

2014 Report to Congress of the

U.S.-China Economic and Security Review Commission



Executive Summary and Recommendations

One Hundred Thirteenth Congress
Second Session
November 2014

Printed for the use of the
U.S.-China Economic and Security Review Commission
Available via the World Wide Web: <http://www.uscc.gov>

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The Commission’s full charter <http://www.uscc.gov/about/uscc-charter> and Statutory Mandate http://www.uscc.gov/about/fact_sheet are available via the World Wide Web.

U.S.-China Economic and Security Review Commission

November 20, 2014

The Honorable Patrick Leahy
President Pro Tempore of the U.S. Senate, Washington, DC 20510

The Honorable John Boehner
Speaker of the U.S. House of Representatives, Washington, DC 20510

Dear Senator Leahy and Speaker Boehner:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to transmit the Commission's 2014 Annual Report to the Congress—the twelfth major Report presented to Congress by the Commission—pursuant to Public Law 106-398 (October 30, 2000), as amended by Public Law No. 109-108 (November 22, 2005). This Report responds to the mandate for the Commission “to monitor, investigate, and report to Congress on the national security implications of the bilateral trade and economic relationship between the United States and the People’s Republic of China.” The Commission reached a broad and bipartisan consensus on the contents of this Report, with all 12 members voting to approve and submit it to Congress.

In accordance with our mandate, this Report, which is current as of October 17, includes detailed treatment of our investigations of the areas identified by Congress for our examination and recommendation. These areas are:

- **Proliferation Practices**—The role of the People’s Republic of China in the proliferation of weapons of mass destruction and other weapons (including dual-use technologies), including actions the United States might take to encourage the People’s Republic of China to cease such practices;
- **Economic Transfers**—The qualitative and quantitative nature of the transfer of United States production activities to the People’s Republic of China, including the relocation of high technology, manufacturing, and research and development facilities, the impact of such transfers on United States national security, the adequacy of United States export control laws, and the effect of such transfers on United States economic security and employment;
- **Energy**—The effect of the large and growing economy of the People’s Republic of China on world energy supplies and the role the United States can play (including joint research and development efforts and technological assistance) in influencing the energy policy of the People’s Republic of China;
- **United States Capital Markets**—The extent of access to and use of United States capital markets by the People’s Republic of China, including whether or not existing disclosure and transparency rules are adequate to identify People’s Republic of China companies engaged in harmful activities;
- **Regional Economic and Security Impacts**—The triangular economic and security relationship among the United States, [Taiwan] and the People’s Republic of China (including the military modernization and force deployments of the People’s Republic of China aimed at [Taiwan]), the national budget of the People’s Republic of China, and the fiscal strength of the People’s Republic of China in relation to internal instability in the People’s Republic of China and the likelihood of the externalization of problems arising from such internal instability;
- **United States-China Bilateral Programs**—Science and technology programs, the degree of noncompliance by the People’s Republic of China with agreements between the United States and the People’s Republic of China on prison labor imports and intellectual property rights, and United States enforcement policies with respect to such agreements;
- **World Trade Organization Compliance**—The compliance of the People’s Republic of China with its accession agreement to the World Trade Organization (WTO); and
- **Freedom of Expression**—The implications of restrictions on speech and access to information in the People’s Republic of China for its relations with the United States in the areas of economic and security policy.

The Commission conducted seven public hearings, taking testimony from 60 witnesses that included members of Congress, the executive branch, industry, academia, think tanks and research institutions, and other experts. For each of these hearings, the Commission produced a transcript (posted on its website at www.uscc.gov). The Commission received a number of briefs by executive branch agencies, the Intelligence Community, and the Department of Defense, including classified briefings on China's military aerospace modernization, China-Russia relations, China-Middle East relations, China-North Korea relations, and China's activities in the East China Sea. The Commission is preparing a classified report to Congress on these and other topics. The Commission also received briefs by foreign diplomatic and military officials as well as U.S. and foreign nongovernmental experts.

Commissioners made official delegation visits to South Korea and Australia to hear and discuss perspectives on China and its global and regional activities. In these visits, the Commission delegation met with U.S. diplomats, host government officials, business representatives, academics, journalists, and other experts. The Commission officially requested the opportunity to visit China this year, but this request was denied by Chinese government authorities.

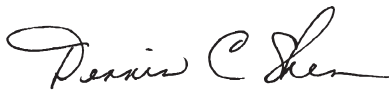
The Commission also relied substantially on the work of our excellent professional staff and supported outside research in accordance with our mandate.

The Report includes 48 recommendations for Congressional action, which appear on page 23 at the conclusion of the Executive Summary.

We offer this Report to Congress in the hope that it will be useful as an updated baseline for assessing progress and challenges in U.S.-China relations.

Thank you for the opportunity to serve. We look forward to continuing to work with you in the upcoming year to address issues of concern in the U.S.-China relationship.

Yours truly,



Dennis C. Shea
Chairman



William A. Reinsch
Vice Chairman

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Introduction

This past year, the new Chinese leadership sought to consolidate political power and keep the economy expanding at a predictable pace even if it meant shelving many of the reforms it embraced in the National People's Congress. Party leaders placed their highest priority on maintaining public support through rapid economic growth and job creation. The Party set as a goal an annual gross domestic product growth rate of 7.5 percent, and toward the end of the year, appeared to be on track to meeting that objective. While Chinese Communist Party General Secretary Xi Jinping moved more cautiously than anticipated on the economic restructuring approved by the top Party leadership in March, he acted quickly on some fronts, particularly in removing from power his political opponents as well as those opposed to his reform agenda. General Secretary Xi surprised most observers with his widely publicized campaign for fighting corruption among government and Party officials. Despite expectations some had for change, China's formula of authoritarian one-party rule and state-directed capitalism prevailed. By most accounts, Xi positioned himself to be the most powerful Party and government leader in two decades as he took direct command of the military and a strengthened internal security apparatus while installing longtime loyalists in key economic policy positions.

Although China's leaders promised to restructure its economy to one based on domestic consumption rather than fixed investment and exports, in 2014 they continued their traditional ways—borrowing heavily to stimulate the economy by building infrastructure, such as railways, highways, and oil and gas distribution systems. Rather than moving forward with the broad reform agenda proposed by General Secretary Xi when he first took office a year ago—by allowing market forces and financial liberalization to play a “decisive role” in the economy—the government continued to subsidize favored industries and maintain an artificially low value of the renminbi in order to boost exports and inhibit imports. The predictable result: Chinese government spending rose 25 percent in the first half of 2014 while the value of the renminbi tumbled and exports to the United States continued to grow. Meanwhile, the trade imbalance headed toward another record figure for 2014, likely surpassing last year's record \$318.7 billion U.S. trade deficit in goods with China.

Structural problems in China's economy persist, to the continuing detriment of China's trading partners and its own citizens. Chinese government-directed excess capacity in industries such as steel, cement, glass, construction, solar panels, and shipbuilding has unfairly harmed international competitors. The lack of opportunity for Chinese citizens to safely and productively invest their savings in the state-owned banking system or the underdeveloped

stock and bond markets or with foreign financial firms has driven China's citizens to speculate in the volatile real estate sector. State-owned banks—the primary source of commercial finance—continue to favor Chinese government-owned companies rather than private companies or entrepreneurs. Promises to provide banking customers with deposit insurance and floating interest rates remain unfulfilled.

During the course of 2014, foreign companies investing in China faced increased regulatory burdens and barriers to business dealings that do not similarly encumber China's highly favored “national champions.” China's anti-monopoly laws, in particular, appear to be focused on disadvantaging foreign invested companies rather than being applied equitably.

For the first time, in 2014, foreign direct investment (FDI) from China into the United States exceeded FDI from the United States to China. While this may spur job growth in the United States, investment by Chinese state-owned or state-controlled companies in the United States risks creating a hybrid economy where privately owned U.S.-based business must compete with Chinese state-financed companies motivated more by Beijing's policy directives than profit. Moreover, there are potential national security concerns associated with investments by Chinese state-owned or state-controlled companies in U.S. critical infrastructure.

China's cyber espionage continued unabated in 2014, despite a concerted U.S. effort since 2013 to expose and stigmatize Chinese economic espionage. In May, the U.S. Justice Department charged five Chinese military officers with cyber-theft from five U.S.-based corporations and a major international labor union. China responded to the allegations by suspending its participation in a bilateral dialogue on cyber security and by retaliating against U.S. based computer software and hardware firms. China's material incentives for continuing this activity are immense and unlikely to be altered by small-scale U.S. actions.

As expected, the 25th anniversary of the Tiananmen Square massacre was noted by Chinese dissidents and by sympathizers in Hong Kong. But it received scant attention by the Chinese government-controlled media and provoked an early crackdown on Chinese political activists in an attempt to muzzle opposition. Amid the pronouncements of coming economic, educational and social improvements, the promise of political reform was notably absent. The central government in Beijing has continued to stifle dissent through use of internal security forces, legal and extralegal measures, and media censorship. Disputes over working conditions and pay in factories, as well as farmland seizures by local and provincial governments and the subsequent sale to business interests, continue to be a source of injustice and protest.

Nevertheless, 2014 was marked by some positive developments. China's government has followed through on its promise to extend better health care and health insurance, particularly to the underserved rural population, although rural-urban inequities persist. The leadership also took the first steps to lift China's onerous residency permit system that discriminates against China's 200 million migrant workers and their families. Leaders began to implement plans for a free trade zone in Shanghai that might provide greater access to foreign financial services and health care companies.

However, many key issues remain unresolved. Market access for U.S. providers of health care goods and services remains restricted. Furthermore, increased spending has not stemmed rising costs and poor delivery in the healthcare sector, and drug safety remains a pressing concern for Chinese patients, as well as for U.S. patients who consume the drugs and drug ingredients that China exports.

During 2014, China's military modernization continued at a fast pace, creating additional challenges for the United States and its allies, and China's neighbors. Most notably, China conducted its first test of a new hypersonic missile vehicle, which could enable China to conduct kinetic strikes anywhere in the world within minutes to hours, and performed its second flight test of a new road-mobile intercontinental missile that will be able to strike the entire continental United States and could carry up to 10 independently maneuverable warheads. Meanwhile, the People's Liberation Army (PLA) increased its inventory of modern submarines, surface ships, and combat aircraft while upgrading its legacy platforms with new weapon systems.

In the maritime domain, the PLA Navy continued its transformation from a coastal force into a technologically advanced navy capable of projecting power throughout the Asia Pacific. Since the Commission's 2013 Annual Report, the PLA Navy has expanded its presence in the East and South China Seas and for the first time begun combat patrols in the Indian Ocean. Additionally, China's first aircraft carrier in January conducted its first long-distance training deployment. The nature of the deployment suggests China is experimenting with multiple types of carrier formations, including those resembling U.S. combined expeditionary groups.

China's growing confidence in its military capabilities has emboldened Beijing to aggressively advance its territorial ambitions. Since approximately 2009, China has increasingly used coercive military and economic measures to assert control over its territorial claims in the East and South China Seas. Since late 2013, however, China has been more willing to advance its sovereignty claims without seeking to justify its actions as responses to perceived provocations by rival claimants. The three most significant manifestations of this new, even more assertive turn are China's establishment of an Air Defense Identification Zone in the East China Sea; China's relocation of an oil rig to waters disputed by Vietnam in the South China Sea; and China's ongoing attempts to prevent the Philippines from resupplying its military outpost at Second Thomas Shoal in the South China Sea.

China in 2014 continued construction work on various land reclamation projects in disputed waters of the South China Sea. In addition to dredging sand to create islands where there previously were none, China appears to be expanding and upgrading military and civilian infrastructure—including radars, satellite communication equipment, antiaircraft and naval guns, helipads, and docks—on some of the islands.

Perhaps of most concern is Beijing's apparent willingness to provoke incidents at sea and in the air that could lead to a major conflict as China's maritime and air forces expand their operations beyond China's immediate periphery. China already has initiated dangerous encounters at sea on several occasions. In December 2013, a U.S. Navy ship was forced to maneuver to avoid a collision with a PLA Navy ship that had intentionally stopped in front of it. Both ships were operating in international waters. Later in 2014, a China Coast Guard ship rammed Vietnamese government ships following China's placement of a state-owned deep-sea drilling platform inside Vietnam's exclusive economic zone, and a Chinese fighter flew within 30 feet of a U.S. Navy reconnaissance aircraft in international airspace.

This pattern of unilateral Chinese actions in sensitive and disputed areas is raising tensions in the Asia Pacific and alienating many of its neighbors. China's deepening economic, diplomatic, and military influence on its geographic periphery has led its neighboring countries to reconsider their security strategies and relationships, particularly those involving the United States. As the United States seeks to reaffirm its alliances and boost its security links with associates in East Asia and Oceania, it must contend with China's competing vision of a China-led regional security architecture. This uncertain environment is further complicated by China's support for North Korea, which continues to pose the most dangerous threat to East Asian security.

Across the Taiwan Strait, Beijing continued its efforts to promote eventual unification by increasing Taiwan's economic interdependence with the mainland while expanding its ability to project military power across the Strait. Some of China's efforts met opposition, however, when more than 100,000 Taiwan citizens protested the proposed ratification of the Cross-Strait Service Trade Agreement. The protests, which came to be known as the Sunflower Movement, illustrated the growing unease in Taiwan over economic interdependence. Concerns over China's creeping influence were not limited to Taiwan, however. Hong Kong's Occupy Central and student protest movements were motivated by China's efforts to control the nomination process for the election of the chief executive. Developments there were closely monitored by Taiwan, which China has suggested might someday wish to join Hong Kong and Macau as another Special Administrative Region.

The United States has fundamental interests at stake in the evolving geopolitical situation in East Asia and the Western Pacific. China's rise as a major military power in the Asia Pacific challenges decades of air and naval dominance by the United States in a region in which Washington has substantial economic and security interests. However, as a result of China's comprehensive and rapid military modernization, the regional balance of power between China, on the one hand, and the United States and its allies and associates on the other, is shifting in China's direction.

The Commission's 2014 Annual Report examines these and other issues as part of its mandate from Congress to monitor the evolving economic and security relationship between our two countries.

