there was we need to have an economic relationship with China because if we didn't have, then we couldn't afford to buy the defense articles that you want us to buy from the United States.

So we need that. But putting it into context allows us to have those difficult conversations with China that we inevitably need to have without making that the only conversation, which then allows China to demagogue what we're doing and demagogue our presence in Asia.

VICE CHAIRMAN SHEA: Thank you.

Dr. Auslin.

DR. AUSLIN: To please the Commission, I'll be happy to disagree with Dr. Lampton.

VICE CHAIRMAN SHEA: Okay. Thank you.

[Laughter.]

DR. AUSLIN: Only for purposes of the hearing. I also don't think that the prescription in terms of looking at nationalism as a driver of inter-state tension is wrong, though I think it's often played up a little. But I think it's just, to me, maybe it's too simplistic. I think it's just a very traditional issue of a rising state that is by its very nature overwhelmingly dominant in the region.

That simply upsets all of the traditional calculations that the other polities around have been able to have for decades. You know, a weak and a divided China, a China that is trying to modernize, as it was through much of the 20th century and the first several decades of the rule of the CCP, obviously is very different from the China of today.

And so it seems to me that everything we see, the concerns, the fears, the desire for reassurance on the part of the United States, all of which is driven simply by this force, which is the rise of China. I don't think, however, that necessarily--just as a starting point, though, I don't think it then imputes something necessarily wrong to China. It is, in essence, a natural feature.

Then you can layer in policy issues, and I think that's where you do have the use of nationalism in ways that stokes conflict and creates problems. We unfortunately are rather far, I would argue—though. I agree with Professor Lampton, it would be nice to have it--but we're far from having those types of bonds of trust and workable mechanisms beyond the very low level that ASEAN provides, which we shouldn't discount, but we also can't expect will solve the traditional nation state national interest

conflicts.

VICE CHAIRMAN SHEA: Thank you very much.
Commissioner Wessel.

COMMISSIONER WESSEL: Thank you, gentlemen.

I'm ending today somewhat puzzled in that we've been talking about the rise of the new leadership and what it means. We're on the heels of a campaign last year, as you well know, that where U.S.-China issues, economic primarily, reached a fever pitch. We are looking at a backdrop of an economy that's not performing as most people would like and where China's impact on us has an impact. I mean it's a measurable impact. I'm not saying there aren't many other things such as our own debt that affect that.

Then when we look at issues such as China's military expansion of capabilities, I'm not saying they're being intrusive in areas, and then looking at many of the value issues that the U.S. has brought to the bilateral relationship, human rights being most important there, I see a policy agenda that has largely left the American people wanting. Economics, concern about military, China's military rise, and many of our basic values not being adequately pursued.

You've all talked about, and correct me if I'm wrong, you know, the engagement, the need, if you will, to manage the relationship and have correct expectations. China hasn't been responding well. We haven't, you know, patience is waning. What do we do about that? Does China--I know they don't agree with our expectations, but do they understand them? Do they understand that our system will require at some point some type of responses?

Some view TPP as an economic containment strategy. I understand, Dr. Lampton, without some key participants that may not have the effect that some want. But where I think tensions are rising, misunderstanding is rising, and management is lacking, do you see it that way? How should we be responding and changing our policies?

Dr. Auslin, do you want to start?

DR. AUSLIN: Thank you very much.

Briefly, I think in response to the question you posed, China not responding, I'm not sure why we would have expected it to respond. I mean it is a sovereign state with its own national interests. What I think we need to do is recognize that. I think we're pretty much there. If we were having this hearing three, four, or five years ago, I think the tone would be very different.

We'd be talking about a strategic partnership and what we could do and what type of mechanisms we could make. I think the bloom is off the rose, quite frankly, in a lot of ways. There are those who are happy about that and those who are not happy about it. But I think there is a reality somewhere in the middle where we just simply say things are not going to develop the way that we want them to develop.

The other question that you ask, does China understand that in the U.S., at some point our system may need some type of response? I think

we've given the signal that we really don't need some type of response. Without going too far on the "we've been pushed around" line, I think that it's probably--again, if you go back in history and you look at how hegemons or great powers have responded to rising powers, there's a great sense of confidence and frustration in great powers. This partly derives from the feeling of invulnerability, and so what the rising power does, is really annoy them, but it really can't materially harm them.

At some point that flips, and that's when things often can go very, very badly. But I would argue that our responses to all of the things that each of us individually could pick out about what we worry about with China, whether it's a satellite shutdown or it's a human rights violation or denying Kitty Hawk portage--all these different things we could add up--we don't take seriously enough because we still don't yet feel a distinct sense of threat.

So if I were China, and I look at it, then I realize there's a huge amount of leeway where the U.S. doesn't respond and shows that there really is nothing that can be done yet that would push a response; therefore it can continue along the path. I think it's the same thing, to be honest, with North Korea in many ways.

COMMISSIONER WESSEL: So are the current modalities, we talked about S&ED, I mean, again, where we really haven't changed. The "pivot" is a nice term, and we're putting in some more resources. Is it enough, and are we near a pivot point-- tipping point is a better word--in terms of what you've just described? How long would you give it before either the tension becomes unacceptable or the acquiescence becomes real?

DR. AUSLIN: Well, very briefly, I think--

COMMISSIONER WESSEL: Or is real?

