

[H.A.S.C. No. 113-69]

**2013 REPORT TO CONGRESS OF THE
U.S.-CHINA ECONOMIC AND SECURITY
REVIEW COMMISSION**

COMMITTEE ON ARMED SERVICES
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

HEARING HELD
NOVEMBER 20, 2013



U.S. GOVERNMENT PRINTING OFFICE

86-076

WASHINGTON : 2014

COMMITTEE ON ARMED SERVICES

ONE HUNDRED THIRTEENTH CONGRESS

HOWARD P. "BUCK" McKEON, California, *Chairman*

MAC THORNBERRY, Texas	ADAM SMITH, Washington
WALTER B. JONES, North Carolina	LORETTA SANCHEZ, California
J. RANDY FORBES, Virginia	MIKE McINTYRE, North Carolina
JEFF MILLER, Florida	ROBERT A. BRADY, Pennsylvania
JOE WILSON, South Carolina	ROBERT E. ANDREWS, New Jersey
FRANK A. LoBIONDO, New Jersey	SUSAN A. DAVIS, California
ROB BISHOP, Utah	JAMES R. LANGEVIN, Rhode Island
MICHAEL R. TURNER, Ohio	RICK LARSEN, Washington
JOHN KLINE, Minnesota	JIM COOPER, Tennessee
MIKE ROGERS, Alabama	MADELEINE Z. BORDALLO, Guam
TRENT FRANKS, Arizona	JOE COURTNEY, Connecticut
BILL SHUSTER, Pennsylvania	DAVID LOEBESACK, Iowa
K. MICHAEL CONAWAY, Texas	NIKI TSONGAS, Massachusetts
DOUG LAMBORN, Colorado	JOHN GARAMENDI, California
ROBERT J. WITTMAN, Virginia	HENRY C. "HANK" JOHNSON, Jr., Georgia
DUNCAN HUNTER, California	COLLEEN W. HANABUSA, Hawaii
JOHN FLEMING, Louisiana	JACKIE SPEIER, California
MIKE COFFMAN, Colorado	RON BARBER, Arizona
E. SCOTT RIGELL, Virginia	ANDRÉ CARSON, Indiana
CHRISTOPHER P. GIBSON, New York	CAROL SHEA-PORTER, New Hampshire
VICKY HARTZLER, Missouri	DANIEL B. MAFFEI, New York
JOSEPH J. HECK, Nevada	DEREK KILMER, Washington
JON RUNYAN, New Jersey	JOAQUIN CASTRO, Texas
AUSTIN SCOTT, Georgia	TAMMY DUCKWORTH, Illinois
STEVEN M. PALAZZO, Mississippi	SCOTT H. PETERS, California
MARTHA ROBY, Alabama	WILLIAM L. ENYART, Illinois
MO BROOKS, Alabama	PETE P. GALLEGO, Texas
RICHARD B. NUGENT, Florida	MARC A. VEASEY, Texas
KRISTI L. NOEM, South Dakota	
PAUL COOK, California	
JIM BRIDENSTINE, Oklahoma	
BRAD R. WENSTRUP, Ohio	
JACKIE WALORSKI, Indiana	

ROBERT L. SIMMONS II, *Staff Director*
KIMBERLY SHAW, *Professional Staff Member*
SPENCER JOHNSON, *Counsel*
AARON FALK, *Clerk*

CONTENTS

CHRONOLOGICAL LIST OF HEARINGS

2013

	Page
HEARING:	
Wednesday, November 20, 2013, 2013 Report to Congress of the U.S.-China Economic and Security Review Commission	1
APPENDIX:	
Wednesday, November 20, 2013	41

WEDNESDAY, NOVEMBER 20, 2013

2013 REPORT TO CONGRESS OF THE U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

STATEMENTS PRESENTED BY MEMBERS OF CONGRESS

McKeon, Hon. Howard P. "Buck," a Representative from California, Chairman, Committee on Armed Services	1
Smith, Hon. Adam, a Representative from Washington, Ranking Member, Committee on Armed Services	2

WITNESSES

Bartholomew, Carolyn, Commissioner, U.S.-China Economic and Security Review Commission	8
Reinsch, Hon. William A., Chairman, U.S.-China Economic and Security Review Commission	3
Shea, Hon. Dennis C., Vice Chairman, U.S.-China Economic and Security Review Commission	5
Wortzel, Dr. Larry M., Commissioner, U.S.-China Economic and Security Review Commission	6

APPENDIX

PREPARED STATEMENTS:

Bartholomew, Carolyn	111
McKeon, Hon. Howard P. "Buck"	45
Reinsch, Hon. William A.	48
Shea, Hon. Dennis C.	78
Smith, Hon. Adam	46
Wortzel, Dr. Larry M.	89

DOCUMENTS SUBMITTED FOR THE RECORD:

[There were no Documents submitted.]

WITNESS RESPONSES TO QUESTIONS ASKED DURING THE HEARING:

[There were no Questions submitted during the hearing.]

QUESTIONS SUBMITTED BY MEMBERS POST HEARING:

[There were no Questions submitted post hearing.]

**2013 REPORT TO CONGRESS OF THE U.S.-CHINA
ECONOMIC AND SECURITY REVIEW COMMISSION**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ARMED SERVICES,
Washington, DC, Wednesday, November 20, 2013.

The committee met, pursuant to call, at 10:02 a.m., in room 2118, Rayburn House Office Building, Hon. Howard P. “Buck” McKeon (chairman of the committee) presiding.

**OPENING STATEMENT OF HON. HOWARD P. “BUCK” MCKEON,
A REPRESENTATIVE FROM CALIFORNIA, CHAIRMAN, COM-
MITTEE ON ARMED SERVICES**

The CHAIRMAN. The committee will come to order. I would like to welcome everyone to today’s hearing on the 2013 Report to Congress of the U.S.-China Economic and Security Review Commission. This hearing is part of a larger oversight effort focus on the Asia-Pacific rebalance led by Mr. Forbes and Ms. Hanabusa, who are providing strong bipartisan leadership on this important topic. We have met with the U.S. Pacific Command officials and last week heard from key ambassadors representing allied and partner nations. However, we cannot consider the rebalance without examining China.

The Commission has undertaken a comprehensive assessment of Chinese military capabilities, economic developments, and political and foreign policy objectives. Their annual report, which was released earlier this morning, is a superb resource for Congress and the public. While we continue to warn about our military’s readiness and the dangerous effects of budget cuts and sequestration, China’s military spending continues to rise and its new leadership seeks to increase combat readiness. Its current pace of military modernization shows that Beijing is developing the ability to project power and influence further abroad. I look forward to hearing the Commission’s assessment of the key military and foreign policy developments made by China in the past year and the implications for our own policies and posture in the region. China can play a constructive role in the region and the world, but for those of us focused on security issues, recent trends in their anti-access and area denial capabilities and cyber espionage campaigns in particular give us cause for concern.

The committee is pleased to welcome the Commission, which is represented today by the Honorable William Reinsch—did I get that close?

Mr. REINSCH. Well done, Mr. Chairman, yes.