Executive Summary

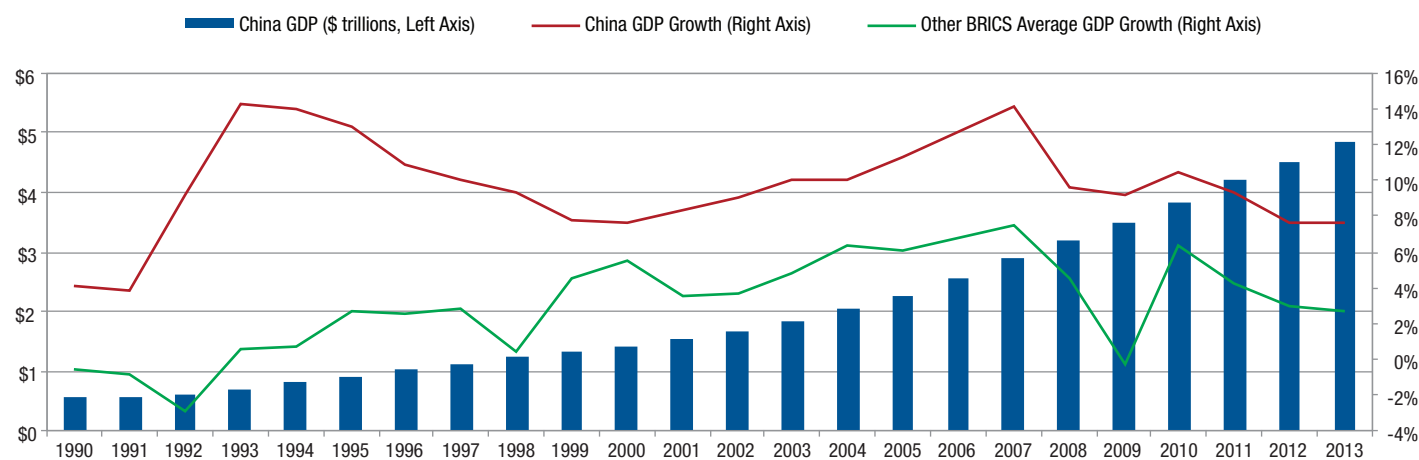
Chapter 1: U.S.-China Economic and Trade Relations

YEAR IN REVIEW: ECONOMICS AND TRADE

In 2014, China's government focused on stimulating its economy to achieve official growth targets, rather than implement substantive economic reform. Although the Chinese government pledged not to employ large-scale stimulus in 2014, Beijing implemented expansionary fiscal initiatives throughout the year, including subsidized fixed investment and exports, credit loosening, and tax incentives to bolster its economy. These measures enabled China to sustain economic growth at or near its official target rate of 7.5 percent through the first three quarters of 2014. However, the government failed to address China's underlying structural problems, such as oversupply, overcapacity, mounting local government debt, and asset bubbles that put its economy at risk of a sharp slowdown or "hard landing." In 2013, Chinese President Xi Jinping laid out a sweeping economic reform agenda during the Third Plenum of the Chinese Communist Party (CCP) to address many of China's underlying economic problems. President Xi's proposed reforms include a revised tax system, financial liberalization, and partial reform of restrictions on imports and inbound foreign investment. However, President Xi's government made minimal progress in implementing these reforms in 2014, and it remains unclear whether the Xi government will accelerate reform in 2015.

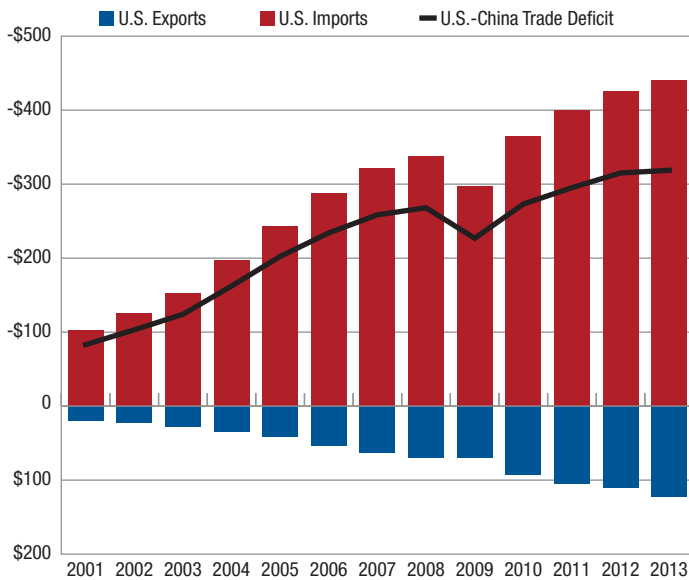
Meanwhile, China's economic imbalances—both external and internal—continue to burden the U.S. and global economies. China's dependence on exports for growth, a policy supported by an undervalued currency, has resulted in China's accumulation of record foreign currency reserves, and contributes to global trade imbalances. Despite China's economic slowdown, its exports continue to grow, and China in 2014 sustained its global trade surplus. In the first eight months of 2014, the U.S.-China trade deficit increased by 4.1 percent year-on-year to a total of \$216 billion. Domestically, the government's failure to shift the economy toward a more consumption-based growth model maintains China's overdependence on exports and investment and limits opportunities for U.S. exports to China.

FIGURE 1: CHINA'S ANNUAL GDP AND GDP GROWTH



Source: World Bank Development Indicators. "Other BRICS Average GDP Growth" is an average of the GDP growth rates of Brazil, Russia, India, and South Africa.

FIGURE 2: U.S. TRADE DEFICIT WITH CHINA (US\$ BILLIONS)



Source: U.S. Bureau of Economic Analysis.

In 2014, Chinese direct investment flows into the United States exceeded U.S. investment into China for the first time as foreign firms faced an increasingly hostile investment climate in China. According to data from China's Ministry of Commerce, foreign direct investment (FDI) into China declined 1.8 percent in the first eight months of 2014 compared to the same period in 2013. China ramped up use of its Anti-Monopoly Law against foreign firms in what appears to be unequal enforcement in order to create favorable market conditions for Chinese competitors. China used the Anti-Monopoly Law to investigate foreign firms in sectors designated by the government as "strategic and emerging," including automobiles and information technology. In addition, uneven enforcement of Chinese laws, lack of transparency, and state-run media attacks on foreign firms contributed to further deterioration of the foreign investment climate in China. At the same time, China accelerated its 2001 "go out" policy, which encourages Chinese firms to expand their global presence. In the United States, stock of Chinese FDI grew from \$1.9 billion in 2007 to \$17 billion in 2012.

Trade tensions between the United States and China escalated in 2014 as key World Trade Organization (WTO) cases advanced or were concluded and the U.S. Department of Justice filed indictments against five Chinese People's Liberation Army (PLA) soldiers for engaging in state-sponsored, cyber-enabled theft of commercial property. The WTO Dispute Resolution Panel ruled in favor of U.S. claims that China was imposing unlawful export restrictions on rare earths and antidumping and countervailing duties on U.S. automobile imports. However, several trade disputes with China remain unresolved or uncontested, including China's consistent failure to report subsidies to the WTO, localization requirements that force the transfer of U.S. technology to Chinese firms, and restricted market access in several industries.

CONCLUSIONS:

- ▶ Despite U.S. exports to China growing by 6.2 percent, imbalances in the U.S.-China trade relationship increased in the first eight months of 2014 as the trade deficit grew by 4.1 percent. China stalled on liberalizing key sectors in which the United States is competitive globally, such as services. Chinese foreign direct investment (FDI) flows into the United States grew, while U.S. FDI into China fell as foreign firms faced an increasingly hostile investment climate in China.
- ▶ Supported by government stimulus, China sustained economic growth at or near its official target rate of 7.5 percent through the first three quarters of 2014. Underlying economic problems in China, including oversupply of property and industrial overcapacity, continue to put economic growth at risk of further deceleration.
- ▶ China's chronic overcapacity, especially in sectors such as steel and solar panels, continued to harm U.S. manufacturing and exports by dumping excess supply into global markets.
- ▶ China's government made little to no progress this year in implementing the economic reforms designated by its leadership during the 2013 Third Plenum. Instead, Chinese President Xi Jinping and his leadership team focused on a broad anticorruption campaign, while using stimulus to avoid further economic slowdown.
- ▶ While disposable income and consumption have increased relative to savings, China has not yet weaned itself off its traditional investment and export-based growth model, and continues to struggle with large internal imbalances.
- ▶ China's nontransparent policymaking came under criticism at the World Trade Organization, and China obstructed progress in key trade negotiations, such as the Information Technology Agreement. China's confrontational behavior in addressing contentious territorial disputes with neighboring countries also harmed economic and trade relations in the Asia Pacific.

U.S.-CHINA BILATERAL TRADE AND ECONOMIC CHALLENGES

Since China joined the WTO in 2001, U.S.-China bilateral trade has grown exponentially, but the trading relationship has become increasingly unbalanced. In the last year, China shipped nearly four dollars' worth of goods to the United States for every dollar's worth of imports from the United States. The resulting U.S. trade deficit with China set a record for the fourth year in a row. This deficit, non-existent three decades ago, is now the largest bilateral deficit in the world—three times the size of the second largest U.S. deficit, with Japan. Americans turn primarily to China to purchase computer and communications equipment and apparel. China's main purchases from the United States, meanwhile, are oil seeds, aircraft, and waste and scrap. China thus has the benefit of selling more value-added goods to the United States, the production of which tends to employ more Chinese workers at higher pay. Meanwhile U.S. exports to China are falling short both in volume and in labor market value. As of the end of August 2014, the U.S. trade deficit with China already stood at \$216 billion, about \$8.5 billion more than the same time last year. At this pace, the 2014 deficit will reach another high.

The size of the overall trade deficit—and the bilateral trade deficit with China in particular—is a perennial source of concern in the United States about declining competitiveness, job losses, and Chinese companies' unfair trade practices. Alliance for American Manufacturing President Scott Paul is among those economists blaming the U.S. trade deficit with China for “a shrinking middle class” and “fewer good job opportunities,” and as “further proof that our economic policies—including a lack of enforcement of existing trade laws—contribute to outsourcing.” U.S. employment in some sectors, particularly the manufacturing sector, has dropped substantially as trade with China has increased. Since China joined the WTO, the United States has lost 29 percent of its manufacturing jobs, according to the U.S. Bureau of Labor Statistics, and economists have begun to establish clear correlations between this job loss and trade with China.

FIGURE 3: U.S. MANUFACTURING JOBS IN THOUSANDS, JANUARY 1978–JANUARY 2014



Source: U.S. Bureau of Labor Statistics.

The bilateral trade imbalance is driven, in large part, by China's mercantilist and state-directed policies. Although China promised extensive market reforms when it joined the WTO, it has been reluctant to implement them. Instead, the Chinese government has institutionalized preferences for state-owned enterprises and favored industries, particularly in areas designated as “strategic.” As a consequence, the United States continues to face challenges with China's WTO-illegal and trade-distorting subsidies, discrimination against U.S. goods, services, and technologies, prohibited localization requirements, and inadequate protections for intellectual property (IP), among other barriers to free trade.

The United States government uses a combination of diplomacy and enforcement tools to try to address China's unfair practices, but despite these efforts, Chinese trade violations continue and the bilateral trading relationship grows more lopsided. Unfortunately, the United States too often chooses dialogue with China over strong enforcement measures, and bilateral talks often fail to deliver much more than an expanding menu of follow-on discussions. And although the Obama Administration has significantly stepped up trade enforcement cases against China, these efforts are limited in their impact because defendants continue to rely on an array of loopholes for avoiding trade remedies.

An even bigger challenge for enforcement efforts looms ahead. In December 2016, the provision of China's WTO accession protocol that enables countries to treat China automatically as a non-market economy expires. The expiration of this WTO provision may potentially make it more difficult for the United States to levy penalty tariffs against China for dumping. This does not mean that the United States will have to recognize China as a market economy. The existing statutory test under U.S. law will still apply for purposes of determining China's status, and multiple subject matter experts testified to the Commission that China is far from meeting the criteria.

As dialogue and enforcement efforts fall short, a rapidly expanding stream of Chinese direct investment is flowing into the United States. This trend could be a boon to U.S. employment if the investments prove to be engines for job creation. However, the presence of Chinese state-owned enterprises in the United States may also pose significant competitive challenges for domestic companies, with potentially serious drawbacks for U.S. workers. Chinese investment in the United States could also create impediments for domestic industries petitioning the federal government for trade enforcement assistance, and anecdotal evidence demonstrates that state efforts to attract Chinese investment can undermine federal trade enforcement measures as well.

CONCLUSIONS:

- ▶ The United States' trade deficit with China is by far its largest, and it has grown sharply in recent years to become the single biggest bilateral deficit in the world. In 2013, it reached \$318.4 billion, setting a record for the fourth straight year, with China exporting nearly four dollars' worth of goods to the United States for every dollar's worth of imports it purchased from the United States. Even as U.S. exports to China have grown, our deficit has grown faster. This deficit is associated with declining U.S. economic competitiveness and job losses, which helps explain why 52 percent of Americans now believe that China poses a critical threat to vital future U.S. economic interests.
- ▶ U.S. employment in some sectors, particularly the manufacturing sector, has dropped substantially as trade with China has increased. Since China joined the World Trade Organization (WTO), the United States has lost 29 percent of its manufacturing jobs, according to the U.S. Bureau of Labor Statistics, and economists have begun to establish clear correlations between this job loss and the bilateral trading relationship.
- ▶ Even as U.S. manufacturing has slumped, U.S. corporations have relocated manufacturing operations to China and imports of Chinese manufactured goods have grown exponentially. As a result, the benefits of the U.S.-China trade relationship have accrued disproportionately to U.S. corporations, while most of the drawbacks have been borne by U.S. workers.
- ▶ Unfair Chinese trade practices, including market protections, subsidization, and favoritism toward certain domestic players, as well as provisions for limiting foreign investment in certain manufacturing operations, have also contributed indirectly to the ongoing decline in U.S. manufacturing employment. Although China committed to sweeping reforms when it joined the WTO, Chinese efforts to honor these commitments have slackened in the last ten years. The Chinese economy benefits from a host of policies and practices that violate the spirit, and even the letter, of Beijing's WTO commitments and harm U.S. interests. Despite a proliferation of bilateral forums for engagement, U.S. efforts to talk through these problems have consistently fallen short. Enforcement actions have increased, but the results of these efforts have been limited, and many issues remain unaddressed.
- ▶ The dominance of state-owned enterprises in the Chinese economy is one of the reasons the United States has not designated China as a market economy, despite China's active pursuit of such a designation for many years. The United States has a statutory test for determining whether an economy can be classified as a market economy. The factors to be considered under U.S. law in granting market economy status include the extent to which the country's currency is convertible, the extent to which wage rates are freely determined by negotiations between labor and management, and the extent to which the government owns or controls the means and decisions of production. Expert witnesses have testified to the Commission that China is not currently a market economy and is not on the path to become one in the near future.
- ▶ Because trade remedies are often inaccessible, they are effectively useless to smaller U.S. companies that cannot afford to pursue cases and to companies that cannot muster the threshold industry support. Available trade remedies remain inadequate and fail to account for the interests of other affected constituents, such as workers and communities; China's undervaluation of its currency, for example, continues to function as a de facto subsidy for its exports, and U.S. law still does not provide a sufficient remedy to this problem for private parties. The Administration has not been effective in getting China to change its policies. A number of U.S. petitioners have asserted claims against China's currency policy as an actionable subsidy, but the Commerce Department has refused to treat currency undervaluation as actionable under the law. Even when trade remedy cases are successful, they do not always deliver sufficient and timely relief.
- ▶ Growing Chinese investment in the United States could be a boon to U.S. employment, but the peculiarities of state influence on Chinese corporate behavior in the United States may also pose significant competitive challenges for domestic companies, with serious drawbacks for U.S. workers. Chinese investment in the United States could pose impediments to members of domestic industries petitioning the Federal Government for trade enforcement assistance, and anecdotal evidence demonstrates that state efforts to attract Chinese investment can also undermine federal trade enforcement efforts. The potential impact of inbound Chinese investment should be more thoroughly investigated and addressed.