DR. AUSLIN: --I don't think there is a shelf life on when it flips. I think it's what somebody does that makes it flip because the conditions of the relationship have degraded to the point that there is no longer leeway to really work an issue.

I wrote one of my columns for the Journal a few months ago called "Less Jaw-Jaw With China." And I actually think we should talk less, but make it more meaningful when we do talk. I think we're in a dialogue dependency trap where we just feel we have to get to that next dialogue. I think it's the same way we feel about North Korea, and I understand that. I'm a diplomatic historian. I understand that.

But I think it is not useful anymore, and instead we send a message by saying we'll talk when it's important and then just very briefly. To wrap up on this because you asked an important question about what do we do ultimately, what's policy, it may be too late, but I do think that there is something to be commended to a "broken windows" policy, and that is, you know, the New York broken windows policy.

VICE CHAIRMAN SHEA: James Q. Wilson.

DR. AUSLIN: Yes. Which is when things start to go bad in the neighborhood, you want to respond to the small things because it sets the

tone for a much larger environmental reaction on the part of all actors involved. We may be past that point with China, and then, of course, you say, well, what do you do when it shoots down a satellite?

But I would argue, at least in what we know openly, the lack of response has meant that the line keeps getting pushed, and at some point, we have to be willing to take the uncomfortable step of some type of short-term, negative impact on the relationship, in order, potentially, and hopefully, to put it on a more productive track.

COMMISSIONER WESSEL: Thank you.

DR. LAMPTON: Let me just say a couple of things. First of all, I agree that this could get out of control in the sense that we're now painting ships and helicopters and there's that level. This could go very far south very fast and drag people in, and so I can see scenarios that would get us in a place nobody, including the Chinese, want to be.

So I'm not unconcerned, but I did understand what Dr. Auslin said, and I agreed with it. We've got massive amounts of leeway here in the sense that this is really a very mixed relationship of competitive and cooperative elements and interdependencies and huge flows of individuals and institutions with their interests. I think that provides an enormous amount of ballast in the relationship, too. So in a funny way, I'm worried about these one-off crisis kinds of situations more than I am the structure of the relationship.

You started your observation by noting that the campaign seemed to be pretty strident--the presidential one. Actually, what struck me, it was more true in the primaries than in the general election. In the general election, the candidates seemed almost to switch positions in their presidential foreign policy debate. President Obama sounded a little more skeptical and candidate Romney actually was quite, I think laudatory would be a fair description. So, actually, I was struck by the degree to which in a meaningful way in the general election China really wasn't much of an issue. In fact, foreign policy really wasn't much of an issue, but certainly China was not. So I had the opposite reaction there.

Also, you know, it isn't that China's been totally unresponsive to everything we want, on all dimensions, all the time. It seems to me that the Chinese give us enough to keep us in the game. That seems to be a little closer to the reality. On currency, they never one day said, "we cave in, you're right, we're going to revalue," but over time they've actually revalued quite a bit. Now, we can argue is it enough, but it's not trivial. The Chinese didn't really like Libya, but they didn't veto us in the U.N. Now, Syria, they've played a less helpful role to put it mildly. On peacekeeping, China has more people in peacekeeping operations than we do. So the fact is we're in a situation where we do get something out of China we want, not to mention all the financial interdependencies that have their pluses and minuses.

There's an interesting book, it just came out about a couple of years ago from Columbia University Press, I won't bore you with it, but it

looked at public opinion polls over the last 50 years with China. What comes across is that the American people have been much more stable about their views of China basically than the discussion in this city.

If you had a trend line, the public opinion line is pretty flat. It's got its skepticisms, but it's not entirely hostile, and then you've got the discussion in Washington that has much bigger amplitude. So, I guess I'm more worried about how we manage these crises, if that's the right word, that have such downside potential, and the relationship itself doesn't seem to me in as bad a shape as maybe we think.

VICE CHAIRMAN SHEA: Commissioner Fiedler. Thank you.

COMMISSIONER WESSEL: Thank you.

COMMISSIONER FIEDLER: I don't want to get caught necessarily in good and bad, but let me paint the following picture. Most of China's neighbors are concerned. We at the Commission have probably never seen the business community in the United States as concerned about doing business in China, and you should understand I'm not a friend of the business community so--but that's what we have him for.

[Laughter.]

COMMISSIONER FIEDLER: But I have noted the increased concern and hostility towards certain Chinese acts. One can argue that the Bush administration had a policy of benign neglect. It may have been occupied with more intense crises so that the benign neglect was intentional. That made a lot of people happy. But suddenly the Obama administration is not neglecting China and is much more assertive and aggressive in articulating concerns it has, which I suspect are because of the business community's concern, and for the first time, more real concern about China's military modernization.

So what we have here is a lot of people who weren't concerned before are now more concerned. All right. Which I don't know is good or bad. Okay. It's a changed relationship, I would say. I don't want to characterize it as good or bad. But it drives different decisions and concerns. The one of treating China as, for sake of a better term, an adolescent, i.e., let's not like talk about it so publicly, they'll be insulted or angry, and we can't control their anger, has sort of evolved into we better talk about it and say straight what the problems are.

So don't you see this as kind of a maturing of the relationship as opposed to--where we're starting to do it with real issues and real ways, and I mean our military folks are concerned in a way that they haven't been concerned before? Don't you see this just as a maturing relationship and that we're maturing faster than the Chinese are on that?