The CHAIRMAN. Thank you. Chairman of the U.S. Economic and Security Review Commission; the Honorable Dennis Shea, vice

chairman of the Commission; Ms. Carolyn Bartholomew, commissioner; and Dr. Larry Wortzel, commissioner. I appreciate all of the work that they and their staff have done, and I look forward to hearing their testimony.

Mr. Smith.

[The prepared statement of Mr. McKeon can be found in the Appendix on page 45.]

STATEMENT OF HON. ADAM SMITH, A REPRESENTATIVE FROM WASHINGTON, RANKING MEMBER, COMMITTEE ON ARMED SERVICES

Mr. SMITH. Thank you, Mr. Chairman. I, too, welcome the report and appreciate the commissioners being here to present it today. I think it is very important that we on this committee keep up to date on developments in China, both in terms of their foreign policy aims and also, most importantly, their military buildup. I think it is something obviously we need to be aware of, but I also agree with the chairman's comments that there is no reason that we should have China as an enemy. We should certainly look for ways to work together. I think we have an increasing number of common interests in terms of peace and stability certainly in Asia but globally. China has become more and more involved economically throughout the world, and I think the most important thing is they actually step up and start assuming that role.

Most recently with the typhoon in the Philippines, we have seen once again that they are not there yet. Right in their backyard, second largest economy in the world, and they really have done nothing to be helpful; whereas the U.S. from all the way across the Pacific has in large numbers proven once again that we are the one indispensable nation in terms of helping people in times of crisis. I very much would like to have help in that regard. I think the world would be better served if a nation like China were to step up and begin to take those sorts of greater responsibilities, and I think we need to look for ways to build that partnership and that relationship, ways we can work together. We already, we do some joint military exercises, and I certainly think the world over the course of the next five decades will be a much, much better place if China and the U.S. found more places to be partners and avoided any sort of conflict. And I think that is distinctly possible, but we have to be aware of what is going on.

This report and the work that you all have done is part of that effort, and I look forward to your presenting it and to our questions as we grow in our understanding of China's role in the world.

Thank you.

I yield back, Mr. Chairman.

[The prepared statement of Mr. Smith can be found in the Appendix on page 46.]

The CHAIRMAN. Thank you.

Mr. Reinsch.

Mr. REINSCH. Thank you very much, Mr. Chairman.

The CHAIRMAN. Excuse me. All of your testimonies, without objection, will be entered in the record in their entirety, and now if you could go ahead.

**STATEMENT OF HON. WILLIAM A. REINSCH, CHAIRMAN, U.S.-
CHINA ECONOMIC AND SECURITY REVIEW COMMISSION**

Mr. REINSCH. Thank you, Mr. Chairman, Mr. Smith, members of the committee. As noted, I am Bill Reinsch, I am the chairman during this year's hearing and report cycle. I am going to provide an overview of our annual report, and Vice Chairman Dennis Shea was going to address China's maritime disputes and cross-strait military issues. Commissioner Larry Wortzel will discuss China's military modernization, U.S.-China security relations and China's cyber activities, and Commissioner Carolyn Bartholomew will address China's foreign policy and Middle East issues.

The most significant development over the past year in the bilateral relationship has been the change in China's leadership. Xi Jinping took over as president and party general secretary and Li Keqiang as premier and party secretary of the State Council. China's leadership change has raised expectations that the government will implement the economic reforms that Beijing has long acknowledged are necessary.

Many of those changes have been advocated as well by the Commission, by the Congress, and by the administration. Most recently the new leadership in Beijing provided unusual level of detail of its intended reforms. Among them were promises to raise taxes on state-owned companies, provide Chinese depositors with insurance against loss of principal and to open state-controlled sectors of the economy to competition.

China's economic growth has slowed to a pace of 7.66 percent so far this year. China's new leadership has pledged to at least maintain that rate by shifting China's industrial policy away from its dependence on exports and massive debt-financed infrastructure projects to an economy more dependent on domestic consumption. This would be a welcome change, one that the United States has been urging for some time and one that would greatly benefit Chinese citizens.

Developments in the national security sphere have not been so benign. Under its new political leadership, China's actions in the East and South China Seas continue to increase tensions in the region. It is becoming clear that China does not intend to resolve its maritime disputes through multilateral negotiations or the application of international laws and adjudicative processes but prefers to use its growing power in support of coercive tactics to pressure its neighbors to concede China's claims.

Meanwhile, China continued to develop and field advanced military platforms and weapons systems. China's comprehensive military modernization is altering the balance of power in Asia, challenging decades of U.S. military preeminence in the region. During China's leadership transition, President Xi also was appointed Central Military Commission [CMC] chairman. The commission, China's highest military decisionmaking body, ensures Communist Party control of the PLA [People's Liberation Army], sets military policy and strategy, interprets party guidance for the military, and oversees the daily operations of the massive PLA bureaucracy.

President Xi is the key link between the party and the military and embodies civilian control of the PLA at the highest level. Since his promotion to CMC chairman, President Xi has moved quickly

to highlight broad military policy themes. These themes include the importance of a strong military to fulfill Xi's China Dream goals, increasing China's combat readiness, and reducing corruption in the PLA. Because of historic ties to the PLA, President Xi is well positioned to take on this wide-reaching and potentially contentious agenda during his tenure and may be more active than his predecessor in managing China's military policy. President Xi has recently begun to enhance civilian control over the PLA by creating an agency that in some respects will be analogous to our National Security Council.

It is important to note that policy changes in China sometimes require years of effort by the leadership to create a consensus for action once the general policy has been agreed to. Typically, central government pronouncements filter down to agency levels and provincial and local bodies for implementation, overseen by the ubiquitous party officials. The recently concluded third plenum provides a window into that process. For example, the new leadership apparently takes seriously the goal of moderating the nation's growing inequality between rich and poor, urban and rural, and coastal and interior regions. One step in the right direction is the proposed extension of land rights to China's farmers, who currently face seizure of their collectively owned land by local government authorities.

Now comes the hard part for China's leadership, which is implementation of these proposed reforms. Reforming the economy by empowering consumers is one necessary step in a process that will require many changes. Some of those changes were topics of the Commission's hearing. For example, China's state-owned enterprises must be weaned from their long dependence on the state-owned financial system. China's banks must be allowed to compete for depositors by offering market rate interest payments and reasonable credit terms to China's entrepreneurs and consumers. China's government should also open its closed financial services industry to foreign investors.

At the same time, China needs to meet Western standards of auditing in order to list Chinese companies on U.S. stock exchanges. The Commission also examined China's interest in investing in the United States. While such investment is small relative to America's other major trading partners, China's acquisition of U.S. companies is growing exponentially. With \$3.66 trillion in foreign currency reserves, China has the potential to become a major investor in U.S. companies and real estate. This past year, China made its largest purchase to date of an American company, Smithfield Foods, for \$7.1 billion U.S. dollars.

The Commission also considered the strong evidence that the Chinese Government is directing and executing a large scale cyber espionage campaign against the United States. China to date has compromised a range of U.S. networks, including those in the Department of Defense, defense contractors, and private enterprises. These activities are designed to achieve a number of China's broad security, political, and economic objectives, such as gathering intelligence, providing Chinese firms with an advantage over their competitors worldwide, advancing long-term research and development objectives, and gaining information that could enable future mili-

tary operations. My colleagues will discuss this issue in greater depth as well as China's military modernization efforts, and China's activities in the East and South China Seas. Thank you all for your interest in our work. When my colleagues have concluded, we would be happy to respond to your questions.