CHINA'S HEALTH CARE INDUSTRY, DRUG SAFETY, AND MARKET ACCESS FOR U.S. MEDICAL GOODS AND SERVICES

The healthcare sector has played a marginal role in U.S.-China relations, but that is beginning to change. China has become the world's top producer of active pharmaceutical ingredients and inert substances, as well as a significant exporter of medical products. U.S. drug companies and distributors are sourcing a large share of ingredients and finished drugs from China and selling them in the United States. Concurrently, China is experiencing a major demographic and epidemiologic transition, challenging the nation's health care system. An older and wealthier population, with a rising incidence of non-communicable diseases, is seeking more frequent and better-quality treatment. U.S. companies that market drugs, medical devices, and healthcare services view China as an important opportunity.

TABLE 1: U.S. IMPORTS OF SELECT PHARMACEUTICALS, DRUG INGREDIENTS, AND VITAMINS

	1998	2003	2008	2013
Volume of Total U.S. Imports (kilograms thousands)				
Ibuprofen	415	1,492	3,017	3,837
Acetaminophen	1,488	2,291	3,040	1,941
Aspirin	2,034	4,314	4,663	4,453
Glands/organs for organotherapeutic uses	—	—	3,758	3,699
Antibiotics	8,455	5,752	6,759	8,233
Vitamin C	12,405	21,601	36,251	33,006
Vitamin D	306	583	1,195	1,246
China's Share of U.S. Imports (%)				
Ibuprofen	0.1%	6.2%	73.4%	70.3%
Acetaminophen	48.5%	65.1%	41.9%	44.7%
Aspirin	37.0%	39.7%	31.8%	28.6%
Glands/organs for organotherapeutic uses	—	—	69.4%	57.9%
Antibiotics	39.4%	26.3%	51.0%	70.4%
Vitamin C	64.7%	86.4%	90.1%	89.9%
Vitamin D	0.3%	16.5%	53.6%	83.4%

Note: HTS codes used for this table are: Ibuprofen (2916391500), acetaminophen (2924296210), aspirin (2918221000), glands and other organs for organotherapeutic uses, dried, whether or not powdered (30019001), antibiotics (all 10-digit codes under HTS 2941), vitamin C and its derivatives (2936270000), vitamins D and their derivatives (2936295020)

Source: U.S. International Trade Commission.

U.S. reliance on foreign medical products has increased substantially in the 21st century, and that trend is reflected in U.S. imports from China. The total number of shipments of products from China regulated by the Food and Drug Administration (FDA) increased from approximately 1.3 million entry lines (i.e., items such as food, drugs, and devices) in 2007 to almost 5.2 million in 2013. In a 2010 study of pharmaceutical executives, 70 percent of respondents cited China as their top source country for pharmaceutical ingredients. The United States imported over 100 million kilograms of pharmaceutical goods from China in 2013, close to a 200 percent increase over the past decade. China is a leading source of U.S. imports of vitamins, antibiotics, and nonprescription painkillers, such as ibuprofen, acetaminophen, and aspirin.

These trends are worrying because China is also a manufacturer of fake and substandard drugs. Tainted heparin, containing ingredients sourced from China, claimed at least 81 lives in the United States in 2007 and 2008. Subtler risks to consumers include inadequate dosages, fake packaging, and ingredient impurities. The Chinese government is taking preliminary steps to improve regulation of pharmaceutical production. Important measures include updating good manufacturing practices legislation in 2011 and consolidating separate regulatory agencies into the China Food and Drug Administration (CFDA) in 2013. However, China's ability to regulate its own producers is hampered by bureaucratic infighting between the CFDA and other central government agencies, as well as excessive decentralization of regulatory responsibilities to local governments. The absence of checks and balances in China's authoritarian system also makes it difficult to hold manufacturers and officials accountable.

Congress has passed new bills, such as the Food and Drug Administration Safety and Innovation Act (2012), to enhance the FDA's efforts to monitor drug safety overseas, at the border, and in the U.S. market. Using a computerized algorithm called PREDICT, U.S. drug regulators are better able to quantify the risks of individual shipments. However, U.S. consumers remain at risk. As of October 2014, the FDA had only one part-time and two full-time drug inspectors to police China's vast and fragmented drug industry. A key problem has been securing work visas from the Chinese government for additional U.S. inspectors. The issue was raised by Vice President Joe Biden on his December 2013 trip to China. But as of September 2014 these efforts had not produced any results. Behind the U.S. border, the FDA faces the challenge of implementing track-and-trace technologies and regulating wholesalers at the state level.

China's median age will exceed that of the United States within this decade, and the proportion aged 65 and above will increase to 25 percent by 2040, totaling 300 million. The incidence of diseases such as cancer and diabetes is rising, brought on not only by aging and insufficient preventive care, but also by increasing affluence, urbanization, and pollution. In response, the Chinese government is stepping up efforts to fix the country's troubled healthcare system. In addition to structural reforms, it invested more than \$371 billion into the healthcare sector between 2009 and 2012. And yet, healthcare costs are rising, hospitals are overcrowded, and patient-on-doctor violence is on the increase. The government has focused on expanding public health insurance coverage and raising fixed investment in infrastructure and machines, without addressing low pay in the medical profession or improving coordination between large hospitals and local clinics. Distorted fee schedules incentivize doctors to undersupply basic services and oversupply costly drugs and treatments.

U.S. companies keen to sell goods and services in China's healthcare sector must contend with Beijing's heavy-handed intervention in the healthcare market. Government entities run the largest hospitals and insurers, set prices, and determine which foreign drugs make it onto drug reimbursement lists. Private sector providers operate on an uneven playing field and as a result have done little to improve overall delivery. Onerous clinical trials can delay the marketing of U.S. drugs by up to eight years. Unequal access to reimbursement lists—which are seldom updated—makes some U.S. drugs expensive for Chinese patients. U.S. device makers likewise suffer from a number of regulatory hurdles that impact data protection and competitiveness.

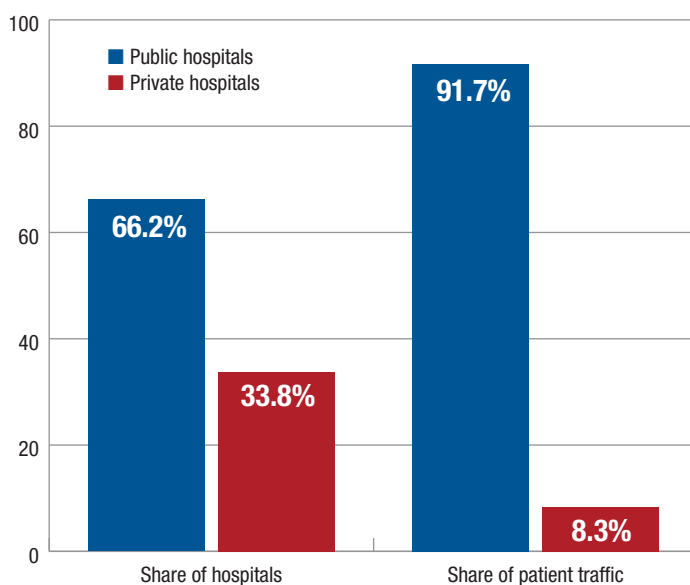
Not least of all, foreign companies are struggling to operate ethically in an authoritarian state plagued by widespread corruption. In September 2014, a secret one-day trial was held in a Chinese court to adjudicate the case of British drug maker GlaxoSmithKline, which stood accused of funneling money through a local travel agency to pay bribes to doctors in return for prescribing its drugs. GlaxoSmithKline was fined nearly half a billion dollars, the highest fine on record against a foreign company. The court also sentenced the company's British former country manager and four other company managers to prison terms of up to four years.

CONCLUSIONS:

- ▶ China today is the world's largest producer of active pharmaceutical ingredients and inert substances. In a 2010 study of pharmaceutical executives by the consulting firm Axendia, 70 percent of respondents cited China as their top source country for pharmaceutical ingredients. China's rise as a pharmaceuticals exporter has coincided with growing reliance on drug and ingredient imports in the United States, which is estimated to be the top importer of China's pharmaceutical raw materials. These trends are worrying because China, by some estimates, is also the world's top supplier of fake and substandard drugs. Tainted heparin, which contained ingredients sourced from China, claimed at least 81 lives in the United States in 2007–2008. More subtle risks of unsafe drugs include inadequate dosages of active ingredients, impure ingredients, and false packaging.
- ▶ Since 2007, the Food and Drug Administration (FDA) has taken important steps to improve drug safety regulation. In China, the FDA is expanding its team of drug inspectors, increasing the frequency of inspections, and working closely with its counterparts at the China Food and Drug Administration (CFDA). In the United States, Congressional legislation has given the agency more authority to hold companies accountable for their supply chain safety, collect user fees from companies to finance regulatory efforts, seize unsafe products at the border, and track-and-trace products via serial numbers. The agency has also transitioned to an electronic, risk-based surveillance system known as PREDICT.
- ▶ There is much work to be done to improve drug safety in the United States. Regulating China's vast drug industry, especially the production of precursor chemicals by semi-legitimate companies, is a severe challenge. China's own drug safety regulation is fragmented and decentralized and lacks civil society monitoring. The FDA's China offices have had trouble securing work visas for new inspectors and conducting unannounced factory inspections.
- ▶ Alongside its role as a pharmaceutical producer, China is undergoing an epidemiologic and demographic transition that is fundamentally changing the country's demand for healthcare. Chronic and non-communicable diseases are on the rise, due to an aging population and to a worrying decline in public health, caused by pollution, poor diet, and other factors. A more affluent and urbanized population is seeking better quality care. Some experts estimate China's healthcare spending to increase from \$357 billion in 2011 to \$1 trillion in 2020, making China the second-largest market after the United States.

- ▶ At present, China's healthcare market is ill equipped to meet the rise in demand for care. Relative to wealthier countries, doctors and hospital beds are in short supply. Healthcare spending is only 5 percent of gross domestic product, compared to an average of 9 percent in Organization for Economic Cooperation and Development countries. To remedy this situation, the Chinese government launched ambitious healthcare reforms in 2009 that aim to extend basic government-subsidized health insurance, expand the population health benefit package, strengthen primary care, control the price of essential drugs, and reform government-owned hospitals. Fiscal spending to support these reforms totaled some \$371 billion in 2009–2012.
- ▶ Not all of China's healthcare reforms have succeeded, and serious problems remain. Expanded insurance coverage has had some success in reducing rural-urban gaps and out-of-pocket spending. But the insurance coverage of migrant workers is not portable, and coverage is limited for costlier drugs and treatments. The absence of a functioning referral system has led to overcrowding in large hospitals and underutilization of local providers.
- ▶ On the supply side, most of China's public funding increases for healthcare have gone toward brick-and-mortar investments and new machines, rather than increases in doctors' salaries. Prices and fees remain subject to government interference, which incentivizes doctors to undersupply basic services and oversupply costly drugs and treatments. The net result is that hospitals are short of qualified staff and rely excessively on drug revenues, while healthcare spending is rising on the back of escalating costs rather than improvements in care. Private sector providers operate on an uneven playing field and have done little to improve overall delivery.
- ▶ U.S. companies that market drugs, medical devices, and healthcare services view China as an important opportunity, not only to source cheap inputs, but also to market goods and conduct research and development. An important impetus to focus resources on China is slowing demand and changing regulation in the United States, as well as a lack of other markets that match China in terms of market size and level of development.
- ▶ Market access for U.S. drug and device makers remains restricted. Companies are concerned about being targeted by China's recent anticorruption drive and indiscriminate use of its antimonopoly law, which ostensibly aim to lower healthcare costs but serve to disadvantage foreign companies. China's process for approving new drugs leads to excessive data transfers. Loopholes in China's intellectual property laws allow local drug makers to reproduce U.S. patent drugs prematurely. Onerous clinical trials, combined with state interference in tendering, pricing, and reimbursement, cause delays of up to eight years for state-of-the-art U.S. drugs, and make these drugs prohibitively expensive for ordinary Chinese patients. U.S. device makers are concerned as well about proposed amendments to China's Medical Device Law, published in March 2014. The amendment could impose hundreds of new requirements on foreign device makers, including indigenous standards for serial number tracking.

**FIGURE 4: PRIVATE VS. PUBLIC HOSPITALS:
SHARE OF PATIENT TRAFFIC, 2010**

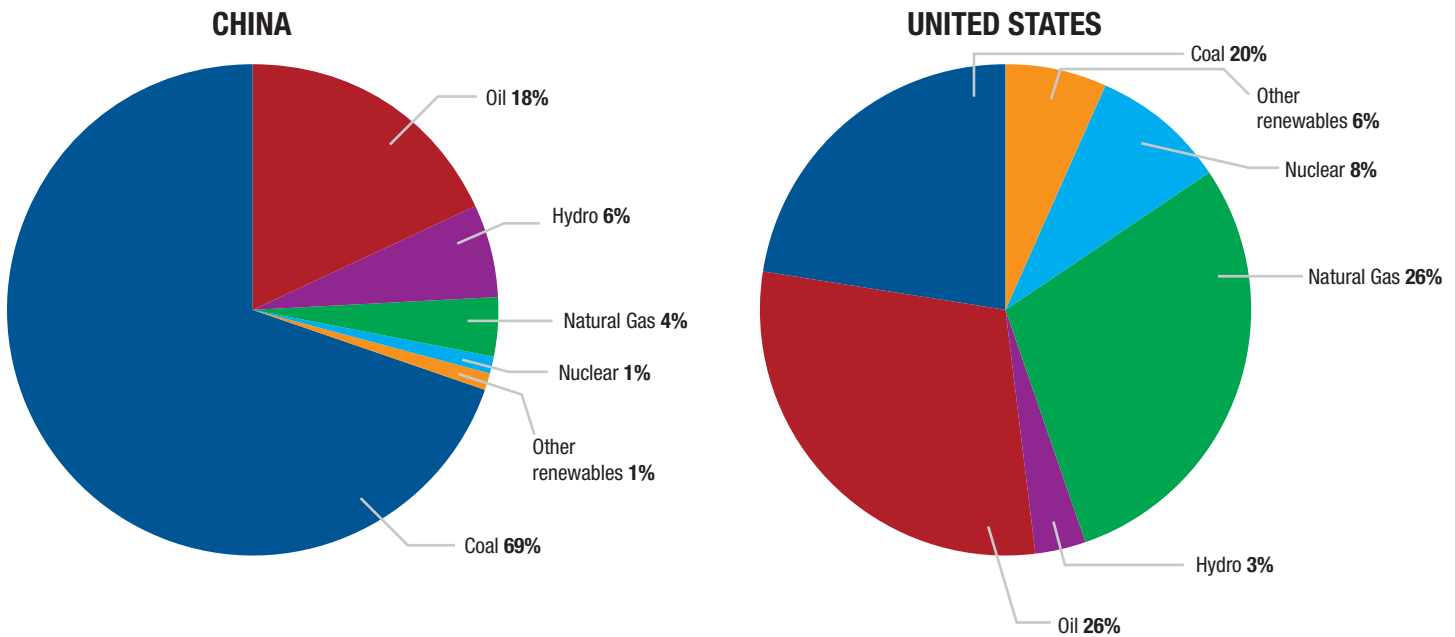


Source: J.P. Morgan.