LtGEN GREGSON: Let me take the duty of going first this time. I understand what you're saying, but I don't think we've learned to think clearly about this nationally. The last time we had a real clear policy and strategy was against a country that was a villain right out of central casting, the Soviet Union.

COMMISSIONER FIEDLER: That's easy, yes.

LtGEN GREGSON: Autarchic economy. They became a villain before we had to characterize them as a villain and all that. China is not the new answer for that because of the complex relationship we have with China --and you just spoke about the business thing. But we have to learn how--in my opinion, we have to learn how to articulate where we stand.

It's one thing for us to talk about theft of intellectual property and things. It's another thing when we haven't created the environment to draw business out of China with a more favorable business structure somewhere else. So it's just, as Michael said, "jaw-jaw." We definitely have not learned how to talk about China from a security point of view.

Somebody up here on the Hill--I forget who it was--but they were very critical of a number of military witnesses because they weren't able to say the word "China" in context with military capabilities. Well, you know, it's not a friend; it's not an enemy. It's a competitive relationship, but it's also cooperative. I would argue this is all the more reason why we need a clear strategy, number one, why we have forces in Asia. And you mentioned the pivot, it's a good thing, and we're resourcing it, or you did, Mr. Wessel. I disagree. I don't think we've resourced it.

I think we've announced it--

COMMISSIONER WESSEL: --resources.

LtGEN GREGSON: I think we've announced it--

COMMISSIONER WESSEL: Correct.

LtGEN GREGSON: And now we've worried our friends and allies over there where they're saying, okay, now what?

Another good reason for us to be clear about why we're in Asia is that we need to have a declared strategy about what we will do in the event of conflict and put all the caveats on it about unlikely and unthinkable, and there is no logical way to get to a conflict and all that. I agree with that.

But in the absence of a declared strategy on what we're going to do in Asia, then everybody reads the American press and reads the wrong thing out of it. You have a secret plan. It's called air-sea battle. No, we don't. And we're not in Asia to attack China. We're in Asia to defend a territory in the interest of our allies and friends, and in that lies a lot of goodness. It puts us on the side of the angels. It reassures our allies.

It doesn't make them worry about using their bases for something that they don't agree with. All those types of things. Similarly, on intellectual property, we talk about it, but we haven't made a big deal out of it. We wash back and forth on human rights. Human rights are a part of our brand. It's one of the more attractive parts of our brand. We don't need to be sticking it in somebody's eye all the time, but we need to make sure that it's understood that's where we stand. These types of things.

I think that the excuse that China is neither ally nor enemy and therefore we can't come up with a clear strategy is exactly backwards. That's the time when above all else we need a clear strategy.

COMMISSIONER FIEDLER: I agree with that. Can I just follow-up?

VICE CHAIRMAN SHEA: Sure.

COMMISSIONER FIEDLER: You all talk about resources, and are you concerned that the Chinese are going to misread our political dysfunction and problem of resources as they can get away with something? I mean, I would submit that that's a misreading of the United States, and I think that's a problem. Do you? You're talking about it a lot so you must have a similar concern.

LtGEN GREGSON: Whatever the probability is that they're going to misread us, I think it's more than zero. That argues for us being clearer on what we're trying to do.

And on the resources thing, clearly, the resources for the Defense Department are going down. We were on a road to, before sequestration, we're on a road to 246 ships, a long way away from what we think we need. Air Forces, ground forces, all that.

COMMISSIONER FIEDLER: I'm not disputing the fact we don't have resources. The question is do you actively think that encourages them to do something stupid?

LtGEN GREGSON: I don't know if it actively encourages them to do something stupid, but it doesn't deter them. There's no dissuasion there. The reason I was putting that preamble on there is that with this realignment, rebalancing, pivot, and all this stuff coming up, at least on the military component, we need to be clear about what we want to have in Asia, ends, ways, means, theory of victory, critical assumptions, all those things that go into a disciplined look at strategy, or we're going to end up with a mistake.

We're going to start drawing down willy-nilly. Everybody who's got a particular weapon system to sell is going to be postulating a problem and then postulating their system as the solution. And this is not a way to organize what we're trying to do, and it's certainly not an intelligent way to nest our military strategy within the national strategy.

To the other part of the dissuasion, there's an opportunity here for us. If we become clear on what we're doing, then that leads us to a road where we have much more extensive bilateral and multilateral training with our allies. It allows them to shape their force within their own budgetary constraints without being redundant with what we're doing. And it also sends the appropriate signal that we're stronger when we're operating together now than we used to be operating separately before.

So for many of these reasons we need to, I would argue, go through all the pain and agony to go through a disciplined process here and come up with something that's coherent.

VICE CHAIRMAN SHEA: We have to go to the next question, but Dr. Auslin, did you have something you wanted to add quickly here or--

DR. AUSLIN: I'll try to be really quick, but the discussion, I think, is important. It just seems to me I wonder, Commissioner Fiedler, if there isn't just a more fundamental mismatch here, that we really--what we impute as U.S. strategy really flows out of the alliances. I mean it's to

defend countries from attack, but the alliance structures, the mutual defense treaties, they didn't envision these island disputes. And quite frankly they really didn't envision freedom of navigation issues because there was no one else who had a navy that could impinge freedom of navigation.