[The prepared statement of Mr. Reinsch can be found in the Appendix on page 48.]

**STATEMENT OF HON. DENNIS C. SHEA, VICE CHAIRMAN, U.S.-
CHINA ECONOMIC AND SECURITY REVIEW COMMISSION**

Mr. SHEA. Mr. Chairman, Ranking Member Smith, distinguished members of the committee, thank you for allowing me to testify today. As Chairman Reinsch stated, I will be focusing on China's maritime disputes and the cross-strait relationship. I have submitted written testimony to the committee, and this is a very abridged version of what that written testimony says.

This year, commissioners held public hearings and met with the leaders of the Armed Forces and political bodies in Japan and Taiwan to sharpen our understanding of the East China Sea dispute and the current state of the cross-strait relationship. Those conversations served as the basis of two sections in this year's report, one on China's maritime disputes and one on Taiwan. China's strategy in the East and South China Seas involves delaying the resolution of its maritime disputes while strengthening its maritime and air forces to better assert its claims. By using its military and maritime law enforcement forces to react to perceived challenges to its sovereignty, China seeks to change the status quo of its maritime disputes in its own favor. China applied this approach in the South China Sea effectively and with some success in the East China Sea in the past year. As Beijing has escalated rhetoric surrounding the dispute, it also has sharply increased air and maritime activity near the contested Senkaku Islands.

Our report also identifies popular nationalism, economic development, and China's sense of sovereignty as key drivers underlying China's maritime disputes, suggesting the complex and intractable nature of these issues. These factors, combined with China's inconsistent adherence to internationally accepted norms of air and maritime operations, contribute to an environment in the East and South China Seas that is both politically and operationally tense.

Turning to Taiwan, China and Taiwan enjoyed generally positive relations this year, characterized by growing economic ties and relatively amicable political relations. Despite these positive trends, China's cross-strait policy remains focused on pursuing balance.

The CHAIRMAN. We don't know what that is. Until we find out, please continue.

Mr. SHEA. Okay. I apologize if I said anything offensive to anyone.

Well, turning to Taiwan, China and Taiwan enjoyed generally positive relations this year, characterized by growing economic ties and relatively amicable political relations. Despite these positive trends, China's cross-strait policy remains focused on pursuing a balance of economic, political, and military power that heavily favors China with the eventual goal of eventually unifying with Taiwan. China is more prepared than in the past to conduct several

different military campaigns against Taiwan, including a partial naval blockade and a limited air and missile campaign. In my view, a strong U.S. military presence in the western Pacific and the deterrent and stability effect it provides is critical to preserving peace in the region.

At the top of the Commission's list of recommendations this year is a recommendation that Congress fund the U.S. Navy shipbuilding and operational efforts to increase its presence in the Asia-Pacific to at least 60 ships and rebalance home ports to 60 percent in the region by 2020. I think my colleague, Commissioner Wortzel, will get into this, but China is undergoing an incredible naval modernization effort, and by 2020, they may have the largest fleet of modern submarines and surface combatants in the western Pacific.

Other recommendations focus on the need for the United States to help our partners and allies improve maritime domain awareness in the East and South China Seas and the need to deepen strategic trust between the United States and China. In environments as potentially explosive as the East and South China Seas, strategic trust provides the foundation to reduce the potential of miscalculation at sea. To further develop the U.S.-Taiwan relationship, we recommend Congress urge Cabinet-level officials to visit Taiwan in order to promote commercial, technological, and people-to-people exchanges. We further recommend Congress direct the administration to permit official travel to Taiwan for senior Defense and State Department officials.

Finally, I would like to highlight a recommendation to Congress to direct the administration to transmit an unclassified report on U.S. arms sales to Taiwan. Taiwan's diminishing ability to maintain a credible deterrent capability could incentivize China to pressure Taiwan toward political talks or to use military force to achieve political objectives. The report we recommend would not only provide accountability on the progress of planned sales, it would also, I believe, support U.S. strategic interests in the Taiwan Strait.

Again, members of the committee, Mr. Chairman, Ranking Member Smith, thank you for this opportunity to testify.

[The prepared statement of Mr. Shea can be found in the Appendix on page 78.]

**STATEMENT OF DR. LARRY M. WORTZEL, COMMISSIONER,
U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION**

Dr. WORTZEL. Mr. Chairman, Ranking Member Smith, members of the committee, I want to thank you for the opportunity to testify today, and what I am going to do is present some of the Commission's findings on China's military modernization, U.S.-China security relations, and cyber activities from this 2013 report to Congress.

The extensive modernization of the People's Liberation Army enables the PLA to conduct operations farther from China's coast and makes the PLA more formidable in all of the dimensions of war—air, space, land, sea, and the electromagnetic spectrum, which includes cyber.

Major elements of PLA modernization are really designed to restrict U.S. freedom of action throughout the western Pacific. China already has 65 submarines that can employ intercontinental ballistic missiles, torpedoes, mines, or anti-ship cruise missiles. The PLA Navy's surface combatant force has modernized, and its 77 major surface combatants are networked and capable of conducting multiple missions, and they are supported by a growing combat logistics force that can sustain them at sea. The PLA Air Force is getting new bomber aircraft that will carry long-range land-attack cruise missiles, and China is also developing new stealth fighters.

While China's military is growing, our own is shrinking. China's firing of a rocket into nearly geosynchronous Earth orbit in 2013 probably tested the vehicle component of a new high-altitude anti-satellite capability, and that would threaten our GPS [Global Positioning System] satellites and our SBIRS [Space-Based Infrared System] infrared missile launch detection satellite.

Bilateral military-to-military relations deepened and expanded in 2013 between China and the U.S. To date, there have been eight rounds of Track 1.5 U.S.-China strategic dialogue that address critical issues, like nuclear strategic stability. I see this as one of the most productive dialogues that takes place with China. Still, I think military contacts with China require constant congressional oversight.

For China's military, cyberspace is an important component in national power, and it is a critical element of its strategic competition with the United States. The Chinese Government is directing and executing a large-scale cyber espionage campaign that poses a major threat to U.S. industry, critical infrastructure, military operations, personnel, equipment, and readiness.

Looking at some of the Commission's recommendations, it looks like the Department of Defense is already taking some action to make at least information technology in the supply chain more secure. They just passed a new—they will pass a new directive. On November 18th, they finally took some action, but we need further work on supply chain security.

The Commission recommends a careful examination of the Federal use of cloud computing platforms and services with attention to where the data storage and computing services are located. If they are located in the Third Department of the People's Liberation Army, it may present a little bit of a security risk. It is clear that naming the perpetrators in China in an attempt to shame the Chinese Government will not deter cyber espionage. Mitigating these problems will require a well-coordinated approach across the government and with industry.

The Commission recommends Congress clarify the actions that U.S. companies may take regarding tracking intellectual property and amend the Economic Espionage Act to permit a private right of action when trade secrets are stolen.

My personal view is the President already has some powerful authority to sanction Chinese people and companies through the International Emergency Economic Powers Act. If the magnitude of Chinese espionage is causing the amount of damage to the U.S. economy that the NSA [National Security Agency] Director tells us is the case, then the President ought to exercise that authority.