U.S.-CHINA CLEAN ENERGY COOPERATION

The United States and China lead in global energy consumption and rely on abundant domestic coal resources to provide energy, which results in high levels of carbon dioxide (CO₂) emissions. China is the world's largest emitter of CO₂, followed by the United States, and their joint efforts are necessary for successful global reduction of emissions. Both countries are investing in renewable resources, such as wind and solar, while at the same time both countries are also working on increasing efficiencies and reducing pollution by making conventional energy sources, such as natural gas and coal, cleaner. At the June 2008 Strategic and Economic Dialogue, the United States and China signed the Ten Year Framework on Energy and Environmental Cooperation, establishing goals for cooperation on clean electricity, clean water, clean air, efficient transportation, and forest conservation. During a November 2009 trip to Beijing, President Obama used this framework as the basis for establishing a number of initiatives to enhance U.S.-China cooperation on clean energy.

FIGURE 5: TOTAL ENERGY CONSUMPTION BY TYPE, 2011



Source: U.S. Energy Information Administration, *International Energy Statistics*.

The U.S.-China Clean Energy Research Center (CERC) is the most ambitious U.S.-China program for joint research and clean energy development to come out of the November 2009 meeting between President Obama and President Hu. As part of the program, the U.S. Department of Energy awarded grants to research teams led by West Virginia University on clean coal, the University of Michigan on clean vehicles, and Lawrence Berkeley National Laboratory on building energy efficiency. These U.S. teams conduct joint research with Chinese teams led by Huazhong University of Science and Technology on clean coal, Tsinghua University on clean vehicles, and the Ministry of Housing and Urban-Rural Development on building energy efficiency. CERC is funded in equal parts by the United States and China, with each consortium allocating a budget of \$50 million for the first five years (\$25 million provided by the national governments matched by \$25 million from industry, universities, research institutions, and other stakeholders). The nature of CERC's work is collaborative, with several participants (academic, industry, or a combination) working on each project at the same time. As of July 2014, CERC consisted of 75 individual projects within its three consortia, of which 58 were joint efforts.

One of CERC's unique features is its Technology Management Plan (TMP), which was created to address IP concerns associated with joint research and development activities. While the TMP does not add any new IP protections that the law does not otherwise provide, TMP establishes a framework to manage any IP developed under the umbrella of CERC. However, to date, most CERC participants still tend to design collaborative projects only around less sensitive research topics, and little of the new IP generated through CERC activities has come from collaborative efforts—an indication that China's history of poor IP protection continues to have a chilling effect on cooperation.

Keen on reducing its reliance on coal, the Chinese government has been investing in nuclear energy and natural gas. However, China lacks knowledge necessary to develop indigenous nuclear technology or to tap its massive reserves of shale gas. Instead, China has sought to acquire the necessary expertise through cooperation with foreign governments and companies. The United States and China are already working together in both governmental and private capacities. However, commercial activities remain the predominant channel for information sharing and technology transfer in the shale gas sector and in the nuclear energy sector. Because U.S. companies are valuable sources of information on fracking technology for Chinese oil companies, Chinese investment in the U.S. shale gas sector has been on the rise. In 2013 alone, China invested \$3.2 billion in the U.S. energy sector. However, the success of Chinese investors in the United States points to a troubling lack of reciprocity: While Chinese companies can freely acquire assets in U.S. oil and natural gas companies, the Chinese government prohibits foreign companies from doing the same, forcing them instead to form partnerships with Chinese entities. The situation is similar when it comes to civil nuclear energy. The United States and China have cooperated for nearly 30 years, although for most of its history, the cooperation has focused primarily on strengthening nuclear safety. More recently, transfer of technology through commercial engagement came to dominate U.S.-China nuclear cooperation. In 2007, U.S.-based Westinghouse (owned by Toshiba Corp.) won the contract to build four AP1000 nuclear reactors in China. The deal included a technology transfer agreement that allowed China's State Nuclear Power Technology Corp., directly under China's State Council, to receive over 75,000 documents that relate to the construction of the AP1000 reactors.

To the extent that China's investment in clean energy leads to reduced emissions of CO₂ and other pollutants, U.S. public and private cooperation with China on development of clean energy has positive outcomes for all nations. China is a global leader in clean energy investment, and Chinese funding could be used to boost technologies that are not cost effective in the short run. China's lack of strong IP standards and potential for future competition with U.S. renewable energy companies remain primary challenges to closer cooperation. Analysts and policymakers continue to fear that China could reap the benefits of cooperation at the expense of U.S. industry and workers.

CONCLUSIONS:

- ▶ The United States and China share similar challenges in their quest for clean energy. Both countries are leading global emitters of greenhouse gasses and could benefit from cooperation on issues related to climate change and environmental protection.
- ▶ The United States and China have been cooperating for over 30 years on environmental and clean energy initiatives, with much of the early agreements focusing more on establishing the basic frameworks for cooperation and on energy policy discussions. In the 2000s, clean energy and climate change mitigation emerged as leading topics of cooperation between China and the United States, culminating in 2009 with the establishment of the Clean Energy Research Center (CERC), a joint research initiative.
- ▶ The CERC facilitates joint research and development on clean energy technology by teams of scientists and engineers from the United States and China. Funded in equal parts by the United States and China, CERC has participation from universities, research institutions and industry. CERC's three research priorities (the consortia) are advanced clean coal technologies; clean vehicles; and building energy efficiency.
- ▶ While Chinese CERC participants have been filing patents in China and in the United States, to date there have been no jointly-created intellectual property (IP) and no U.S. inventions patented in China, suggesting that China's history of lax protection of IP dampens enthusiasm for collaboration.
- ▶ While collaboration under CERC is research-driven, U.S.-China cooperation on shale gas development is more commercial, largely involving investment by Chinese companies in U.S. shale assets in order to acquire technology and know-how.
- ▶ Similar to shale gas, U.S.-China cooperation on civil nuclear energy involves a sale of technology to China, supplemented by nuclear safety, safeguards, and security training to Chinese regulators and technicians to ensure China meets the highest nuclear safety and nonproliferation standards.

Chapter 2: Military and Security Issues Involving China

YEAR IN REVIEW: SECURITY AND FOREIGN AFFAIRS

Although it is still early in his administration, General Secretary Xi appears to have consolidated a high degree of control over China's security and foreign policy-making processes in his first two years in power. His proactive—and sometimes aggressive—approach to security and foreign affairs has been a hallmark of his tenure thus far. In fact, China's Foreign Minister remarked in a high-profile press conference in March 2014 that “‘active’ is the most salient feature” of China's diplomacy under the Xi Administration. President Xi has emphasized “peripheral diplomacy” and in the past year has announced several ambitious projects to link China with its continental and maritime neighbors, including a Silk Road Economic Route across Eurasia, a 21st Century Maritime Silk Road through the Indo-Pacific, and a Bangladesh-China-India-Myanmar Economic Corridor. In addition, the PLA increased its global footprint in 2014, continuing its counterpiracy operations in the Gulf of Aden, conducting humanitarian assistance and disaster relief operations in the aftermath of Typhoon Haiyan in the Philippines, and participating in regional search and rescue operations following the disappearance of Malaysia Airlines Flight 370. The PLA also participated in more exercises and drills with foreign militaries in 2014 than in any previous year since 2005, and participated for the first time in the U.S.-led multinational Rim of the Pacific exercise.

Beijing's efforts to cultivate positive relations with peripheral countries were overshadowed, however, by its increasingly bold and coercive actions toward its maritime neighbors. Although China's assertive approach to its maritime territorial disputes has been ongoing since approximately 2009, the past year saw several worrying new developments. First, China in late 2013 established an Air Defense Identification Zone over islands and waters in the East China Sea contested by Japan. Not only did this ratchet up already-simmering tensions between Beijing and Tokyo over the dispute, but it led to dangerous air encounters between Chinese and Japanese military aircraft. In May 2014, China sparked widespread protests in Vietnam (and attracted criticism from the international community) when it moved an oil rig into Vietnam's exclusive economic zone.* The rig was accompanied by dozens of Chinese fishing, Coast Guard, and naval vessels, and clashes between these and Vietnamese boats injured dozens of Vietnamese fishermen and sunk a Vietnamese fishing boat. Starting in March 2014, the China Coast Guard began to disrupt access by the Philippines to one of its naval outposts in the South China Sea in an apparent effort to weaken Manila's control

* According to the United Nations Convention on the Law of the Sea, a coastal state is entitled to an exclusive economic zone, a 200-nautical mile zone extending from the coastline of its mainland and from the coastline of any territorial land features. Within this zone, the state enjoys “sovereign rights” for economic exploitation (such as oil and natural gas exploration and exploitation), but not full sovereignty. United Nations Convention on the Law of the Sea, “Article 56: Rights, Jurisdiction, and Duties of the Coastal State in the Exclusive Economic Zone.” http://www.un.org/depts/los/convention_agreements/texts/unclos/part5.htm; United Nations Convention on the Law of the Sea, “Article 121: Regime of Islands.” http://www.un.org/depts/los/convention_agreements/texts/unclos/part8.htm.

over contested parts of the Spratly Islands. And finally, in an effort to augment its own presence in the Spratly Islands, China ramped up land reclamation projects on at least five reefs, several of which now appear to feature robust civilian and military infrastructure including radars, satellite communication equipment, antiaircraft and naval guns, helipads, docks, and potentially an airstrip.

FIGURE 6: CHINA'S LAND RECLAMATION ACTIVITIES AT JOHNSON SOUTH REEF, MARCH 2012–MARCH 2014



Photographs of China's land reclamation activities on Johnson South Reef taken in March 2012, February 2013, February 2014, and March 2014. Image adapted from Pia Lee-Brago, "Photos Reveal Stages of China Reclamation at Reef," *Philippine Star*, May 16, 2014. <http://www.philstar.com/headlines/2014/05/16/1323659/photos-reveal-stages-china-reclamation-reef>.

With a few exceptions, the U.S.-China security relationship deteriorated in 2014 as well. Turmoil in the East and South China Seas was a key driver of this downturn in bilateral relations, not least of all because two of the countries embroiled in territorial disputes with China – Japan and the Philippines – are U.S. treaty allies. In addition, Chinese military aircraft and vessels have on several occasions since late 2013 confronted U.S. military aircraft and ships in East Asia's air and maritime commons. On each of these occasions, Chinese military personnel engaged in unsafe, unprofessional, and aggressive behavior that could have resulted in the loss of life or a major political crisis. China's decision to send an uninvited intelligence collection ship to spy on the U.S.-led Rim of the Pacific exercise also was inappropriate, and undermined the spirit of cooperation and transparency that the exercise sought to cultivate. It is becoming clear that President Xi's government is willing to cause a much higher level of tension in the bilateral relationship than past administrations have. Unfortunately, China's pursuit of a more confrontational relationship with the United States likely will persist.

CONCLUSIONS:

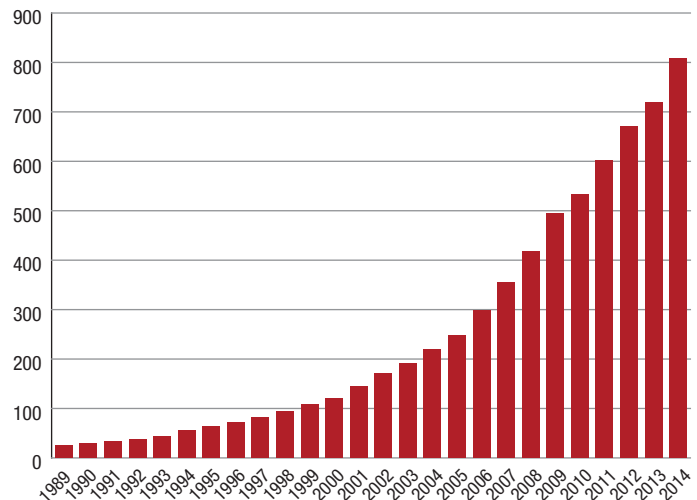
- ▶ China has been aggressively advancing its security interests in East Asia. This has led to tension, confrontation, and near-crises with its neighbors and the United States and has fueled competition with the United States that increasingly appears to be devolving into a zero-sum rivalry. A central characteristic of this pattern is Beijing's effort to force the United States to choose between abandoning its East Asian allies to appease China and facing potential conflict with Beijing by protecting its allies from China's steady encroachment. China's pattern of behavior is likely to persist.
- ▶ China's People's Liberation Army has undertaken provocative, aggressive, and dangerous behavior aimed at the U.S. military in maritime East Asia, which creates the risk of misperception, miscalculation, escalation, and loss of life.
- ▶ Having rapidly consolidated power, Chinese President Xi Jinping appears to have achieved a higher degree of control over China's national security and foreign policy than his predecessor and is pursuing a more active role for China in regional and international affairs. President Xi's proposed regional arrangements, the Silk Road Economic Belt, 21st Century Maritime Silk Road, and Bangladesh-China-India-Myanmar Economic Corridor, are designed to project a positive and "responsible" image of China to the region and the world, develop trade routes, and gain access to natural resources. These initiatives, couched in terms of cooperation and friendship, belie China's increasingly strident efforts to intimidate and coerce many of its neighbors.
- ▶ China's territorial dispute with Japan remains one of the region's most dangerous flashpoints. China's declaration of an Air Defense Identification Zone over contested waters in the East China Sea in late 2013 ratcheted up tensions with Japan and created an unsafe and unpredictable air environment in the region. On two occasions in 2014, Chinese and Japanese military aircraft activity in China's Air Defense Identification Zone led to close encounters which could have resulted in an accident and loss of life.
- ▶ China moved aggressively in asserting its claims in the South China Sea in 2014, using unilateral and destabilizing actions to advance its territorial ambitions. In March, it began attempts to block access to a Philippine military outpost in the South China Sea, Second Thomas Shoal. In May, it moved an oil rig into Vietnam's exclusive economic zone. Throughout the year, it continued work on various land reclamation projects in the South China Sea, including building military facilities on Fiery Cross Reef and potentially Johnson South Reef in the Spratly Islands. China's actions have introduced greater instability to the region and violate China's 2002 agreement with the Association of Southeast Asian Nations, which stipulates that all claimants should "exercise self-restraint in the conduct of activities that would complicate or escalate disputes and affect peace and stability."

- ▶ China's People's Liberation Army participated in more exercises and drills with foreign militaries in 2014 than in any previous year since 2005. In particular, China's participation in the U.S.-led Rim of the Pacific exercise illustrated the People's Liberation Army's intent to increase its participation in regional and global security affairs. However, China's decision to send an uninvited intelligence collection ship to the exercise seemed to belie its rhetoric of peaceful cooperation with its neighbors.
- ▶ Due largely to institutional and training reforms over the last decade, China's People's Liberation Army now is able to maintain higher day-to-day readiness rates and conduct longer-range and more frequent, robust, and realistic training. As these reforms continue, the Chinese military gradually will become more proficient and confident operating its advanced weapons, platforms, and systems and conducting large-scale, sophisticated operations.
- ▶ China's naval operations within weapons range of U.S. bases and operating areas in the Indian Ocean region will become more frequent as China expands and modernizes its fleet of submarines and surface combatants. However, the Chinese navy in the near term likely will not seek to develop the ability to establish sea control or sustain combat operations in the Indian Ocean against a modern navy.

CHINA'S MILITARY MODERNIZATION

China's rapid economic growth has enabled it to provide consistent and sizeable increases to the PLA budget to support its military modernization and its gradually expanding missions. China's announced official projected defense budget increased from RMB 720 billion (approximately \$119.5 billion) in 2013 to RMB 808 billion (approximately \$131.6 billion) in 2014, a 12.2 percent increase. With the exception of 2010, China's official defense budget has increased in nominal terms by double-digits every year since 1989. China's actual aggregate defense spending is higher than the officially announced budget due to Beijing's omission of major defense-related expenditures—such as purchases of advanced weapons, research and development programs, and local government support to the PLA—from its official figures.