So the problem I think when we talk about resourcing, and we talk about what we want to do, is we really haven't articulated what the strategy is. Would we defend Japan against some amphibious invasion as we envisioned in the 1950s? I think so. But what resources do we need to ensure that island disputes don't turn into war? Are we going to get involved in every one?

But there's a mismatch there. Whether or not that then makes China make miscalculations may be, but I think the bigger problem is on our end, that we're working from one set of assumptions, but the reality is different.

VICE CHAIRMAN SHEA: Okay. Commissioner Talent. Thank you.

COMMISSIONER TALENT: Thank you, Mr. Chairman, and you all have been discussing the subject I wanted to raise. Your last answer, Dr. Auslin, may have given a little clarity in the question I had because Dr. Lampton and General Gregson both lamented the absence of a strategy, which I agree with. I think it's more than just in the Pacific and more than just in the last few years.

I don't think the United States has ever identified what strategically it is trying to do in the world since the fall of the Berlin wall. I think that a huge part of our problem all over the world is exactly that, and it makes planning and diplomacy very difficult.

But having given you my view, you seem to say in the first part of your statement, Dr. Auslin, that we, in fact, have had a remarkably consistent set of policies in the Pacific. So I'd like you to clarify that a little bit more.

Another question I had for the General--I think he's answered it--however we end up defining the rebalancing or whatever it's called, can it be credible in the context of the very substantial decline in American military power, which you're correct, General, began to occur even before the sequester, the decline in naval shipbuilding, in particular, in a theater of the world where everybody agrees that naval power, amphibious capability, and the rest of it?

So give me a little bit more on how that undermines the credibility of whatever policy if, indeed, you think it does. Or if you think we can make up for it with artful alliances or cooperation with partners, et cetera?

And then another point I want to just get your comments on, and it's a follow-up on what Jeff asked about, adolescence and then adulthood and the rest of it. The Chinese seem terrified or angry at the possibility that we might be trying to contain them. Well, I mean what would really be wrong with at least in private conversations saying to them, look, you have

said some things and done some things which suggest you're trying to assert your view of your nationalism. We understand you're certainly entitled to that, in a way that interferes with our obligations, our partnerships, and our interests, and insofar as you're trying to do that, well, yes, frankly, we are trying to contain it because we'd rather contain it than actually have to fight you.

Now, I understand you don't want to say that. We don't want Secretary Kerry to say that in a speech, but what would be wrong with just saying that? I mean it seems to me that the next stage in this relationship needs to be one where there is some forum where people can talk honestly about it. My guess is that particularly Xi, if he's really trying to change, that new leadership might respond very well privately to that and might be looking for us to have a real frank exchange which could then go on to talking about what we might tolerate and wouldn't tolerate and what we'd do and wouldn't do.

So, if you'd comment on that, I'd appreciate it.

DR. AUSLIN: I'll start briefly. I fear the tyranny of the green, yellow and red lights here.

VICE CHAIRMAN SHEA: Don't worry. We're very relaxed here.

DR. AUSLIN: I'm trying to go quickly, and hopefully not--

COMMISSIONER TALENT: Well, I'm new, but observing the senior members, I'm beginning to understand that tyranny here is observed more in the break than--

DR. AUSLIN: Senator, you asked about the overall strategy, and I mean I would agree with you. First of all, our vision of strategy I think is historically abnormal. We always talk about grand strategy, and we always immediately, because it's what we grew up with, think of the Cold War. We think of containment, a remarkably successful strategy, which does not match most of the periods in American history when you had both a national consensus, a national commitment of the resources, and quite frankly the success that we had.

And so all we've been doing for 20 years is looking for another grand strategy, and I think we should stop thinking about grand strategies. Maybe we had one and that was right at the time so let's not worry about it. The problem I think in the Asia-Pacific, and relative to the rise of China, is that our entire posture is based on Cold War predicate, if I can use it in that sense.

The alliances we made and the force posture itself was all designed for a very core purpose of containing the Soviet Union and helping nations that were at risk of falling to communism. So it made perfect sense while that was still something we had to worry about. Since then, however, while we've had goals that I elaborated in the paper, such as maintaining freedom of navigation and supporting liberalization and open markets and the like, the question is what strategy do you actually need, particularly for the military side of things, to enforce that or to see that through?

We don't have a posture that's fit to where we can respond to all of the different changes that are happening today. Now, it would be a lot easier I think if we decided we're going to contain North Korea. I mean that we can probably do militarily. We've chosen not really--

But with China, I don't see how the professed goals that we have for a region as a whole match what we see happening in the relationship because of the issues that have been brought up--the mismatch in values, the mismatch in what seemed to be ultimate goals. I think maybe we are at the point, what Commissioner Fiedler said, of a maturity in terms of the region.

No one was, if I could put it this way, mature enough to contest freedom of navigation. No one was mature enough to potentially change, really change unilaterally, borders through taking over islands, or extract resources themselves. They can do that now or they're getting to be able to do that.

So we're at a maturity, not just maybe in terms of the own actors' perceptions of what they want, but actually in their ability to do it; therefore, we are stuck with a posture, and in many ways a mind-set, that doesn't fit this at all, even though the ultimate goals I think we still all share.