In closing, I would like to address the U.S. rebalance to Asia. The Navy aims to increase its presence in Asia to 60 ships and 60 percent of home ports by 2020. However, Chief of Naval Operations, Admiral Greenert, has recently warned that budget constraints would delay or prevent the Navy from achieving those objectives in a rebalance. So you can have 60 percent of something out there, but by 2020, China's navy and air force will outnumber and almost match the technical capabilities of our own forces in the Asia and Pacific. A shrunken military may be insufficient to deter China or to reassure our friends and allies in the region. I thank you for the opportunity to appear today, and I am happy to respond to any questions you may have.

[The prepared statement of Dr. Wortzel can be found in the Appendix on page 89.]

**STATEMENT OF CAROLYN BARTHOLOMEW, COMMISSIONER,
U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION**

Ms. BARTHOLOMEW. Thank you.

Mr. Chairman, Ranking Member Smith, members of the committee, I join my colleagues in thanking you for the opportunity to testify today. I would like to start by expressing my condolences on the recent loss of former Chairman Skelton. His leadership, like yours, has supported our troops and protected our national interests in the great tradition of this distinguished committee.

Like my colleagues, I have submitted my written statement for the record. Today I will be discussing China's foreign policy, particularly in regard to the Middle East and North Africa, which I will refer to today collectively as MENA, and also India and North Korea, all of which we examined in our 2013 annual report.

As China's global interests expand, Beijing is becoming increasingly assertive and active in its foreign affairs. This trend is apparent in MENA where China's ever-growing demand for energy imports has driven Beijing to pursue greater political and security engagement. Beijing's emergent influence in MENA has at times competed with or challenged U.S. strategic interests, particularly in Syria and Iran. As in other parts of the world, it remains to be seen whether China's stated interests in regional stability and peace will make a lasting positive impact in MENA. Given the United States deep security interests in the region, China's developing role there presents geostrategic opportunities and challenges for U.S. diplomats, policymakers, and Armed Forces.

In the past decade China's trade and economic ties with MENA have grown substantially, driven primarily by China's demand for energy. Over half of China's crude oil imports are from MENA, and China's dependence on the region will only continue to grow in the coming decades. Given this trend, the Commission expects China will increasingly augment its already robust economic ties in the region with stronger political and security engagement in an effort to protect and enhance its energy security interests.

Historically, China has avoided directly opposing U.S. power in the region, content to free ride on the U.S. security presence there. In recent years, however, Beijing appears increasingly willing to take positions on important regional issues that directly oppose or undermine U.S. interests and objectives. This is clearly the case

with Syria. Despite its emphasis on neutrality and peaceful resolution in public statements, China repeatedly has used its veto power to prevent the U.N. from singling out, blaming, or imposing sanctions on the Syrian Government.

In recent weeks, Beijing has slightly reoriented its policy to appear less supportive of Assad and more supportive of mainstream efforts to facilitate peace in Syria. For instance, China has made occasional efforts to reach out to the Syrian opposition, has called for talks between the regime and the opposition in Geneva, and has supported efforts to eliminate chemical weapons from the country. These recent efforts notwithstanding, China's fundamental position on the conflict does not seem to have changed.

Another problematic element of China's MENA engagement is Beijing's continued ties with and support for Iran. As elsewhere in the region, energy interests are a primary driver of the Sino-Iranian relationship, although I would note that there has been a relationship that has been a millennium going between the two countries. China is Iran's top crude oil customer and sources about 8 percent of its crude oil imports from Iran. Although China seeks to prevent its ties with Iran from becoming a flash point in U.S.-China relations, China has not halted its energy trade with Iran, despite U.S. sanctions. Instead, Beijing maximizes its economic leverage over Tehran to secure advantageous oil trade deals, then seeks exemptions from or exploits loopholes in the sanctions to ensure steady access to energy.

Concerns persist about the role of China in proliferation of weapons to Iran. In the past, China sold tactical ballistic and anti-ship cruise missiles to Iran. China may continue to provide support to Iran's advanced conventional weapons programs. Since 2009, the U.S. has sanctioned six Chinese entities for missile or weapons proliferation to Iran. Moreover, while Beijing insists it has not provided assistance to Iran's nuclear program since 1997, open source reporting suggests that Chinese assistance and components have continued to augment Iran's nuclear programs.

China's growing assertiveness was on display in its relationship with India this year as well. Sino-Indian tensions flared in April when New Delhi claimed that 30 to 50 Chinese soldiers crossed the China-India border about 12 miles beyond the line of actual control, the effective border between the two countries, and stayed there for 3 weeks. While Beijing and New Delhi resolved the border impasse in May after a series of talks, the potential for periodic low-level confrontations between border patrols to escalate likely will persist.

Turning finally to China's relations with North Korea, Beijing for decades has provided Pyongyang with economic and political support, shielding its neighbor from harsh punishment by the international community for its destabilizing rhetoric and activities. While Beijing appeared increasingly dissatisfied with Pyongyang after a series of North Korean provocations in the past year, the Commission assesses Beijing is not likely to significantly alter its support for the country.

In conclusion, the impact of China gradually taking on a more assertive global role will be significant. Beijing may become more willing to use its increasing political and economic clout to wield

its influence. This trend has significant implications for the U.S., particularly if China's foreign policies undermine or challenge America's.

Thank you for the opportunity to testify. Like my colleagues, I look forward to your questions.

[The prepared statement of Ms. Bartholomew can be found in the Appendix on page 111.]

Mr. FORBES [presiding]. Thank you all for your testimony. We appreciate you volunteering to do this effort. You do a wonderful job and produce a good report. It is my understanding that you also have with you several members of your staff who contribute so much on this today.

And Mr. Chairman, I wonder if you would just ask them to stand up, any members that are here, so we can thank them for the good work that they do if you have anybody with you today.

Mr. REINSCH. Go ahead, everybody.

[Applause.]

Mr. FORBES. Well, we want to thank you all for the good work that you guys do on that.

And I just have a quick question for you. As we look at the capabilities, your report makes clear the enormous increase in capabilities that China is having. This weekend I was with a former member of the current administration who had been with the Pentagon and made an interesting observation that it didn't matter what the intentions of China might be, the capabilities are what we had to plan for, but having given that assumption, you guys are looking at this in a very careful way. Could you give us just your assessment of what you think the Chinese intentions are? We see these capabilities, and there is a huge dispute as to what their intentions are, but as we see this beginning to take shape more and more, I would just ask you to look in your crystal ball and give us your best assessment of what you think the intentions of all this military buildup is, and I will let you decide who wants to respond.

Mr. REINSCH. You may find we don't all agree on that.

Mr. FORBES. No, no that is what this is about. So we appreciate that.

Mr. REINSCH. Dennis, go ahead.

Mr. SHEA. I will just very briefly—there are probably multiple, multiple intentions, but one of the intentions that particularly concerns me is they are trying to deny access to the western Pacific by U.S. forces and to extend military power out to the second island chain, which is about 1,800 nautical miles from the Chinese coast, and be able to operate freely in that area and basically remove the United States as the predominant military force in that region of the world.