FIGURE 7. CHINA'S ANNOUNCED OFFICIAL DEFENSE BUDGET (RENMINBI, BILLIONS), 1989–2014



Note: These numbers represent China's announced official defense budgets, not actual aggregate defense spending. They do not account for inflation or appreciation in the value of China's currency.

This figure reflects Commission judgments based on several sources. Each provides data for part of the period 1989–2014. The most recent source is used when these sources disagree. For 1989–93, David Shambaugh, *Modernizing China's Military: Progress, Problems, and Prospects* (Berkeley, CA: University of California Press, 2002), p. 189; for 1994–2001, Dennis J. Blasko et al., *Defense-Related Spending in China: A Preliminary Analysis and Comparison with American Equivalents* (The United States - China Policy Foundation, 2007), p. 19. <http://www.uscpf.org/v2/pdf/defense-report.pdf>; for 2002–12, Andrew Erickson and Adam Liff, "Demystifying China's Defense Spending: Less Mysterious in the Aggregate," *China Quarterly* (December 2013): 805–830; for 2013, Jeremy Page, "China Raises Defense Spending 12.2% for 2014," *Wall Street Journal*, March 5, 2014. <http://online.wsj.com/articles/SB10001424052702304732804579421021045941010>. Michael Forsythe and Henry Sanderson, "China Boosts Defense Spending as Military Modernizes Arsenal," *Bloomberg*, March 5, 2013. <http://www.bloomberg.com/news/2013-03-05/china-boosts-defense-spending-as-military-modernizes-its-arsenal.html>; and for 2014, Andrew Erickson and Adam Liff, "The Budget This Time: Taking the Measure of China's Defense Spending," *Asan Forum* 2:2 (March–April 2014). <http://www.theasanforum.org/the-budget-this-time-taking-the-measure-of-chinas-defense-spending/>.

In the late 1990s, China's leaders began to take concrete steps to strengthen the country's defense industry. Although the PLA has not fully overcome its dependence on foreign suppliers, China since then has increased the size and capacity of several defense sectors in support of the PLA's equipment modernization plans. In particular, China has made progress in its missile sector and now is able to rapidly develop and produce a diverse array of advanced ballistic and cruise missiles. China maintains the largest and most lethal short-range ballistic missile force in the world; fielded the world's first antiship ballistic missile in 2010; deployed its military's first long-range, air-launched land-attack cruise missile in 2012; and will widely deploy its military's first indigenous advanced, long-range submarine-launched antiship missile in the next few years, if it has not already. In 2014, China conducted its first test of a new hypersonic missile vehicle, which can conduct kinetic strikes anywhere in the world within minutes to hours, and performed its second flight test of a new road-mobile intercontinental missile that will be able to strike the entire continental United States and could carry up to 10 independently maneuverable warheads.

In the maritime domain, China in 2014 continued its transformation from a coastal force into a technologically advanced navy capable of projecting power throughout the Asia Pacific. Since the Commission's 2013 Annual Report, the PLA Navy has expanded its presence in the East and South China Seas and for the first time begun combat patrols in the Indian Ocean. Additionally, China's first aircraft carrier in January conducted its first long-distance training deployment. The nature of the deployment suggests China is experimenting with multiple types of carrier formations, including those resembling U.S. combined expeditionary groups.

Regarding China's nuclear forces, high-confidence assessments of the numbers of Chinese nuclear-capable ballistic missiles and nuclear warheads are not possible due to China's lack of transparency about its nuclear program. The Department of Defense (DoD) has not released detailed information on China's nuclear program, only noting in 2013 that "China's nuclear arsenal currently consists of approximately 50–75 intercontinental ballistic missiles," and that "the number of Chinese intercontinental missile nuclear warheads capable of reaching the United States could expand to well over 100 within the next 15 years." DoD has not provided an unclassified estimate of China's nuclear warhead stockpile since 2006, when the Defense Intelligence Agency said China had more than 100 nuclear warheads. Estimates of China's nuclear forces and nuclear capabilities by nongovernmental experts and foreign governments tend to be higher. Despite the uncertainty surrounding China's stockpiles of nuclear missiles and nuclear warheads, it is clear China's nuclear forces over the next three to five years will expand considerably and become more lethal and survivable with the fielding of additional road-mobile nuclear missiles; as many as five nuclear-powered ballistic missile submarines, each of which can carry 12 sea-launched intercontinental-range ballistic missiles; and intercontinental ballistic missiles armed with multiple independently targetable reentry vehicles.

In space, China in 2014 continued to pursue a broad counterspace program to challenge U.S. information superiority in a conflict and disrupt or destroy U.S. satellites if necessary. Beijing also likely calculates its growing space warfare capabilities will enhance its strategic deterrent as well as allow China to coerce the United States and other countries into not interfering with China militarily. Based on the number and diversity of China's existing and developmental counterspace capabilities, China probably will be able to hold at risk U.S. national security satellites in every orbital regime in the next five to ten years.

China's rapid military modernization is altering the military balance of power in the Asia Pacific in ways that could engender destabilizing security competition between other major nearby countries, such as Japan and India, and exacerbate regional hotspots such as Taiwan, the Korean Peninsula, the East China Sea, and the South China Sea. Moreover, China's growing antiaccess/area denial capabilities increasingly will challenge the ability of the United States to deter regional conflicts, defend longtime regional allies and partners, and maintain open and secure access to the air and maritime commons in the Asia Pacific. While the United States currently has the world's most capable navy, its surface firepower is concentrated in aircraft carrier task forces. China is pursuing a missile-centric strategy with the purpose of holding U.S. aircraft carriers at high risk if they operate in China's near seas and thereby hinder their access to those waters in the event of a crisis. Given China's growing navy and the U.S. Navy's planned decline in the size of its fleet, the balance of power and presence in the region is shifting in China's direction. By 2020, China could have as many as 351 submarines and missile-equipped surface ships in the Asia Pacific. By comparison, the U.S. Navy, budget permitting, plans to have 67 submarines and surface ships stationed in or forward deployed to the region in 2020, a modest increase from 50 in 2014. Furthermore, Frank Kendall, undersecretary of defense for acquisition, technology, and logistics, testified to the House Armed Services Committee in January 2014 that concerning "technological superiority, DoD is being challenged in ways that I have not seen for decades, particularly in the Asia Pacific region. . . . Technological superiority is not assured and we cannot be complacent about our posture."

China's rise as a major military power challenges decades of air and naval dominance by the United States in a region in which Washington has substantial economic and security interests.

CONCLUSIONS:

- ▶ As a result of China's comprehensive and rapid military modernization, the regional balance of power between China, on the one hand, and the United States and its allies and associates on the other, is shifting in China's direction.
- ▶ China's accelerated military modernization program has been enabled by China's rapid economic growth; reliable and generous increases to the People's Liberation Army's (PLA's) budget; gradual improvements to China's defense industrial base; and China's acquisition and assimilation of foreign technologies—especially from Russia, Europe, and the United States—through both purchase and theft.

- ▶ Since 2000, China has significantly upgraded the quality of its air and maritime forces as well as expanded the types of platforms it operates. Together with the fielding of robust command, control, communication, computers, intelligence, surveillance and reconnaissance capabilities, these improvements have increased China's ability to challenge the United States and its allies and partners for air and maritime superiority in the Asia Pacific. China's power projection capability will grow rapidly between now and 2020 with the addition of up to approximately 60 new submarines and surface ships; China's first carrier-based aviation wing and second aircraft carrier; and 600 new modern combat aircraft, including China's first fifth-generation fighters.
- ▶ After over a decade of research, development, and production, many of China's regional strike capabilities have matured. China's ballistic and cruise missiles have the potential to provide the PLA with a decisive military advantage in the event of a regional conflict and are contributing to a growing imbalance in the regional security dynamic. China now is able to threaten U.S. bases and operating areas throughout the Asia Pacific, including those that it previously could not reach with conventional weapons, such as U.S. forces on Guam.
- ▶ China's nuclear force will rapidly expand and modernize over the next five years, providing Beijing with a more extensive range of military and foreign policy options and potentially weakening U.S. extended deterrence, particularly with respect to Japan.
- ▶ China is becoming one of the world's preeminent space powers after decades of high prioritization and steady investment from Chinese leaders, indigenous research and development, and a significant effort to acquire and assimilate foreign technologies, especially from the United States. Qualitatively, China now produces near-state-of-the-art space systems for certain applications, such as intelligence, surveillance, and reconnaissance satellites to support China's long-range cruise missiles. Quantitatively, China's numerous active programs continue to increase its inventory of satellites and other space assets.
- ▶ Based on the number and diversity of China's existing and developmental counterspace capabilities, China likely will be able to hold at risk U.S. national security satellites in every orbital regime in the next five to ten years.
- ▶ Fundamental U.S. interests are at stake in the evolving geopolitical situation in East Asia and the Western Pacific. China's rise as a major military power in the Asia Pacific challenges decades of air and naval dominance by the United States in a region in which Washington has substantial economic and security interests.

CHINA'S DOMESTIC STABILITY

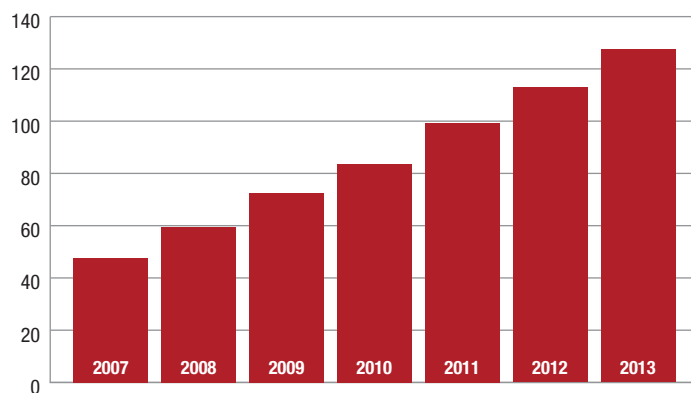
Twenty-five years after the Tiananmen Square massacre, many of the underlying causes of unrest persist, leading to hundreds of thousands of localized protests each year. The most common sources of dissatisfaction in China are land seizures and labor disputes. Other social issues that contribute to the rising levels of unrest include unemployment, the urban-rural divide, religious repression, environmental degradation, and corruption. Heightened public awareness combined with the growth of Internet connectivity and social media have helped citizens to organize protests and to air grievances. In response, the Chinese leadership attempts to suppress and censor most protests to prevent a sudden national movement capable of toppling the CCP. The limited legal channels available for Chinese citizens to seek redress for their grievances, such as petitioning and lawsuits, are mostly ineffective and often serve to encourage further unrest rather than resolve citizen complaints.

Over the past year, ethnic unrest in the Xinjiang Uyghur Autonomous Region has intensified with major attacks against civilians by militant Uyghur separatists. Uyghur militants also have demonstrated their capacity to attack outside Xinjiang. Chinese internal security forces' increasingly harsh response to ethnic unrest and tightened restrictions on Uyghur minorities' political, religious, and cultural expression and freedom of movement have contributed to growing radicalization of disenfranchised Uyghurs within Xinjiang. Such responses have resulted in greater conflict between Uyghurs and the government and Han Chinese.

The Chinese leadership has historically maintained domestic stability by relying on internal security forces and closely monitoring unrest. President Xi has centralized China's stability maintenance apparatus by chairing two new policymaking bodies on domestic security and the Internet. In addition, President Xi has implemented a wide reaching campaign against outspoken dissidents and advocates calling for reform under Chinese law. China's three main internal security forces over the last decade have expanded capabilities, allowing for faster, more robust, and more lethal responses to sudden outbreaks of unrest. The Chinese government's announced public security spending in 2013 was approximately RMB 778.7 billion (about \$127.4 billion), exceeding national defense spending for the fourth year in a row.

China's information controls also have been tightened since President Xi took office, particularly China's censorship of private communications and social media. The Chinese leadership has implemented new regulations on domestic news media and has increased harassment and economic pressure on U.S. and other foreign media to coerce compliance with its information controls. In 2014, President Xi assumed authority of the Internet control apparatus, instituting wide-scale Internet campaigns intended to stifle dissent and crack down on popular Chinese microbloggers and other leaders of public opinion. China's restrictive Internet and media controls are increasingly affecting U.S. companies operating in China, blocking market access, and forcing companies to relocate their operations or to self-censor.

FIGURE 8: CHINA'S OFFICIAL SPENDING ON PUBLIC SECURITY, 2007–2013 (US\$ BILLIONS)



Note: All data is extracted from budget execution figures, reflecting the official year-end funds outlaid. All budgetary figures are converted from RMB into USD based on China's year-end nominal exchange rate. China's Ministry of Finance does not provide specific national "public security" budgetary data prior to 2007.

Source: China's Ministry of Finance, <http://yss.mof.gov.cn/zhengwuxinxi/caizhengshuju/>.

TABLE 2: TIMELINE OF RECENT REPORTED MAJOR ATTACKS IN CHINA

Date	Location	Explanation
October 28, 2013	<i>Tiananmen Square Car Bombing</i> Beijing, Beijing Municipality	A car bomb was driven into the gate of Tiananmen Square killing five and injuring approximately 40 people. The East Turkestan Islamic Movement (ETIM) claimed responsibility.
March 1, 2014	<i>Knife Attack</i> Kunming, Yunnan	A group of eight knife-wielding attackers, rumored to be Uyghur separatists, killed 29 people and wounded more than 143 in the Kunming train station.
April 30, 2014	<i>Train Station Bombing</i> Urumqi, Xinjiang	Shortly after President Xi's trip to the province, a bombing at the Urumqi train station killed three and injured 79 people. Chinese officials blamed ETIM; the Turkestan Islamic Party (TIP) claimed responsibility.
May 22, 2014	<i>Market Bombing</i> Urumqi, Xinjiang	Two cars drove through a Han vegetable market and set off handmade explosive devices, killing 43 people and injuring 94.
July 28, 2014	<i>Violent Clashes</i> Shache County, Xinjiang	Violent clashes between Chinese police and Uyghurs reportedly led to the deaths of 35 civilians and 59 terrorists and the arrest of 215 people. Chinese officials waited a day to report the violence and blamed the bloodshed on ETIM and the influence of foreign terrorist organizations. The number is likely higher with one Han resident claiming more than 1,000 people were killed, and the World Uyghur Congress claiming at least 2,000.
September 21, 2014	<i>Multiple Bombings</i> Bugur County, Xinjiang	Several bombs detonated in a shop, open market, and two police stations. Chinese official media initially reported 2 deaths and revised its figures five days later to 50 deaths, including 40 'rioters' and 54 injured. Radio Free Asia disputes these figures with reports from eyewitnesses of over 100 people injured.