Whether or not we will have to either alter those goals or materially alter the way that we go about them is the right question. I would argue that it's not just about China, though that is the proximate cause of why we feel we don't have enough to carry out the commitments we've made.

DR. LAMPTON: This maturity idea, I think you can view it this way. I think we have had a straight discussion with China that ought to even be more emphasized--and that is that the only power that can contain China is China. For the last 30 years, before 2009, China really grew its national power very substantially and didn't create so much anxiety among its neighbors.

Then if you go to 2008, 2009, and thereafter, and suddenly China has been much less reassuring. What I tell the Chinese is you're driving everybody into the arms of a security protector. If you don't like that, then you're the ones that can change the policy by, in effect, once again restoring confidence with your smaller neighbors. Your foreign minister is shaking his hand at the Singapore foreign minister and saying you're a small country, and I'm a big country and don't forget it; it is not reassuring foreign policy.

So I think we lay the onus on China containing itself--in that sense, we're responding to demand within the region.

COMMISSIONER TALENT: But Dr. Lampton, I have to ask because this goes with this adolescence metaphor, don't you think they understand that? You're treating them as if they're like a kid that just doesn't understand how to act socially. Don't you think they know that when they shake their fingers and say those sorts of things, that that's how it's going to be taken? I mean--

DR. LAMPTON: Well--

COMMISSIONER TALENT: And if I'm wrong, tell me. I mean--

feel better than I do.

DR. LAMPTON: When we say "they," I mean we've got this society of 1.3 billion, and there are different elements in the bureaucracy, territorially, and bureaucratic interests -- all the things we know. I think what we have to do is both speak to those constructive constituencies that in some cases share, if not our views, are certainly much closer to our views. I think we have to have some rewards for better behavior.

In other words, I don't think China has fully made up its mind on all of these issues. It's not that we can determine the outcomes, but we're not irrelevant to them. So I'm just talking about putting our hands on the scales of more rather than less; let us say, there are less disruptive actors within the Chinese system.

But, of course, I think there are actors in China--I think everybody understands that-- some Chinese actors like the more assertive approach. Others in China really see that approach is, in the long-run, not consistent with China's economic interests or the role they foresee China playing.

VICE CHAIRMAN SHEA: Thank you.

We've got to move on to the next question. Commissioner

Wortzel.

COMMISSIONER WORTZEL: General Gregson, I want to thank you for introducing ends, ways and means or goals, sort of operational moves and the resources behind strategy.

The fourth paragraph of your testimony emphasizes that we need to underpin a pivot or strategic rebalance with a strategy. Unfortunately, the National Security Strategy of the United States published in 2010 says that our strategy is to develop cooperative partnerships in the region, to seek stability in the region, and to promote commerce in the region. That's right out of the NSS 2010.

It reminds me of the Three Stooges, if you remember the bit on Niagara Falls where Curly turns and chokes somebody because that's the pivot.

[Laughter.]

COMMISSIONER WORTZEL: There's nothing behind it yet or there doesn't seem to be.

LtGEN GREGSON: You and I might be the only people in the room old enough to remember.

COMMISSIONER WORTZEL: That might be.

VICE CHAIRMAN SHEA: No, I remember that routine.

COMMISSIONER WORTZEL: The Congressional Research Service in analyzing the pivot says that the strategic goals are to develop stronger regional partners, enhance their capabilities, and to develop a collective capability with partners and allies. That's pretty military. The Joint Operational Access Concept by JCS says it's going to be a component of the national strategy, which we don't have, but that it's a military operational component.

Now, the only paper here, submission testimony, that derives a strategy from actions is from Mike, Dr. Lampton. On page three, he says the strategic emphasis of the rebalance or pivot to Asia is on maintaining a balance of power in the region. That's a strategic goal. That's a reasonable one. So, one, is it adequate; and, two, if one could carry out some of the constituent components of the pivot and air-sea battle, would it be adequate to reinforce a balance of power strategy; and, three, it seems to me if you're balancing power and there's room for China, would it be more reassuring to articulate that?

LtGEN GREGSON: You raised the issue of the 2010 National Strategy, and as you know, I had a hand in writing a few papers in the Pentagon that came out titled "Strategy." But they were pretty much lists of aspirations instead of strategy. The currency of the term has been debased, and we don't do the hard ends, ways, means coherence, getting back to the question over here about resources and things.

I think dashing to the end of your comments that there's room here for a strategy that is both reassuring to a strategy properly defined that is reassuring to our allies, that is adequate, that is capable of being executed, and also contributes to lessening the anxiety of those constituencies within China that we're trying to appeal to--the business communities, the others, those types of things.

Hard to write. Yes. It might be impossible to write within the system, but somebody, private sector or something, has got to get a straw man out there and then we can start putting flesh on the bones.

DR. LAMPTON: I'd say a couple of things. One is I think if we're going to have a strategy of maintaining balance of power, we need an economic foundation that sends the message to everybody that we can do it.

And, therefore, frame it in friendly way. Our best foreign policy is going to be good domestic economic policy and including our allies' economies. I think the Chinese think we're on economic skids of sort--- that's probably the central message we're inadvertently sending. So I'm of the belief that we get our economic house in order and show good growth, and that it would help if our allies were doing that. That would be the single biggest thing we could do to elicit, let's say, a more productive environment for China to make decisions.