Mr. FORBES. Any other thoughts?

Mr. REINSCH. Larry or Carolyn?

Ms. BARTHOLOMEW. Larry, you can go.

Dr. WORTZEL. I think their goals are at two levels. I think in the western Pacific, that 1,800-mile range to prevent the United States from intervening in any contingencies is a very serious range, and it is a range that is roughly equal to the combat radius of carrier aircraft and the range of a Tomahawk cruise missile. They want

to keep us far enough out that we can't get near their coast or their interior.

But the greater charge that the previous Communist Party Chairman gave—Hu Jintao gave to the Chinese military, which Xi Jinping reinforced, is the ability to go out beyond that western Pacific and have a military capable of defending China's interests, global interests. Now, they look at about 2050 before that comes about, but they are worried about sea lines of communication into the Indian Ocean. They are worried about their oil supplies. And they recognize that, yes, they have been free riders, as Ms. Bartholomew said, but they are not comfortable with that.

Mr. REINSCH. My background is in trade and economics, so I defer to Larry and the others on particularly the short-term military issues.

I guess I would say that I think in the medium term, their policy goal is to expand the range of influence in the region, particularly over that part of Asia to the south of them that has over thousands of years of history that they have historically tried to influence, and I think they want to, you know, recapture the historic relationship they have had with those parties. I don't think they intend to do that in a military way particularly. I think it is a combination of exercising a variety of means of influence, but that includes some fairly aggressive tactics in the South China Sea, as we have seen.

I think one of the dilemmas they face, and Larry alluded to it, is whether they can successfully or whether they even want to make a transition from a regional power to a global power. They have been very tentative in looking outside their region. I thought their participation—and their participation is limited but still helpful—in the Somali anti-piracy effort, for example, is a very important step, it was a very important step for them. Their contribution to U.N. peacekeeping forces has been, I think, a significant contribution. Their efforts to reach out beyond their comfort zone, if you will, so far have been careful, cautious, and largely constructive. We do have situations obviously where their policies, Middle East being one that Carolyn talked about, have bumped up against ours in part because we have different interests, and those are areas where we are simply going to, I think, continue to have different interests for the long term.

Ms. BARTHOLOMEW. All right.

Mr. SHEA. Clean up.

Ms. BARTHOLOMEW. Yeah, I will do clean-up. You will see, we have 12 of us on this Commission, and we have a wide range of views, and you guys know what it is like marking something up. When we go through our report, it ends up for the most part being a consensus document, which means sitting in the room, hammering it out paragraph by paragraph, line by line, and sometimes word by word. So thank you for the opportunity. I think you will see that there are probably some differences in some of our views.

I think just from sort of a bigger picture that I think that China is ultimately interested in retaking what it sees as a historic position in the world. I do think that it is necessarily going to be taking on a bigger global role, partly because of its search for resources, which it needs in order to build its economy the way that it wants

to. I think that that will potentially and frankly inevitably end up challenging U.S. power in a lot of ways, sometimes intentionally, but sometimes it is just we will be playing in the same space.

I know people like to give the Chinese Government credit for their work on counter-piracy. I guess I always need to say that they are there protecting their own interests, and we see the world fundamentally differently, which is that the U.S. sees that it has a global responsibility and it isn't just our interests that we are advancing.

And the final thing that I really would like to note is that I am particularly concerned about what I see as China exporting a model of economic growth with authoritarian government, and we see that is certainly of interest in Africa, both in North Africa and in the rest of Africa and other places; people who have a tendency toward authoritarian orientation and see opportunities for doing economic growth in trade deals with China, I think is going to be a real challenge for us.

Mr. FORBES. Well, thank you all, and the chairman and the ranking member both had commitments that they had to step out for, but we are ably represented by Congressman Davis, and I would like to recognize her for any questions that she might have.

Mrs. DAVIS. Thank you, Mr. Forbes.

I might just follow up on your question. Just if you could maybe characterize in some ways the differences on the committee and perhaps kind of the range of where people were coming in and what you think that was based on because we really appreciate the fact that you are here and the fact that there certainly are some differences. There are differences, of course, as you know, on this committee, and if you could give us a little more depth about that, that would be helpful.

Ms. BARTHOLOMEW. We probably all have different views on that, too.

Mr. REINSCH. Well, let me begin on that one. I think one of the advantages of the Commission is that the members bring to it different background and expertise. I said mine is primarily in international economic policy and trade, although I served in the Clinton administration as Under Secretary of Commerce for Export Administration and dealt with export controls and technology transfer.

Others bring different experience. Larry is known to many of you, his long experience in the military. That has meant in effect the Commission approaches the issues differently based largely on the differences of background.

A number of members of the Commission over the years, and I have served on it from its inception, have been primarily concerned with the military challenge that China poses for us in multiple areas, and our work there has shifted over time from, you know, nuclear power to naval power, satellites, cybersecurity, whatever.

I think a number of the other commissioners, many of them on the Democratic side, frankly, have focused more on China's economic challenge and the challenge it presents to our industrial base, not only our defense industrial base but our manufacturing base, and our overall trade relationship to China.

The mandate that Congress gave us when we began was to study both, and we have tried very hard each year to, you know, balance our hearings and activities so that we focus on both. I think it is fair to say that all of us, and you can all disagree with me if you want, but I think all of us see that China poses a lot of challenges for us. I use the word advisedly. In our first year, in our first report, the biggest debate we had was over whether to use the word “threat” or not, and I was one of those that preferred not to use the word “threat,” but I think “challenge” is an appropriate word. China presents challenges all over the map, largely because of its size, and as Carolyn said, there are areas where we are going to bump up against each other or not deliberately but because we are both large powers that share space. So I think we try to navigate our way through that and try to identify hopefully in advance those areas where we would recommend Congress take a closer look at.

Mr. SHEA. Yeah, I think we are divided into two teams, security and economics, and my assessment is that there is general close to unanimity on the security side, and there is less unanimity on the economic side.

One issue that the Commission has sort of advanced is examining the investment by Chinese state-owned enterprises into the United States, which at this point is relatively modest. I think most of us think there should be a heightened level of examination and concern about this. There are a minority of commissioners who will say, well, it is just like Japanese investment in the 1980s, but I think some of us, including myself, say, well, these state-owned enterprises are organs of the Chinese Communist Party. The leaders are appointed by the Organization Department of the Chinese Communist Party, the large ones. They, China is engaged in a massive economic espionage campaign against the United States. That didn’t happen in the 1980s, I don’t believe, by Japan. And China is building up a military that is designed to restrict U.S. access to the western Pacific. So—and it is all part of the larger Chinese enterprise. So we are called the Economic and Security Review Commission for a reason, because the two areas are closely linked.

Ms. BARTHOLOMEW. Yes, it is a good and interesting question, and for those of you who don’t know of us, I mean, as I said, there are 12 of us, 3 each appointed by the House and Senate Democratic and Republican leadership, so we come with different orientations and with different levels of expertise.

I think in the 10 years that I have served on the Commission, I see that a number of people have sort of a strong economic orientation and some sense that economic strength is critically important to our national security and our national strength, and others have had a more what I would call traditional military and security orientation. But I do think that over the 10 years that I have served on the Commission, that we are seeing more alignment in places, and that was in some ways what we were established to do.