Source: "China Says Islamist's Holy War Message Proves Terror Threat," Reuters, November 25, 2013. <http://www.reuters.com/article/2013/11/25/us-china-xinjiang-idUSBRE9A00B520131125>; Shannon Tiezzi, "Who Is Fighting China's War on Terror?" Diplomat, November 26, 2013. <http://thediplomat.com/2013/11/who-is-fighting-chinas-war-on-terror/>; "China Kunming Knife Attack: Three Suspects Captured," BBC, March 3, 2014. <http://www.bbc.com/news/world-asia-china-26420863>; AFP, "Kunming Knife Gang 'Tried to Leave China' before Attack," Telegraph, March 5, 2014. <http://www.telegraph.co.uk/news/worldnews/asia/china/10677244/Kunming-knife-gang-tried-to-leave-China-before-attack.html>; Christopher Bodeen, "Attacks Show Bolder Terror Threat Growing in China," Associated Press, May 2, 2014. <http://www.washingtontimes.com/news/2014/may/2/attacks-show-bolder-terror-threat-growing-in-china/>; Michael Martina and Megha Rajagopalan, "Islamist Group Claims China Station Bombing: SITE," Reuters, May 14, 2014. <http://www.reuters.com/article/2014/05/14/us-china-xinjiang-idUSBREA4D07H20140514>; Edward Wong and Chris Buckley, "32 Terrorist Groups Smashed in Xinjiang, China Says," New York Times, June 23, 2014. <http://www.nytimes.com/2014/06/24/world/asia/32-terrorist-groups-smashed-in-xinjiang-china-says.html>; Alexa Olesen, "In One Xinjiang City, Beards and Muslim Headscarves Banned from Buses," Foreign Policy, August 5, 2014. http://www.foreignpolicy.com/articles/2014/08/05/karamay_bans_beards_muslim_headscarves_from_public_buses_xinjiang; Xinhua, "37 Civilians Killed, 13 Injured in Xinjiang Terror Attack," China Daily, August 3, 2014. http://www.chinadaily.com.cn/china/2014-08/03/content_18237292.htm; Shohret Hoshur and Qiao Long, "'At Least 2,000 Uyghurs Killed' in Yarkand Violence: Exile Leader," Radio Free Asia, August 5, 2014. <http://www.rfa.org/english/news/uyghur/yarkand-08052014150547.html>; Xinhua (English edition), "40 Rioters Dead in Luntai Country Violence in Xinjiang," September 25, 2014. http://news.xinhuanet.com/english/china/2014-09/25/c_127035563.htm; and Shohret Hoshur and Eset Sulaiman, "Official Death Toll in Xinjiang's Bugur Violence Climbs to 50," Radio Free Asia, September 25, 2014. <http://www.rfa.org/english/news/uyghur/bugur-09252014210804.html>.

CONCLUSIONS:

- ▶ Heightened public awareness, the growth in Internet and social media use, and the lack of satisfactory channels for redress have led to a large number of “mass incidents” each year. Public outrage centers on land seizures, labor disputes, wide-scale corruption, cultural and religious repression, and environmental degradation. Such incidents challenge the legitimacy and competence of the Chinese Communist Party (CCP) and the government at all levels. Local governments have responded to such incidents with a mixture of repression and concessions.
- ▶ This year marked an escalation in violence linked to unrest in Xinjiang. Clashes between Uyghurs and police are increasingly ending in bloodshed, including the death of nearly 100 people in late July. In addition, attacks by militant Uyghur separatists are shifting from targeting government officials and buildings to attacking civilians and soft targets such as train stations and public spaces.
- ▶ In an effort to address the underlying causes of unrest, President Xi has launched robust anticorruption and counterterrorism campaigns, dedicated resources to address the public’s environmental and health concerns, and proposed hukou system reforms.
- ▶ In response to rising levels of unrest, China’s leaders are expanding and improving China’s stability maintenance apparatus by streamlining domestic security policymaking, strengthening forces responsible for maintaining internal security, tightening the Party’s control over legal institutions, significantly increasing funding for public security, and using information controls to clamp down on dissent.
- ▶ With the entire legal apparatus under the CCP’s control, local and national officials contain unrest by limiting citizens’ access to legal counsel and impartial trials, restricting the ability of citizens to obtain redress for grievances through official channels, and detaining government critics through legal and extralegal means. Although President Xi has implemented several substantial reforms and hinted at others, the same legal mechanisms to target dissent likely will persist, and meaningful reform will remain elusive.
- ▶ President Xi has implemented a campaign not seen in China since the 1970s against individuals expressing dissent. In addition to targeting outspoken dissidents, President Xi has cracked down on popular online commentators. This year’s 25th anniversary of the Tiananmen Square massacre marked the harshest crackdown on dissenters yet and the tightest online censorship implemented thus far.

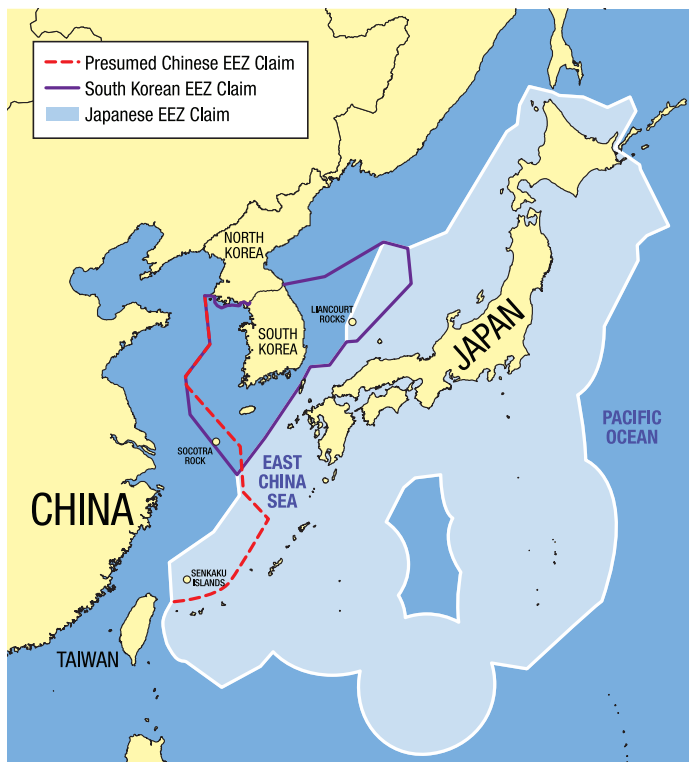
- ▶ Although China already has one of the most restricted media environments in the world, since President Xi took office, China has increased censorship of domestic and foreign media. China’s information controls directly affect U.S. media companies and journalists with China operations through visa restrictions, cyber attacks, physical harassment, favoritism, and threats. Tightened media controls also affect Chinese citizens who face increasing difficulty accessing information sources that express alternative views from the CCP.
- ▶ Beijing likely will take calculated measures to strengthen Internet controls. However, China probably will struggle with the rapid and unpredictable development of Internet-based applications and technologies that could help users defy Beijing’s current controls. Furthermore, the increasing number and sophistication of Internet users in China makes Beijing’s approach vulnerable to public backlash when authorities restrain users’ access and network performance, especially in sectors where the Internet has become a critical component of economic growth and commerce.

Chapter 3: China and the World

CHINA AND ASIA’S EVOLVING SECURITY ARCHITECTURE

Using a variety of foreign and domestic policy tools, Beijing is attempting to expand a sphere of influence in its peripheral regions. Recent public statements by high-level Chinese officials suggest China is departing from its traditional low-profile foreign policy to “hide capacities and bide time.” Senior Chinese leaders in the past year have begun to challenge the U.S. position as the primary power in East Asia by promoting a new Asian security architecture led by Asian countries, with China in the leading role. As it seeks to take on a role as a “major responsible country,” China’s influence in Asia is deepening and the security architecture of Asia is adjusting to this change.

FIGURE 9. EAST CHINA SEA MAP

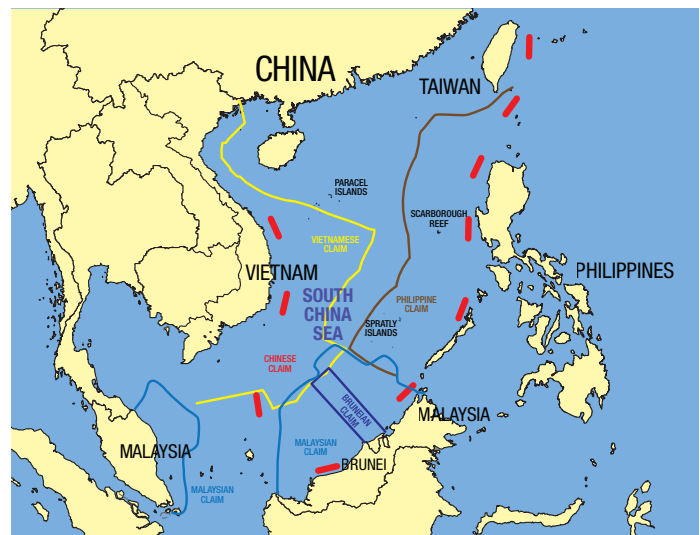


Sources: U.S. Navy, Maritime Claims Reference Manual, 2014; Flanders Marine Institute, "EEZ Boundaries," <http://www.marineregions.org/eezsearch.php>. Commission staff approximation of maritime claims. Names and boundary representation are not authoritative. The EEZ approximations shown are derived from the straight baseline claims of China, Taiwan, South Korea, and Japan, none of which is recognized by the United States. Japan's EEZ claim also includes an additional region in its outer islands further east, not shown here.

In Northeast Asia, China seeks to thwart the potential for a trilateral U.S.-Japan-South Korea alliance. Published Chinese views on China-Japan security relations encompass a mix of suspicion, alarm, and concern—especially on the issues of Japan's increasingly robust defense and security establishment, the development of the U.S.-Japan alliance, and perceived lack of Japanese atonement over its wartime past. Conversely, official Chinese views on China's relations with South Korea reflect an interest in continued cooperation between Beijing and Seoul on regional security.

Whereas Japan is balancing against China by boosting its own capabilities and reaffirming its alliance with the United States, South Korea appears to be pursuing a hedging strategy by cultivating its security relationships not only with the United States but with China as well. The challenge for Washington as it seeks to modernize its Northeast Asian alliances will be to balance differing sets of security perceptions and priorities in Tokyo and Seoul as well as manage simmering political tensions stemming from their troubled past.

FIGURE 10. SOUTH CHINA SEA MAP



Sources: U.S. Department of Energy, South China Sea Maritime Claims Map, 2013. <http://www.eia.gov/countries/regions-topics.cfm?fips=scs>; Gregory Poling, The South China Sea in Focus: Clarifying the Limits of Maritime Dispute (Center for Strategic and International Studies, July 2013). http://csis.org/files/publication/130717_Poling_SouthChinaSea_Web.pdf. Commission staff approximation of maritime claims. Names and boundary representation are not authoritative. Both Vietnam and the Philippines claim the Spratly Islands independently of their maritime claims.

Southeast Asia and Oceania generally share the same wary view of the unfolding U.S.-China competition for regional power and influence. China's central objectives with regard to Southeast Asia are to defend its sovereignty claims and preserve its territorial integrity; to secure and ensure access to resources for continued economic development; and to maintain a secure buffer zone around the Chinese mainland. With Australia, China seeks to maintain strong trade ties while pursuing stronger security relations to at least partially counterbalance the formal and robust U.S.-Australia alliance.

Southeast Asian states and Australia are hedging against what they perceive to be strategic uncertainty in the region by building new security relationships, strengthening existing security relationships, diversifying and strengthening military and paramilitary capabilities, and emphasizing the role of regional institutions and international law to manage disputes. As the United States continues to rebalance to Asia, achieving its security goals in the region will require reassurance and reinforcement of its alliances and security associates in addition to continued strong engagement with regional political and security institutions.

CONCLUSIONS:

- ▶ Beijing has concluded the U.S.-led East Asia security architecture does not benefit its core interests of regime preservation, economic and social development, and territorial integrity. In 2014, China's leaders began to promote a vision of regional security that marginalizes the United States and "relies on the people in Asia to run Asia's affairs, deal with Asia's problems, and uphold Asia's security"—a vision at odds with the present security architecture encompassing a strong network of U.S. alliances and partnerships in East Asia.

- ▶ China is engaged in a sustained and substantial military buildup that is shifting the balance of power in the region, and is using its growing military advantages to support its drive for a dominant sphere of influence in East Asia
- ▶ China employs economic incentives and punishments toward its neighbors to support its diplomatic and security goals in East Asia to extract political or security concessions from its Asian neighbors. The market dependencies of many East Asian countries on China—the result of China’s deep integration into regional manufacturing supply chains—afford it leverage in pursuing regional security interests.
- ▶ China’s security relations with Japan are deteriorating over the Senkaku Islands dispute and grievances over Japan’s wartime past. Conversely, China’s security relations with South Korea are warming as Beijing seeks continued cooperation with Seoul on North Korea. The two Northeast Asian powers differ in their responses to China’s assertive security policy in the region: Japan is balancing against China by boosting its own defensive capabilities and its alliance with the United States, while South Korea appears to be pursuing a hedging strategy by maintaining security relations with both the United States and China.
- ▶ The current regional security arrangement in Northeast Asia, for which the U.S. alliances with Japan and South Korea provide a basis, will probably remain unchanged in the near term. Differences in security priorities between Japan and South Korea means that without greater political will to overcome these differences, full-fledged trilateral security cooperation among Japan, South Korea, and the United States is unlikely to materialize in the near- to mid-term.
- ▶ China’s increasingly assertive actions in the South China Sea have led Southeast Asia and Australia to build new defense relationships, deepen existing defense relationships, strengthen military and paramilitary capabilities, and emphasize the role of regional institutions and international law to manage disputes.
- ▶ As the United States seeks to reaffirm its alliance with Australia as part of the U.S. rebalance to Asia, China is seeking stronger security ties with Australia to serve as a counterweight to the alliance. Australia’s challenge is to ensure its own economic and security interests in the midst of the ongoing Pacific power shift. Similarly, continued U.S. engagement with ASEAN ensures the political sustainability of U.S. security policy in East Asia, but carries the risk of relying too heavily upon an organization which has yet to define its role in East Asian security.

RECENT DEVELOPMENTS IN CHINA’S RELATIONSHIP WITH NORTH KOREA

Sino-North Korean relations have become increasingly tense since late 2012, and high levels of distrust and frustration now characterize the relationship, particularly on the Chinese side. The downturn in bilateral relations began with North Korea’s December 2012 rocket launch, which was a thinly-veiled attempt to test the North’s ballistic missile technology. Pyongyang conducted its third nuclear test soon thereafter despite repeated warnings from Beijing. As tensions rose, high-level contacts between North Korean and Chinese officials decreased in 2013 and 2014. One of the clearest indications of turmoil in the relationship was Kim Jong-Un’s purge and execution of his powerful uncle, Jang Song-taek, in late 2013. Mr. Jang, who had been Beijing’s most important interlocutor in Pyongyang, was accused of crimes of selling “precious underground resources” and “selling off North Korean land” to China. Meanwhile, China and North Korea each are seeking to balance the other by strengthening ties with other countries. China’s relations with South Korea have warmed significantly since mid-2013, much to Pyongyang’s consternation. For its part, North Korea has sought to diversify its external relations, and has been reaching out to Russia and others.