If I was just trying to describe the strategy, I think the strategy would say economic growth in the United States is the first central pillar of our policy. Secondly, our objective in the region is to maintain the balance of power. We're prepared to do it with our traditional allies and ourselves, but we'd rather join with China, I mean in the case of North Korea; right? China can be part of this balancing or it can be the problem. We, in fact, prefer it not be the problem. Anyway, I think the elements of the strategy are there, but it starts with the Chinese assessment of our capability, and, you know, we're not at our finest hour.

DR. AUSLIN: Commissioner Wortzel, if I can, I'd actually say we don't want a balance of power in China. But what I mean by that is

maybe not what--

COMMISSIONER WORTZEL: In Asia.

DR. AUSLIN: Yeah, Asia. Thank you. In Asia. What I mean by that is maybe not what you'd expect. I think what we actually want is a political equilibrium. Without getting too wrapped up in it, there's a difference, and there's an historical difference between balance of power and political equilibrium.

What we have today is more like a balance of power, and in many ways, the pivot or the rebalance, using the word "balance," actually is what historically you see with a balance of power. When Secretary Panetta went to Shangri-La--and I was there in the audience--and said let me tell you what the rebalance means, it means 60 percent of the Navy is going into the Pacific. I mean, you know, they are mostly there already. But still he said 60 percent of the Navy. That's a balancing, right? We see a Chinese growth in the Navy; therefore, we're going to put 60 percent in.

They get missiles. We're going to put in BMD. We got stealth. They're going to do some. We're going to put in more stealth. That's a balancing. What I think we want politically, and everything that is in I would argue American diplomatic DNA, is not a balancing. We want a political equilibrium. That's the type of relationship we talk about with China.

We want an equilibrium where people understand--where both parties or all parties understand what the rules are, what the benefits are, supposedly what the penalties will be for transgressing it--because the alternative is to do what we are now getting into the cycle of doing, which is a tit-for-tat attempt to balance.

Now, we can do that today because we have these treaty alliances from the Cold War, but they weren't designed for that. We know the problems of trying to get our allies to suddenly start balancing against China. We've been trying to do that for 20 years with the Japanese. Now, because of their own fear, they're moving towards that.

But, inherently, I'm not sure that's a healthy situation. The problem is we talk politically one way, and yet we act in a different way. We act as a balancer, and we're increasingly acting as a balancer. We talk, S&ED or these other things, as a political "equilibrium," if that's a word. It may not be, but you know what I'm saying.

VICE CHAIRMAN SHEA: Yes.

DR. AUSLIN: Yes. Looking for political equilibrium.

VICE CHAIRMAN SHEA: Right.

DR. AUSLIN: We're going to have to decide which one we want, and if we come down to the conclusion, as I would argue the pivot actually gets us towards, to say we are now a balancer in Asia. That is a very different long-term relationship than the political equilibrium that I would argue President Nixon and Secretary of State Kissinger thought they were going to introduce into Asia by bringing China into the community of nations.

And it will then determine which of the two paths get to the strategy that Senator Talent was asking, what is the strategy?

VICE CHAIRMAN SHEA: Okay. Thank you.

Chairman Reinsch.

CHAIRMAN REINSCH: I don't think I agree with that last line of analysis. That's not what I want to talk about, but it seems to me you're looking only at pieces of the puzzle, not at the whole thing. It doesn't surprise me that Panetta is going to talk about the Navy. I mean that's what his job is. There are multiple elements to the thing. If you focus only on defense, then I think you make a good point about balance, but there are other pieces.

And, in fact, I want to ask specifically about another piece. And that's the TPP, the Trans-Pacific Partnership negotiations. I'd like those of you, any of you that want to comment, to just do free verse for a minute on, one, how you see it--of course, if you don't think we have a strategy, it's hard to answer the question--how you see it fitting into our strategy?

Second and more important, how do you see the Chinese reacting to it both short-term while the construction of it is ongoing, but also long-term, assuming that it's successfully set up? When do you think they would come in or do you think that they would regard it as an adversarial action and take other steps of their own?

LtGEN GREGSON: I'll take a swing at this first and then defer to my two colleagues. The TPP potentially represents what we talk about with the liberal economic order and all the things that pertain to that. China is certainly willing to join the TPP--like we championed their accession to the WTO. I would envision under certain conditions being met we would champion China's accession to the TPP.

It's a way to improve the economic condition. It's a way to improve trade. It's a way to lead with what we're trying to do in Asia without it being presumed that we're leading with the military, with the closed fist. It's not going to go anywhere without strong national leadership here and elsewhere because if it's left to the trade negotiators, trade negotiators will do what trade negotiators do, and it will go on forever.

If we want to change the atmosphere in Asia, this is not a bad way to start to move it in the right direction.

DR. AUSLIN: Just briefly, Chairman Reinsch, I actually think the TPP is a balancing strategy. First of all, we didn't come up with it. We jumped in and then decided, as we often do, we're going to make it bigger and better; right? It was smaller, and it was a little bit more fitted, but why did we want to balance? Why is TPP balancing? Because we saw China conducting free trade agreements around the region.

Now, the Doha Round had ended. I would argue the administration did not put much of an emphasis on free trade policies for much of its first term, and in a way, this was low-hanging fruit. It was there; we could grab it and grab on to it and, of course, become the biggest player in it and bring in our friends, like Japan and Mexico and Canada. But

we did it, I think, very self-consciously to balance what we saw China doing.