I would say out of fondness with my colleague Dr. Wortzel, the first time I saw him really interested and then concerned about the economic issues is when we—manufacturing, when we looked at the defense industrial base and what was the ability of our manufacturing sector to be able to create components for the warfighter

if we needed it, as things were being outsourced more and more, and what was the future of our tool and die industry, so there are places that we have really crossed over in terms of looking at the issues and bringing our own orientations but recognizing that there are a lot of challenges that we can all work together on.

Dr. WORTZEL. I came on to this Commission with a very strong orientation toward espionage, military developments, and looking very hard at Chinese long-term intentions, as their military literature defined it, and probably for the first year resisted almost attending a hearing that had anything to do with economics. But I was educated.

And I have to say that if I had to pick out a single area where you might find tension and debate, it is over the orientation of the United States as a free trade and open trading nation and the challenge that is posed by dealing with an authoritarian state composed almost entirely of state-owned industries, populated with people who have to follow the dictates of a long-term plan by the Communist Party and how you—our tensions tend to be over how you maintain a free and open trading system with proper national security controls for exports and still meet the challenge of this controlled economy that has so many substitutes.

Mrs. DAVIS. Thank you.

Thank you, Mr. Chairman.

Mr. FORBES. Thank you, Ms. Davis.

Mr. Conaway is recognized for 5 minutes.

Mr. CONAWAY. Well, thank you, Mr. Chairman.

And ladies and gentlemen of the Commission, thank you for your work on this issue. The—just a quick brief look at your report shows at first blush a particularly juggernaut of China across all these spectrums. Could you also talk to us or did your Commission look at where is China's Achilles heels to be able to fulfill all of these grand schemes? You know, they have got a particular, almost visceral fear of internal unrest. They have got demographic issues, a one child policy. They have got a tremendous imbalance in marriage age females versus males and an economy that has got to grow faster than ours in order to soak up all the new interests. Could your Commission talk to us a little about those aspects of can China actually deliver on all of their grand schemes?

Mr. REINSCH. Yes, I think that you have provided a very good list, and these are issues that we have looked at over the years. They have an enormous number of problems. They have a demographic problem, as you noticed, as you noted. In past years, we have spent a lot of time on their environmental problems, which actually is one area where cooperation between us and them can be useful, both in terms of technology sharing and because of the environmental benefits. If they clean up their air and water, that is good for everybody, beginning with their people, but it is also good for our people, because their air blows over in this direction, and people who represent the West Coast are familiar with that problem.

They know it is a problem, and they are under significant domestic internal pressure to deal with it. It is visible every day, and if you go there, you will experience that.

My own interest has been in their enormous economic problems. Right now, in the wake of the financial crisis, you know, virtually every country has economic problems. I, frankly, would much rather be us than them under the current circumstances. Their steps to—they are moving in the right direction economically, but they have, I think, a long way to go. They are taking baby steps, and they have the central dilemma of, how do you liberalize economically without opening the door to pressures for political liberalization, which is the central conundrum of how they are trying to operate?

This regime—I am sorry, this administration if, I mean, President Xi and Premier Li, if anything, have given early indications of being tougher politically even than their predecessors and more resistant to political change and trying to address demands for political reform by fighting corruption. Unfortunately, in my view, corruption is kind of an integral part of the way the regime operates. They can't effectively deal with corruption without undermining the party's control, and that is their central dilemma. And they have to face the problem of trying to deal with that in that context. They have to deal with the fact that anything they do to liberalize the economy is inevitably going to create political pressures that are going to complicate their life. That, to me, is the biggest problem they have got.

Mr. SHEA. I think, Congressman, you and Chairman Reinsch have put together a nice list of the problems that China faces.

The one additional vulnerability or two additional vulnerabilities I would see are the debt. We don't know how much debt is in the system. They had a huge stimulus program. They rely on local governments to finance infrastructure projects, so there is a huge amount of debt floating around in the system, and it is very opaque. We just don't have a good handle on how much outstanding debt there is.

There is also, they don't have a strong culture of breakthrough innovation. They are very good at incremental innovation. We had a hearing last year on this subject, and they are very good at going on the manufacturing floor and trying stuff out in the marketplace, bringing it back, fixing it, but very much incremental. They don't necessarily have a culture yet of people challenging conventional wisdom, breakthrough thinking.

Dr. WORTZEL. I would like to address some of the things that we have had in previous annual reports that I think meet your question. Among them, the inability to master the metallurgy for jet turbine fan engines and marine engines, naval engines. They just can't do it.

The attempts with difficulties in addressing air and water pollution that we have looked at in China, you know, there are real ways we could help them there.

Dennis mentioned the problems in innovation, and then, finally, the weaknesses in their military and developing a cadre of personnel that are able to maintain a networked, I think I can use the acronym in this committee, C4ISR [command, control, communications, computers, intelligence, surveillance and reconnaissance] system that they know they need.

Mr. FORBES. The gentleman's time has expired.

And the ranking member has been a strong leader in this area, and he has returned, so the chair would recognize him for any questions he may have.

Mr. SMITH. Thank you, Mr. Chairman.

I think you mentioned in your opening remarks a lot of the different areas where China has, you know, conflicts over the islands and, you know, differences with, you know, border disputes. What do you think are the most likely to cause problems in those areas? What is the greatest challenge, the country they are most likely to come into conflict with, and how might we go about trying to resolve some of those border disputes? What role should we play? What role should others play? Because that seems to be the area that, you know, is most causing China to be more belligerent as they, you know, advance territorial claims, you know, basically because they want the mineral rights, and they think they are the biggest kid on the block so they can go ahead and force their way in. What is the best way to defuse that?

Mr. SHEA. I think the best way is to have a strong U.S. military presence there. If Japan weren't operating under a security umbrella with the United States, I wonder what would be happening now. So I think the best way to preserve peace in the area is to have a strong, strong naval, U.S. naval presence.

One thing that is very concerning is the possibility of something happening, an incident happening at sea that is unintentional. You probably, the committee has probably heard about the incident earlier this year, the two incidents involving the PLA Navy locking target, radar targeting on a Japanese vessel, naval vessel, and a Japanese helicopter. The Japanese showed tremendous restraint in not reacting to that. It seems as if—my impression is that that was more of a tactical decision made by the local PLA, the commander of the PLA Navy vessel, as opposed to some sort of great strategic decision. I think the PLA Navy is getting a little more sophisticated and aware of norms, maritime norms, but something like that could really—is really a problem.

I have asked some Japanese interlocutors, do you have a phone where you call, can someone in the Japanese military call someone in the Chinese military directly and say, we have this situation at sea? We don't want this thing to blow out of control, and there is no mechanism for that type of consultation or communication. So I believe transparency, communication, strong U.S. military presence.

Ms. BARTHOLOMEW. Yeah, I would join in that. I think internally one of the biggest flash points they have is Xinjiang and how that is handled and what ultimately happens, but as I look at China and the region, I am concerned about I guess what I would call incremental expansionism, which is that their moves in the South and East China Seas to sort of, they have these historic claims, but it is sort of they keep moving forward a little bit and not ever coming back quite as far as they had done before.