Pyongyang’s provocations have led to a shift in China’s perception of North Korea. For example, Beijing has allowed a vibrant public debate on the utility and wisdom of Chinese policy toward North Korea to emerge since Pyongyang’s 2013 nuclear test. Further, although China historically has not viewed North Korean denuclearization as an urgent task, Beijing now appears to be genuinely concerned about Pyongyang’s accelerating nuclear program. As a result, China has redoubled efforts to restart the long-stalled Six-Party Talks between China, Japan, North Korea, Russia, South Korea, and the United States, which were established over a decade ago to negotiate the termination of North Korea’s nuclear program. China’s efforts to restart the negotiations are intended to “keep them talking and not fighting,” but also are motivated by Beijing’s desire to exert control over the negotiating process and assert influence over the parties involved. These efforts on the diplomatic front have been accompanied by progress in China’s enforcement of United Nations sanctions against North Korea, although significant gaps remain.

China's growing displeasure with North Korea notwithstanding, Beijing continues to support the Kim regime in an effort to encourage continued stability in the North. China fears instability could prompt a political or humanitarian crisis, leading to regime collapse, which could result in a refugee crisis on its border. More concerning to China's leaders, however, is the prospect that a North Korean collapse could provide a pretext for U.S. military intervention in North Korea. In Beijing's view, a sustained U.S. or U.S.-South Korean allied military presence on the Korean Peninsula is inimical to China's security interests, and China would perceive U.S. troops crossing into North Korea as an urgent deterioration of its already degraded security environment. Unfortunately, China's mistrust of the U.S.-South Korea alliance, its alliance with North Korea, and its unique security priorities vis-à-vis the North prevent it from meaningfully engaging with South Korea and the United States in discussions about North Korean collapse scenarios and contingency planning.

CONCLUSIONS:

- ▶ North Korea has the potential to be one of the most dangerous flashpoints in U.S.-China relations. Although regime collapse or a major humanitarian disaster in North Korea do not appear likely in the near term, such an event could lead to war on the Korean Peninsula, which likely would draw simultaneous military intervention jointly by the United States and South Korea and by China. At the current time, trilateral communication among these countries about their intentions and possible actions in the event of a major contingency in North Korea appears dangerously insufficient to avoid accidents, miscalculation, and conflict.
- ▶ Sino-North Korean relations are at their lowest point in decades. This is driven largely by China's frustration over North Korea's destabilizing behaviors since late 2012, including a nuclear test and a high volume of missile tests. Beijing's frustration with Pyongyang notwithstanding, China continues to support North Korea in the interest of stability. China assesses that as long as the North Korean regime remains stable, North Korea will continue to exist as a buffer between itself and U.S.-allied South Korea. Preserving this buffer is the fundamental objective of China's relationship with North Korea.
- ▶ China appears to be genuinely concerned about North Korea's nuclear program. This concern is mostly over second-order effects of the North's nuclear advances. For example, China believes North Korea's continued progress on its nuclear program incentivizes the United States to strengthen its military presence and capabilities on the Korean Peninsula. Further, China believes the North's nuclear progress could prompt U.S. allies Japan and South Korea to develop their own nuclear programs. Either of these outcomes would constitute a major deterioration of China's security environment.

- ▶ Since 2013, China has redoubled its efforts to restart the Six-Party Talks. Although Beijing is skeptical North Korea will halt its nuclear program as a result of the Six-Party Talks, it values the forum because it ensures China will have a central role in the international community's interaction with North Korea and allows China to exert influence over the parties involved.
- ▶ China increasingly views U.S. interests on the Korean Peninsula as inimical to its own. Beijing assumes Washington uses North Korean provocations as a pretext to bolster the U.S. military presence and capabilities on the Korean Peninsula and justify a "rebalance" policy that is actually aimed at containing China.
- ▶ China's relationship with South Korea is significantly improving in both the economic and security realms. Beijing's efforts to strengthen ties with Seoul reflect China's frustration with North Korea and are meant in part to signal its disapproval to Pyongyang. China's pursuit of stronger ties with South Korea also is aimed in part at drawing South Korea away from its alliance with the United States. As its influence over South Korea grows, China judges it eventually will be in a stronger position to pressure South Korea to reduce its security ties with the United States.

TAIWAN

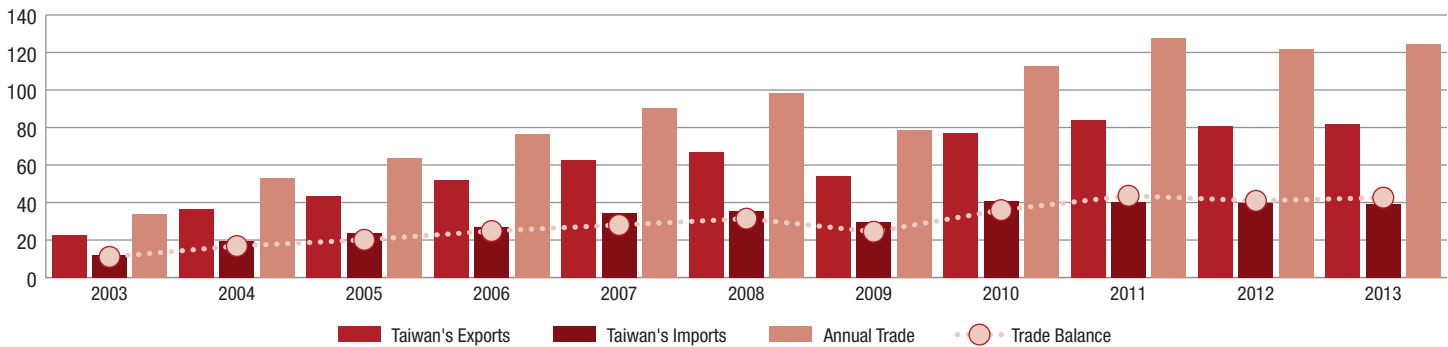
Cross-Strait economic ties continue to grow. China is Taiwan's largest trading partner, largest export market, and largest source of imports. In 2013, annual cross-Strait trade reached \$124.4 billion, a nearly 27 percent increase since 2008. This expansion continued through the first seven months of 2014, growing 4.1 percent when compared with the same period last year. In 2014, China for the first time surpassed Japan to become Taiwan's largest source of imports. Although China remains the largest destination, Taiwan FDI to China reached a three-year low in 2013 (\$9.2 billion, a 40 percent decline year on year), as labor costs in China rose and slower Chinese demand for Taiwan manufactured goods cut exports. In contrast, Chinese FDI to Taiwan has grown nearly 300 percent from \$94 million in 2010 to \$349 million in 2013 due to the loosening of investment caps and regulations on mainland investment into Taiwan under President Ma Ying-jeou.

TABLE 3: CROSS-STRAIT FDI FLOWS, 2009–2014 (US\$ MILLIONS)

	2009	2010	2011	2012	2013	Jan.- Aug. 2014
Taiwan's FDI to China	\$7,143	\$14,618	\$14,377	\$12,792	\$9,190	\$6,484
China's FDI to Taiwan	\$37	\$94	\$52	\$332	\$349	\$239

Source: Ministry of Economic Affairs, Overseas Chinese and Foreign Investment Commission (Taiwan).

FIGURE 11: CROSS-STRAIT TRADE, 2003–2013 (US\$ BILLIONS)



Source: Bureau of Foreign Trade (Taiwan).

However, deepening cross-Strait trade and investment have increased public concerns over Taiwan's growing dependence on China's economy and Taiwan's vulnerability to Chinese economic and political coercion. In 2014, protestors occupied Taiwan's legislative chamber for 23 days in opposition to the Cross-Strait Services Trade Agreement (CSSTA), which was signed in 2013 but has yet to be ratified by the Taiwan legislature. The grassroots protest movement, later called the Sunflower Movement, ignited a public debate in Taiwan about the agreement, further delayed its ratification, and temporarily postponed negotiations of other cross-Strait agreements. Cross-Strait negotiations have since resumed, but it is unclear how successful these negotiations will be given Taiwan citizens' strong opposition to the CSSTA.

In February 2014, prior to the Sunflower Movement, Taiwan and China reached a milestone in cross-Strait relations by holding the first formal talks between the heads of Taiwan's Mainland Affairs Council and China's Taiwan Affairs Office (TAO) since Taiwan and China split in 1949. Later, in June 2014, the director of TAO Zhang Zhijun visited Taiwan, the first visit to Taiwan by a TAO director.

In 2014, the United States raised the visibility of relations with Taiwan by sending U.S. Environmental Protection Agency Administrator Gina McCarthy to Taiwan—the first visit by a U.S. Cabinet-level official since 2000. Annual bilateral trade reached \$57.3 billion in 2013 and continued to grow during the first seven months of 2014, increasing 6 percent over the same period last year. U.S.-Taiwan military-to-military contact also increased in 2013. In 2013, U.S. DoD personnel conducted more than 2,000 visits to Taiwan, compared to approximately 1,500 visits in 2012.

Six years of cross-Strait rapprochement have been beneficial to the United States by temporarily reducing the likelihood of military conflict, enhancing regional stability and development, and allowing U.S. policymakers to address other priorities in the U.S.-China and U.S.-Taiwan relationships. However, improved cross-Strait relations have not resolved the fundamental sovereignty issues between Taiwan and China. China's military modernization continues to focus on improving its ability to conduct military operations against Taiwan and to deter, delay, and deny any U.S. intervention in a cross-Strait conflict. China's military now appears to possess an increasing advantage over Taiwan's military. The increased range and capabilities of China's power projection platforms have largely negated Taiwan's historic geographic advantages in a cross-Strait conflict.

CONCLUSIONS:

- ▶ Under President Ma, cross-Strait economic relations have deepened with the expansion of trade and investment and the signing of numerous economic agreements. However, these agreements face increasing public and political opposition. The Taiwan public's concerns about the effects of cross-Strait economic integration on the country's economy and political autonomy led to a temporary postponement of cross-Strait negotiations and a push for increased oversight of cross-Strait agreements by Taiwan's legislature.
- ▶ Prior to the Sunflower Movement, cross-Strait relations reached a milestone with the first formal talks between the heads of Taiwan's Mainland Affairs Council and China's Taiwan Affairs Office in February 2014. After a temporary postponement following the protests, Taiwan and China restarted trade negotiations in September, but the Taiwan legislature will unlikely ratify any new agreements until it agrees on a formal legislative oversight process for cross-Strait agreements.
- ▶ U.S.-Taiwan relations took positive but small steps forward this past year with progress in the bilateral Trade and Investment Framework Agreement (TIFA) talks, the first trip to Taiwan by a Cabinet-level official since 2000, and recent growth in bilateral trade. Remaining obstacles to further progress in the TIFA talks are disputes over pork imports, pharmaceutical intellectual property rights, and private-equity investment regulations.
- ▶ The United States and Taiwan continue to engage in a robust but low-profile security partnership, including increased military-to-military contact in 2013. However, the U.S. government has not authorized a major arms sale to Taiwan since 2011, which allows China to further tip the cross-Strait balance of power in its favor.
- ▶ Taiwan has expanded its international engagement in recent years, but China continues to restrict Taiwan's participation in most international organizations. Furthermore, Taiwan's discussions with other countries regarding bilateral free trade agreements have reportedly stalled due to those countries' hesitation over China's opposition and questions about Taiwan's ability to ratify any negotiated free trade agreement following strong public opposition to the Cross-Strait Services Trade Agreement.

► Despite the recent cross-Strait rapprochement, the core sovereignty and security issues between Taiwan and China remain unresolved. China's military modernization has significantly increased Beijing's ability to conduct military operations against Taiwan and to deter, delay, and deny any U.S. intervention in a cross-Strait conflict. Taiwan's recent focus on developing innovative and asymmetric military capabilities and continued acquisition of major conventional platforms and weapon systems from the United States have improved Taiwan's military capabilities. However, the cross-Strait balance of power has shifted decidedly in China's favor.

HONG KONG

In 2014 Hong Kong's government advanced the electoral reform process aimed at implementing universal suffrage for the 2017 chief executive election. However, democracy advocates in Hong Kong sought not only expansion of direct election to all Hong Kong's eligible voters, but also relaxation of restrictive nominating requirements for potential candidates. After Beijing ruled out a nominating process open to public participation, and instead adopted a framework that favors pro-Beijing candidates, protesters initiated an extended occupation of areas around government buildings and the Central business district to pressure the government to accept a fair nominating process.

Currently, to be nominated, a potential chief executive candidate must be supported by no fewer than 150 members (or 12.5 percent) of a 1,200-member election committee, which also elects the chief executive. With strong business and political ties to mainland China, many committee members are local elites seeking to curry favor with government officials and Communist Party members in Beijing. One member of Hong Kong's Legislative Council estimated that nearly 80 percent of election committee members are controlled by Beijing.

On August 31, 2014, China's National People's Congress (NPC) issued a decision allowing all registered voters to participate in the next chief executive election, but proposed a nominating mechanism that may prevent candidates who are not pro-Beijing from standing for election. According to the NPC, only two or three candidates may be nominated to stand for election, each of whom must be supported by more than 50 percent of the nominating committee, which will be modeled on the current election committee and is expected to maintain the same pro-Beijing bias. Moreover, the chief executive candidate must be a "patriot" who will not oppose CCP dictates or one-party rule.

FIGURE 12: A DEMOCRACY PROTESTER RAISES UMBRELLAS AS POLICE FIRE TEAR GAS TO DISPERSE CROWDS.



Source: Photo by Bobby Yip (Reuters). Gus Lubin and Michael B. Kelley, "Hong Kong Police Fire Tear Gas at Protesters, But They're Not Going Anywhere," Business Insider, September 28, 2014. <http://www.businessinsider.com/hong-kong-protests-2014-9>.

In a strongly-worded paper on the implementation of the “one country, two systems” policy, issued on June 10, 2014, China’s State Council Information Office reasserted China’s control over the “high degree of autonomy” granted to Hong Kong upon its handover and enshrined in the Basic Law.** The paper required all Hong Kong’s administrators, including members of its independent judiciary, to be “patriotic” and “love the country” (i.e., the People’s Republic of China). The paper also warned of foreign forces acting in collusion with groups within Hong Kong to promote democracy in order to thwart China’s unity.

China’s interference in and control over Hong Kong’s political developments incited a large-scale public backlash from democracy activists and student protesters. The Occupy Central campaign, which was organized in 2013 to lobby the central government for true democratic electoral reform, conducted an unofficial referendum on electoral reform which showed that 90 percent of voters wanted the Legislative Council (LegCo), Hong Kong’s legislature, to veto any government proposal that does not allow for genuine fair nomination of chief executive candidates. While all 27 pro-democracy LegCo members (of 70 total members) vowed to veto a final electoral reform proposal that is based on Beijing’s framework, if the proposal was successfully vetoed, the 2017 election would follow the same procedures as in 2012.

China’s military activity in Hong Kong also increased in 2014. In February, the Hong Kong government advanced the construction of a Chinese military port along the waterfront of Victoria Harbor. The PLA administers Hong Kong’s defense through its Hong Kong garrison, and maintains 19 military sites there. The garrison is obligated by law to reveal the location of military sites that restrict public access; however, one undisclosed restricted access military zone containing a radar station was discovered in July 2014. One LegCo member supported conducting a judicial review of this concealment. Displays of new weaponry and anti-riot gear by the military garrison worried democracy protesters that peaceful demonstrations may be met with military force.