And I think what you said is a really important point, the rebalance as our policy, whether it's a strategy or not, all about military or are there other parts to it? I mean I would be hard-pressed, even though I understand what our goals are, to say that our policy, come strategy in the region, is really anything more than a rebalancing attempt that is overwhelmingly military.

I don't see really anything on the political side. I understand the President and the Secretary have been more involved, and they've gone--the President has gone to the East Asian Summit, but again we're a free rider there, in essence. We're not guiding anything that's going on there. We're not promoting--we have no initiatives of our own, I would argue.

And because of the presence that we have militarily, which our friends and allies depend upon, not only do they naturally look to that when they talk to us about what are you doing in the region, I think in many ways we reflexively think about it. Despite all the outstanding work done by our diplomats, I don't think there's a lot of initiative. I think TPP itself fits into a rebalance, and it's good, and we should pursue it.

But what worries me again is that it is seen as a response; it is not coming from necessarily a strategy in which we're invoking or attempting to give life to some of our deeper values. But what I'm worried is that we see they're doing it, and we got to do it, too.

DR. LAMPTON: I'll just agree with what was said and add I think that if you look at what China's strategy was in a period before we were talking about TPP, it was ASEAN Plus 3. They were trying to build all sorts of organizations that would exclude us from the region. That was a self-conscious strategy, and I see this is as our response.

I wish we had a bigger response than these particular economies, the small TPP negotiating economies we currently are dealing with. Also, the notion that this is high standard, and then you include Vietnam? I'm not a trade expert, but I hadn't associated, until TPP, Vietnam with high trade standards. Maybe I need to be educated there.

But in any case, it gets back to that impulse of trying to build trade organizations in East Asia and Southeast Asia that include the big players. So my misgivings were not over TPP, per se, as it just didn't strike me as the players you ultimately want to hitch up with.

CHAIRMAN REINSCH: Thank you.

VICE CHAIRMAN SHEA: We have one final question for you this afternoon.

COMMISSIONER BARTHOLOMEW: Final. Wait. I have a question.

VICE CHAIRMAN SHEA: Yeah. It's your question. One final question.

COMMISSIONER BARTHOLOMEW: All right. Final.

VICE CHAIRMAN SHEA: It's going to be your question, Carolyn.

COMMISSIONER BARTHOLOMEW: All right. It's interesting to listen, but, first, again, thank you to all of you. General Gregson, thank you, in particular, for your distinguished service to our nation over many years.

As I listen to all of this, I think, well, first, some of the things that people are talking about strategy are tactics. I mean TPP is not a strategy; it's a tool. It's a tactic. And regional organizations, that's a tool. To me, it's not a strategy. But I have seen over the years that one of the reasons there has been difficulty putting together a strategy is that we can't even come to some sort of consensus on what the priorities should be.

So it's easy to say maintaining global balance of power, though even here we've had a distinction about, well, what is the balance of power or regional balance of power. How the Chinese would define that is quite different, I think, than how we would define it.

And, in fact, this Commission called several years ago for the development of an architecture for the policy because it just seems to be no matter which administration kind of ad hoc. There's a crisis, and people deal with it. There's a business transaction that somebody wants to take place, and people deal with it. And so we have not been able to do it. And I just even wonder whether the three of you, not to add all of our own, what we think the priorities should be, actually could put together a strategy that reflects the priorities that people would place?

So, Dr. Auslin, you talk about values. You know, where in the priority of what you're trying to achieve would be democracy promotion? I'm just saying this hypothetically.

Dr. Lampton, on the business, I was very pleased to hear you actually say that you thought the economic health here in the United States needs to be a significant thing that we focus on. In your statement, when you say when we're evaluating the policy, and I'm presuming that means the policy of the pivot, it should be judged by the degree of regional stability achieved, the degree to which it contributes to continued high speed economic growth in the Asia-Pacific.

Well, for some of us, it needs to be judged by how our economic growth is going here in the United States, including what's happening to the manufacturing base. So I agree completely that we need a strategy. Where I struggle a little bit more is how do we, how does anybody pull together the competing interests that there are?

General Gregson, I've been doing this, like many of us, for over 20 years now--U.S.-China policy--and I remember right after the Tiananmen Square massacre, you know, and people wanted to move forward on doing action on one front, and we kept being told by different administrations, well, we can't do anything to upset the Chinese on issue X because we need their cooperation. I'm saying this particularly, too, because it was always North Korea. We need their cooperation on North Korea.

So there were a lot of things along the way that we could have done to help shape the relationship that we didn't do. Then we ended up not

getting the cooperation that people thought we should be getting in exchange for whatever it is we're doing.

So I don't know that I have a question. It's just listening to all of this, all of these sorts of ideas that come up. Another one that I have always found troubling is when we give the Chinese government credit for doing things that they are doing which are in their own interests. Now, of course, they're doing things in their own interests, but when you're talking about what then Zoellick was talking about, responsible stakeholder, we are talking about the need for China to be cooperating in the global commons.

So, okay, on currency, they did a little bit. I would argue that they did it for their own economic reasons. So, you know, they did it, something, not enough, but they did something; but they have been woefully inadequate when it comes to Iran, Syria, North Korea. You know, how do we decide enough of where our priorities are in those interests that we can pull together and move forward on a strategy and the implementation of a strategy that reflects the interests of the United States?