And it is affecting the Philippines, as you mentioned, Mr. Smith, you know, the terrible tragedy that happened in the Philippines and what kind of role, but it is affecting Vietnam and Indonesia and Japan, and I think I certainly agree with my colleague that having a U.S., a strong U.S. presence in the region I think to rebal-

ance both militarily and economically and diplomatically, it is going to be really important to try to defuse some of these things.

Mr. SMITH. One other question along these lines if I could, and China, the neighbors around China, one of the concerns is that as we, you know, go through some of the budget struggles that we have had and speculation about sequestration and all that, you know, the neighbors, they are going to recalculate basically that, you know, well, China is the only person, but it just seems to me that it is unlikely because the relationship with China is difficult, but how do you see that playing out? What are Vietnam, Philippines, how are they going to deal with the fact that we may not have as big a presence as we would like? I mean, I think we are going to have a presence, but how do you see that rebalancing?

And I am sorry, Dr. Wortzel, you were going to dive in there, so I will let you.

Dr. WORTZEL. That is all right. I will start with that, sir. It seems to me that part of it depends on whether the surrounding nations are traditional U.S. alliance partners, so that extended deterrence and the confidence in U.S. extended deterrence is extremely important in the region. I think that Secretary Clinton and Panetta and Gates' remarks on the importance of resolving maritime disputes peacefully and that U.S. does have an interest there are extremely important, and the explanation and the situation with the Senkakus in Japan is very different than the situation with the Philippines and Scarborough Shoal, but your question on what is the most explosive, potentially explosive problem, in my view, is not the land borders, that could, you could have scuffles; the most potentially explosive or volatile problem is the positions that China takes on the range of activities that can be conducted in the South China Sea, East China Sea, and its own exclusive economic zone because that is where you get things like the EP-3 incident. That is where you get the painting of Japanese ships with fire control radar. That is where you get the *Invincible* and *Bowditch* incidents, and those things can really spiral out of control.

Mr. REINSCH. If I could add, I think that in terms of how others are going to respond, in the short run, Chinese behavior, which I would characterize as aggressive in the region, if anything, is driving them closer to us, and you have seen that.

Mr. SMITH. That would have been my logical conclusion as well, yeah.

Mr. REINSCH. I think that eventually the Chinese are going to figure that out and will probably respond with more sophisticated tactics, but in the short run, it has helped us. There is at the same time and always has been in the region this lingering fear that the Americans are going to leave, and it is one of these things that no matter how many times every administration of the last six or seven has said we are not leaving, there is always still this undercurrent of fear that we might. I think it is incumbent on every administration, regardless of party, to continue to reassert our interests in the region and continue to take concrete steps to demonstrate our interest in the region.

Frankly, from my point of view, the most useful thing the United States can do in the short run is to conclude the TPP [Trans-Pacific Partnership] negotiations, and Congress can approve the TPP.

Mr. SMITH. Right.

Mr. REINSCH. A little lobbying here, and we can demonstrate to the region that we have an ongoing long-term trade and investment, which is important, and as well as military commitment to the region.

Beyond that, I think you are going to see different countries reacting in different ways. The Vietnamese, who historically have had an adversarial relationship with China, haven't changed, and I think are focusing first on a search for more friends anywhere they can find them, including us, and will be looking at their own military buildup. The Philippines, for obvious reasons, which is having a terrible crisis they have to deal with in the extreme short run, I think is going to be doing the same thing.

The countries farther south I think are—it is a little bit more complicated. Indonesia is facing an election and probably a change of administration. It is hard to predict what is going to happen there. But the picture will be different in each case.

Mr. SMITH. Okay. I think that pretty thoroughly answers my question. I will yield back, give some others a chance. Thank you, Mr. Chairman.

Mr. FORBES. Thank you, Mr. Smith. The Chair now recognizes the chairman of the Readiness Subcommittee, Mr. Wittman, for 5 minutes.

Mr. WITTMAN. Thank you, Mr. Chairman. Chairman, members of the Commission, thank you so much for joining us today. I want to begin with Dr. Wortzel, and ask you a question about the readiness posture both of China and of the United States. As you know, President Xi has said that he is emphasizing the readiness of Chinese military forces. I want to know, in that perspective, how does China view the current situation in the United States with sequestration, the current military readiness challenges that we have? And where does that put China from the standpoint of their strategic thinking about the United States, not just in the Asia-Pacific, but how they are interacting across the globe?

Dr. WORTZEL. Well, they see us, their military thinkers and writers and political leaders, see us in a slow decline, and struggling to meet the obligations that we have cut out for ourselves. And they look at, you know, some things that might be effective operational tactics like air-sea battle and think that we may not be quite capable of doing those things with the proper number of forces.

At the same time, I think they recognize that we really do have probably the best, most used, and most practiced military at operations in the world, and they don't have that. They have a lot of great operational doctrine, in part, modeled on ours. They have exercised it several times in what we would call unified commands, supported across the Armed Forces in an integrated way, but they have never really used it. And they are not practiced at using it. And I think that is going to take them quite some time.

Mr. WITTMAN. Very good. I want to pose a question to the entire panel. Looking at the recent natural disaster there in the Philippines, looking at the U.S. response, which I think we are all very proud of, and we understand what we can do in that region of the world, and then looking at the Chinese response, what does that

do for our relationships in the region, not just with the Philippines, but how other nations look at us? And what does it say about the Chinese limited response? And what does it say about Chinese capacity? Is it an issue of a lack of will to do this? Is it an issue of a lack of capacity? Where does that stand? And again, how is that viewed within that particular region?

Ms. BARTHOLOMEW. Yeah. Well, I think, as you said, Mr. Wittman, that we can all be really proud of the way that our Armed Forces respond, both in the Philippines, I would say going back to the tsunami in Indonesia, and also the Tohoku earthquake in Japan. I think that that buys us an enormous amount of good will. It is not the reason that we do it, but it is one of the benefits that we do it. And I found it particularly interesting, as Mr. Smith mentioned, that China's first response on the Philippines was really pathetic. I mean, it is the only way to describe it. And I think that there was enough international concern and outcry that they have stepped up some. But, you know, people remember who is there and helping them. It is like constituent service in some ways, people remember who has helped them.

So, you know, I know that one of the sort of shared military exercises is disaster response that is happening. I don't think that it is simply going to be the mechanics and the logistics of disaster response. I think that the Chinese are going to need to change their entire orientation in terms of what is their responsibility in the region when it comes to crises. But I am, like you, very proud of our armed services and the way that they always respond to these things.

Mr. REINSCH. If I could add to that, I was struck on the financial relief side that a single American company, Philip Morris International, has contributed more to the Philippines than the Chinese, all of China has, which I think says something. One of the things, when I used to teach this issue years ago, one of the texts I used talked about the key element of hegemonic leadership globally is the willingness essentially to take one for the team, to take on, to bear costs in the interests of maintaining the system and helping everybody else. It is what the United States did after World War II, for example, to rebuild the system. And the costs were not that great at the time, but the rewards—not the direct rewards, but the rewards for the people of Europe were enormous.

The Chinese continue to demonstrate over and over and over again that they haven't learned that lesson. Their responses tend to be tactical. They are mad at the Philippines for reasons that we all know. So their response is to demonstrate their irritation. Unless they grow beyond that, their capacity for leadership, either regionally or globally, is going to be limited.