Hong Kong’s global press freedom ranking slipped from 35th in 2013 to 37th in 2014, continuing a downward trend dating back to 2004, according to Freedom House. One blow to press freedom occurred when Kevin Lau, then-editor of independent newspaper Ming Pao, which often featured content critical of the Chinese government, was removed from his position without explanation and subsequently brutally attacked by knife-wielding assailants. Many members of Hong Kong’s media community believed the attack was politically motivated. In another instance, due to pressure from the central government’s liaison office in Hong Kong, major international companies dropped advertisements in prominent independent news outlet Next Media, owned by outspoken pro-democracy advocate Jimmy Lai.

CONCLUSIONS:

- ▶ China’s central government has put forth a framework for the election of Hong Kong’s next chief executive in 2017 that effectively excludes democratic candidates from nomination and allows Beijing to control the outcome. This proposal conflicts with standards set forth in Hong Kong’s Basic Law and the International Convention on Civil and Political Rights, and runs counter to international commitments made by China in the 1984 Sino-UK Joint Declaration to preserve Hong Kong’s “high degree of autonomy” and way of life for 50 years following its 1997 handover from the United Kingdom.
- ▶ Increased Chinese military activity in Hong Kong signals China’s determined presence there and serves to intimidate pro-democracy activists from participating in the Occupy Central movement and other peaceful movements out of fear of military retaliation.
- ▶ Increased infringement on Hong Kong’s press freedom, particularly in the forms of violence against journalists and political pressure on advertisers, threatens the media’s ability to serve as a watchdog. The steady erosion of press freedom is a worrying trend that has worsened over the last ten years, and appears to be targeted at outspoken pro-democracy media.

** The “one country, two systems” framework is a policy measure adopted by China following the establishment of Hong Kong and Macau as special administrative regions. The system grants Hong Kong and Macau the right to self govern their economy and political system to a certain extent, excluding foreign affairs and defense. China’s policies concerning Hong Kong are outlined in the 1984 Sino-British Joint Declaration, a legally binding international treaty that dictated the terms of Hong Kong’s handover from the United Kingdom in 1997. In the Joint Declaration, China granted Hong Kong a “high degree of autonomy,” and promised that “Hong Kong will retain its current lifestyle and legal, social, and economic systems until at least the year 2047.”

Comprehensive List of the Commission's Recommendations

The Commission believes that ten of its 48 recommendations to Congress are of particular significance. These recommendations are denoted in **bold blue text**.

Chapter 1: U.S.-China Economic and Trade Relations

SECTION 2: U.S.-CHINA BILATERAL TRADE AND ECONOMIC CHALLENGES

The Commission recommends:

1. Congress direct the Government Accountability Office to update its report on the effectiveness of the U.S.-China Joint Commission on Commerce and Trade (JCCT) and the Strategic and Economic Dialogue (S&ED). The updated report should include an assessment of the objectives sought by the United States in these talks and whether China has honored its commitments to date.
2. Congress require the Department of the Treasury to include in its semiannual report to Congress specific information on the beneficial economic impact of China moving to a freely floating currency in terms of U.S. exports, economic growth, and job creation. In addition, Congress should urge the Administration to begin immediate consultations at the G-7 to identify a multilateral approach to addressing China's currency manipulation.
3. Congress direct the Interagency Trade Enforcement Center (ITEC) to provide briefings to the House Ways and Means and Senate Finance Committees and the House and Senate Appropriations Committees on its activities, since its creation, to coordinate and improve upon the enforcement of U.S. laws against unfair trade. Congress should examine whether providing statutory authority for ITEC would enhance enforcement activities and ensure that adequate resources are available and that other Departments and Agencies are responsive to its requests.
4. Congress consider amending existing trade enforcement rules to ensure that foreign investment in the United States cannot be used to impede the ability of domestic producers to bring petitions for trade enforcement actions. Congress could direct the Department of Commerce to update its regulations and procedures for antidumping and countervailing duty cases to create a rebuttable presumption that firms that are state-owned, state-controlled, or state-invested with facilities in the United States are operating at the direction of the state. Those state-directed companies would then be excluded from calculations of industry support or opposition unless they can prove that there is no such involvement or direction.
5. Congress consider whether state and local governments should be treated as interested parties under laws against unfair trade and thereby have standing to bring or participate in trade cases. Further, Congress should consider creating a private right of action allowing U.S. companies to take legal action against competitors directly in antidumping and countervailing duty cases, rather than having to rely on U.S. government assistance.
6. Congress seek clarification from the executive branch as to its interpretation of Article 15 of China's World Trade Organization Accession Protocol concerning China's achievement of "market economy" status.
7. Congress consider legislation that would make available a remedy to domestic firms that have been injured from the anticompetitive actions (such as access to low-cost or no-cost capital) of foreign state-owned companies for the injury that has been inflicted and allow for the potential award of treble damages.
8. Congress direct the Council of Economic Advisers (CEA) to brief the Joint Economic Committee on existing data collection efforts within the Administration regarding investments by Chinese entities in the United States. CEA shall describe the differing data sets available from public and private sources and the extent to which existing data provides adequate information to U.S. policy makers to assess changing trends and the potential economic implications from these investments.
9. Congress require the Department of Commerce to prepare a comprehensive analysis of excess productive capacity in China across a range of sectors, including, but not limited to, steel, glass, paper, cement and solar products, and provide a report to the President and to Congress on what actions should be taken to address this problem. This report shall be prepared annually for a period of five years, at a minimum. In addition, the Administration should consult with major trade allies with similar concerns about Chinese overcapacity in these sectors to determine what multilateral engagement would effectively deal with this problem. As part of this approach, the Administration shall evaluate the effectiveness of other efforts to address global and China's overcapacity in certain sectors, such as the Organization for Economic Cooperation and Development Steel Committee, the U.S.-China Steel Dialogue, and JCCT and S&ED talks.

10. Congress request that the Office of the United States Trade Representative, Department of Commerce, and International Trade Commission report to Congress on the extent to which existing authorities would allow for sanctions to be imposed against entities that benefit from trade secrets or other information obtained through cyber intrusions or other illegal means and were provided by a national government, foreign intelligence service, or other entity utilizing such means. If authorities do not exist, they should provide a proposal to address such problems.

11. Congress require the Office of the United States Trade Representative to brief the House Ways and Means and Senate Finance Committees, within 60 days, on trade enforcement issues involving China which have been initiated or announced since 2009, but have not yet been resolved, and identify what steps will be taken to ensure a more rapid resolution of such issues. The briefing shall include an estimate of the economic value to the U.S. in terms of production and job creation, if the identified market barrier or impediment were eliminated.

SECTION 3: CHINA'S HEALTH CARE INDUSTRY, DRUG SAFETY, AND MARKET ACCESS FOR U.S. MEDICAL GOODS AND SERVICES

The Commission recommends:

12. Congress urge the Institutes of Medicine of the National Academies to convene a task force to assess purchasing decisions by U.S. wholesalers, retailers, and healthcare providers with regard to China-origin drugs and drug ingredients, and to recommend ways in which to improve information sharing and coordination with the Food and Drug Administration (FDA).

13. Congress urge the FDA to insist on expedited approvals from the Chinese government for work visas for the FDA staff, and on expanded authority to conduct unannounced visits at drug manufacturing facilities in China.

14. Congress monitor the efficacy of the FDA's regulatory activities in China, consider ways to optimize the use of appropriated funding, and identify what other steps are necessary to protect the health and safety of the U.S. population.

15. Congress pursue measures to improve the government's information about drug ingredient and dietary supplement producers, especially for imports. To this end, Congress should urge the FDA to work with its Chinese counterparts to establish a more comprehensive regulatory regime for registering China-based active pharmaceutical ingredient (API) producers, and make this producer information available on demand for U.S. agencies.

16. Congress adopt measures that make greater use of "track and trace" technology. To this end, Congress should: (1) urge the U.S. government negotiators to demand that China harmonize with internationally recognized standards its unique device identifiers for medical devices and its serialized verification of APIs, so as to allow for equivalency with U.S. systems and standards; (2) make the use of serial numbers for product verification at U.S. pharmacies mandatory at all times, not only in cases where a product is suspect (as currently spelled out in the Drug Quality and Security Act).

17. Congress direct the Trade Policy Review Group of the Office of the U.S. Trade Representative to review the interests of U.S. healthcare goods and services providers in the Chinese market, Chinese market barriers, and opportunities to promote human health in China in ways that support U.S. consumer and business interests.

SECTION 4: U.S.-CHINA CLEAN ENERGY COOPERATION

The Commission recommends:

18. Congress direct the Government Accountability Office to conduct an assessment of government-led U.S.-China collaborative initiatives on clean energy. This assessment should describe the nature of collaboration, including funding, participation, and reporting on the outcomes; consider whether the intellectual property rights of U.S. researchers and companies are being protected; examine whether Chinese state-owned enterprises are benefitting from U.S. taxpayer-funded research; investigate if any U.S. companies, universities and labs participating in government-led collaboration with China have been subject to cyber penetrations originating in China; and evaluate the benefits of this collaboration for the United States. Further, this assessment should examine redundancies, if any, among various U.S.-China government-led collaborative programs, and make suggestions for improving collaboration.

19. Congress require that the Department of Energy, in consultation with the Department of Commerce, identify barriers to market access in China for clean and renewable energy products and services and their impact on U.S. production and job creation, and report to the committees of jurisdiction, within 120 days, on specific action plans to address these barriers. As part of this report, the Departments shall identify sourcing patterns that have changed over the last 10 years in these sectors and also the extent to which U.S. companies are producing in the Chinese market to serve that market and whether they were previously able to manufacture these products in the United States for export to China.

Chapter 2: Military and Security Issues Involving China

SECTION 2: CHINA'S MILITARY MODERNIZATION

The Commission recommends:

20. Congress fund the U.S. Navy's shipbuilding and operational efforts to increase its presence in the Asia Pacific to at least 67 ships and rebalance homeports to 60 percent in the region by 2020 so that the United States will have the capacity to maintain readiness and presence in the Asia Pacific, offset China's growing military capabilities, and surge naval assets in the event of a contingency.
21. Congress appoint an outside panel of experts to do a net assessment of the Sino-American military balance and make recommendations to Congress regarding the adequacy of the current U.S. military plans and budgets to meet the security requirements of the United States in the Pacific.
22. Congress ensure the adequacy of open source collection, production, and dissemination capabilities vis-à-vis security issues involving China.
23. Congress direct U.S. Pacific Command to brief Congress on the People's Liberation Army Navy's participation in the Rim of the Pacific-2014 exercise.
24. Congress direct the Department of Defense to provide to Congress its purpose and rationale for its military-to-military engagement planning with the People's Liberation Army, including proposed programs already discussed with the People's Liberation Army.
25. Given the importance of understanding China's nuclear and conventional ballistic missile programs, Congress direct the Government Accountability Office to provide an unclassified report, with a classified annex, that examines China's nuclear and conventional ballistic missile capabilities, intentions, and force structure.

SECTION 3: CHINA'S DOMESTIC STABILITY

The Commission recommends:

26. Members of Congress reaffirm their support for human rights, freedom of expression, and rule of law in China and raise citizens' rights to freedom of speech, expression, and religion in their meetings with Chinese government officials.
27. Congress support the efforts of the U.S. Agency for International Development, U.S. Department of State, and the National Endowment for Democracy to strengthen governance and improve the well-being of Chinese citizens through capacity-building training programs and exchanges.

28. Congress closely monitor U.S.-China counterterrorism cooperation to ensure the United States is not endorsing or providing any support for China's suppression of Chinese citizens, including Uyghurs, Tibetans, and other ethnic minorities.
29. Congress continue to support and fund media outlets that promote the free flow of information and Internet freedom within China.

Chapter 3: China and the World

SECTION 1: CHINA AND ASIA'S EVOLVING SECURITY ARCHITECTURE

The Commission recommends:

30. Congress require the Administration to submit a one-time interagency report clarifying the progress of the Asia rebalance policy.
31. Congress emphasize the value of the U.S.-Australia alliance in its interactions with Australian legislators.
32. Congress express support for Japan's efforts to exercise "collective self-defense" in its interactions with Japanese legislators.
33. Congress examine the Administration's progress on greater intelligence, surveillance, and reconnaissance (ISR) integration and sharing between the United States and its allies and security associates in East Asia and Oceania. In addition, Congress should support efforts by the Department of Defense to improve ISR capabilities of allies and security associates in East Asia and develop a "common operating picture" for the East and South China Seas.
34. Congress urge the Administration to encourage allies to develop their missile defense capabilities.

SECTION 2: RECENT DEVELOPMENTS IN CHINA'S RELATIONSHIP WITH NORTH KOREA

The Commission recommends:

35. Appropriate Congressional committees require the Departments of Defense and State to jointly produce a classified report on U.S. efforts to engage with China, South Korea, and Japan on issues related to North Korean stability. The report should include a discussion of prospects for political crisis or regime collapse in North Korea; a discussion of each country's outlook and approach to contingency planning for North Korea collapse scenarios; a detailed explanation of the current state of engagement among these countries on contingency planning for North Korea collapse scenarios; and an overview of existing track two dialogues aimed at enhancing understanding and cooperation among these countries on issues related to North Korean stability, to include an assessment of the effectiveness of these track two dialogues.

36. Congress require future classified and unclassified Department of Defense reports on 'Military and Security Developments Involving the Democratic People's Republic of Korea' to include a full discussion of China's activities impacting the military and security situation in North Korea.
37. Congress support nongovernmental organizations that encourage democracy and promote human rights and economic liberalization in North Korea.
38. Congress support nongovernmental organizations that facilitate exchanges and dialogues among the United States, Japan, South Korea, and China on issues related to security and weapons proliferation on the Korean Peninsula.
39. Members of Congress and Congressional staff in their interactions with official delegations from China exchange views on North Korea.

SECTION 3: TAIWAN

The Commission recommends:

40. Congress direct the Administration to permit and encourage official travel to Taiwan for uniformed military personnel above the level of O6 and urge Cabinet-level officials to make more frequent visits to Taiwan to promote commercial, technological, people-to-people, and military exchanges.
41. Congress urge the Administration to make available to Taiwan the arms and equipment it needs for its self-defense, consistent with the Taiwan Relations Act, due to the shifting cross-Strait military balance.
42. Congress encourage the Administration to increase its public support of Taiwan's participation in international organizations such as the United Nations Framework Convention on Climate Change.
43. Congress encourage the Administration to strengthen economic cooperation between the United States and Taiwan to further their economic growth and prosperity.

SECTION 4: HONG KONG

The Commission recommends:

44. Congress adopt a resolution urging China to keep its commitments to allow broadly representative nomination and election of Hong Kong's chief executive by universal suffrage in accordance with democratic procedures as articulated in the 1984 Sino-British Joint Declaration on the Question of Hong Kong, the Basic Law of the Hong Kong Special Administrative Region, and the International Covenant on Civil and Political Rights.
45. Members of Congress, when visiting mainland China, also visit Hong Kong to engage with high-level administrators on such issues as democratic election.
46. Members of Congress, jointly with members of British Parliament, promote Hong Kong's high degree of autonomy in accordance with the Sino-British Joint Declaration and the Basic Law.
47. Congress renew the biennial reporting requirements of the U.S.-Hong Kong Policy Act of 1992.
48. Congress reconvene a congressional caucus on Hong Kong to ensure continuous attention to the region's democracy and civil rights issues.



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Executive Summary and Recommendations