It's a huge question, I know.

LtGEN GREGSON: Thank you.

COMMISSIONER BARTHOLOMEW: Yeah, I know.

LtGEN GREGSON: Of the three of us up here, I spent most of my adult life as an infantry officer so I'll dive into this political science thing here with some trepidation. It's always easier to perform the diagnosis than it is to come up with the cure. So saying, as I have been, that we need a strategy is much easier than getting all the contending interests together and finding all the trade space and actually coming up with a strategy that's not so watered down that it becomes like the things we publish before--a list of aspirations.

Secondly, I think you hit on a tendency that I think every new administration tries regardless of party, that if we accede to Chinese interests on issue A, they'll accede to our interest on issue B. And so far, I think our record is perfect; it hasn't worked.

COMMISSIONER BARTHOLOMEW: Batting zero.

LtGEN GREGSON: Yeah. The bit about North Korea shows that China is going to act in what China perceives is its own interests, and their interests in North Korea are not trivial. If they get a flood of refugees into Manchuria, that's a problem.

But it calls for--and, again, easy to say, easy to prescribe, but hard to do--it calls for a very clear and candid relationship. Speaking of North Korea, we're about to enter the usual cycle that we do. North Korea does something egregious. We say this time we're going to get tough. We're going to get another hard-hitting U.N. Security Council resolution.

North Korea's biggest danger may be their proliferation. We periodically say we're going to clamp down on their proliferation of nuclear material, dangerous weapons, all those things, and then suddenly it drifts away from our attention span, and we're back to a very unsatisfactory status quo.

How to fix all this, I don't know. It's going to take--you know, your Commission's efforts are a valuable part of the conversation. We need other conversations equally pointed going on elsewhere, I think.

DR. LAMPTON: Just to reassure you, I grew up in California. I always considered the United States part of the Asia-Pacific, and certainly growth throughout that region is what I meant and not to exclude the United States. So I think that is logical enough.

In terms of interest, the core is: China is going to do what's in its interests. The question is, does increasing interdependence with China over time change the environment in which Chinese are assessing what is in their interests? And I think our hope--hope--key--underscored word--our hope has been that as China becomes more connected like in the Middle East, and dependent on oil, dependent on sea lanes of communication, that we will increasingly share interests in how to maintain stability in the Middle East or the security of sea lanes, and so on.

Now, that's been an aspiration and I think it has undergirded the notion that over time China will have more convergent interests. But at some point--I mean trying to be objective--you have to ask, Is this proving true? I'm still willing to say the jury is still out, but all the evidence isn't pointing in the direction of the hopeful expectation.

The other way to put it is, as China gets more capabilities, will it use them to promote its interests less cooperatively and with more vigor? And so, there is a hopeful, and it probably has been the dominant line, underlying engagement-- the more China is enmeshed in this global structure of our creation, the more China is going to behave in ways that we will find, if not absolutely acceptable to us, at least we can tolerate.

But I think we're going to have to start looking at the evidence, and we should be willing to reassess that position.

VICE CHAIRMAN SHEA: Dr. Auslin, you have the final word.

DR. AUSLIN: Thank you.

Commissioner Bartholomew, as usual, you've asked the big question, and I apologize for coming to you today in, I guess, a more historical frame of mind than a policy frame of mind, but you asked a real sort of historical question. And I guess the road to recovery starts with admitting the problems. I mean we need to admit we don't have strategy. We simply don't. And then when we admit that as a nation, we can start to ask the more fundamental questions, which is what type of nation do we want to be?

It's really easy if you're Rome or Britain because you're a territorial power, and rightly or wrongly, you have to defend territory, and everything that flows from that, strategic lines of communication and everything.

We are a trading state that acts like a territorial power. But we're not a territorial power, and so we defend the sinews of the international system that are vital for what a territorial power holds, but which most trading states themselves cannot defend except on a small scale.

But we impute to that a much larger set of responsibilities to friends and allies. The problem is, let's be honest, friends and allies can never replace in the hierarchy of national interests the core interests of the United States. And that's why I think we all really stop for a second. When a Chinese general or a North Korean general or someone says are you willing to trade LA for "x", Seoul, Pyongyang, Tokyo, whatever it happens to be, because we understand that we've made commitments that made sense, especially when we were in a position of power that we had, that now have gotten us into this set of relationships that go far beyond what we initially envisioned. Partly, that's an issue of, I would argue, just relative decline in maturity of the United States as a power.

But maybe we have to get a little bit more fundamental and say are we simply a trading state? Are we some type of quasi-territorial power? What do we want to be? Until we get there, I don't think we can even begin to answer your questions.

Values, I think, are very much the long game. As we learned painfully in the past decade, we can't simply develop them willy-nilly wherever we want, and I would argue we were learning that in the 1940s in Japan as well.

So I think that the problem is we're tied to the present and the immediate exigencies of these commitments, but the goals we have go far beyond what we've thought about, the actual role we want to play and that we can play in the world.

VICE CHAIRMAN SHEA: Well, thank you, all. We have our homework to think about what role the U.S. should play in the world, but thank you very much, gentlemen, for your very fine testimony. We appreciate it.

The hearing is over.