Mr. WITTMAN. Okay. Thank you, Mr. Chairman. I yield back.

Mr. FORBES. Ms. Bordallo, the ranking member of the Readiness Subcommittee, is now recognized for 5 minutes.

Ms. BORDALLO. Thank you very much, Mr. Chairman. And I thank all of our witnesses for being here today to give us further information. My first question is in regards to how China views our selective hardening and dispersal plans. As your report has discussed over the past year, China has enhanced its anti-access/area denial [A2/AD] capabilities with certain stand-off weapons systems.

So part of countering that A2/AD threat is selective hardening and dispersal of Air Force facilities in the Pacific Command area of responsibility. How important would you say are these actions to countering the A2/AD threat? And what message does this send China? How does this change their calculations?

Dr. WORTZEL. I think that we absolutely need to harden and disperse. And it is critical to the survival of our military assets. But I think what it will do is force the Chinese to improve their ability to mass weapons on a target, to use intelligence, surveillance, and reconnaissance to identify hardened targets, and to improve their ability for precision strikes on those targets. So hardening is one part of what we need to do. It seems to me that the second part are ballistic missile and cruise missile defenses. That the real answer, in my opinion, to massed warheads, whether they are coming from ballistic missiles or cruise missiles, is you really have to move forward on directed energy, whether it is ship-based or land-based or air-based laser and things like that. So we really don't have adequate—in my opinion, adequate responses to what they can mass in terms of cruise missile and artillery fires.

Ms. BORDALLO. Thank you. I have another question. It is also for any of the witnesses. There has been a lot of discussion about the outcomes from the third plenum session of the 18th Congress in Beijing. There has been a lot of focus on the development of the national security council-like entity, although we wait for the details of how this organization is going to be structured, as well as the announcement that China was easing its one child policy and closing their detention centers.

Now, I know it is only a few days since the session concluded, but I am wondering what all these actions in total paint. Tell us. Can you comment on their actions? Is it serious concern among the political elites about growing internal instability in China? And is there a way of trying to more effectively coordinate government, but also defuse political hot button items?

Mr. REINSCH. Let me begin, if I may, Ms. Bordallo.

Ms. BORDALLO. Yes.

Mr. REINSCH. First, just to note, these events all happened after our report, so obviously, they are not covered in the report. We did produce a detailed memorandum on the plenum document and the document that appeared last Friday as well. We have circulated it to members of the committee, I believe. If we haven't, we are going to. And it is also on our Web site. So I would encourage you to have your staff to take a look at that for greater detail. The initial document was disappointing, partly because it was at 40,000 feet, and managed to say several different things in different directions simultaneously.

I think that we would probably say—and we haven't had a chance to discuss it collectively—but I think that our view would be that the document they provided on Friday has a number of promising elements to it. The biggest question always, as I mentioned in my opening statement, is whether they will actually be able to implement these things. You know, the old slogan that mountains are high and the emperor is far away is as true now as it was 5,000 years ago. These things often don't happen at the local level.

And in terms of, you know, public unrest, as you mentioned, some things that will be very popular, like expanding land use rights for farmers, for example, to prevent arbitrary seizures, and dealing with the hukou system, the urban and residential permit system in some modest ways, whether those are implemented or not really is going to be up to local authorities, and not the national authority. And we simply have to wait and see what happens.

The sign from the document is entirely a positive one. In some larger areas, I think their steps forward are modest. Even assuming they are implemented, they will be modest. I think the debate amongst economists is going to be whether they are heading for a hard landing or a soft landing. That the course they have embarked upon is untenable for the long term economically. But whether they are going to be able to sort of skate through it or suffer a more serious setback is I think an issue that economists are going to be debating. I think I will stop there.

Mr. SHEA. Ms. Bordallo, you asked about the creation of a national security committee. One thing of interest in that is it also covers domestic security. And you asked the question are they concerned about internal instability? And the clear answer is yes. Now, we also have a memo on this, which we can share, share with you as well, prepared by our very crack staff. But some have speculated that the positioning of internal security as a responsibility of this national security committee is an effort to reduce the power of something called the politics and law leading small group—they do everything by small groups in the Politburo—which has overseen the police, judicial system, and civilian intelligence operations within China.

And there is an individual, Zhou Yongkang, who used to run that, a former member of the standing committee of the Politburo, whose colleagues are being investigated in PetroChina and other areas.

Ms. BORDALLO. Well, thank you very much. My time is up. And the chairman is nodding at me. I would like to hear more.

Mr. FORBES. Thank you. And as you guys know, you work very closely with Congressman Bordallo, so I am sure that you can give her that additional information. Dr. Heck is recognized for 5 minutes.

Dr. HECK. Thank you, Mr. Chairman. Thank you all for being here. Recognizing that we are in the Armed Services Committee, I am going to take advantage, I want to take advantage of having you before me and go on a topic that is not related to the military. And that has do with the importance of gaming to Macau. As you may guess, I represent southern Nevada.

Mr. REINSCH. That is not unexpected.

Dr. HECK. So with 87.5 percent of total government revenue coming from gaming from Macau, allowing them to accumulate the third largest budget surplus as a percentage of GDP [gross domestic product], and surpassing Las Vegas as the world's largest gambling market, I wonder what you think the greatest implications are for Macau on the U.S. gaming industry.

Mr. REINSCH. This is an issue that we have studied for the first time in the Commission's history. We had not addressed Macau for

the previous 12 cycles. So this was new for us. And as you know from the statistics you cited, it is impossible to study Macau without studying gaming, since it is such a significant part of what goes on there. We had testimony from your regulators, from Federal Treasury authorities and regulatory authorities, and also from experts. We also ended up meeting with representatives of two of the American casinos that operate in Macau at great length. And they provided us with a lot of information about the procedures that they follow in the Macau casinos to insulate themselves, in an attempt to insulate themselves from some of the problems that our report identifies. I think the report speaks for itself on this. We felt that the way that Macau is regulated, the way it is structured, and the way it works, it interacts with Chinese law in both the prohibitions on gambling in the rest of China, except for lotteries, but at the same time, the prohibition on collecting gambling debts in the rest of China, promotes a culture that contributes to organized crime and money laundering because of capital controls on moving money from the mainland to, well, anywhere, but in this case, Macau.

There is an extended record on this subject dating back to congressional investigations 20 years ago before the Senate Permanent Subcommittee on Investigations that looked at various aspects of this issue that has suggested that money laundering and organized crime are significant problems. There was, on the international front, the issue, the case a few years ago of Banco Delta Asia, which had ties to North Korea, and there were questions then about flow of funds into and out of North Korea that would enable them to do some of the things that our government has been objecting to for a long time.

We concluded that this was an issue that needed more work. And the essence of our investigation—I am sorry, the essence of our recommendations to the Congress is that this is something that needs to be looked into in more detail by the authorities that have basically more expertise and more assets than we do.

Dr. HECK. Were you able to come to any conclusions or ideas of what this would mean? What Macau's success would potentially mean to the U.S. gaming industry?

Mr. REINSCH. I wouldn't say that—we did not come to a conclusion with respect to the—specifically with respect to the activities of the American casinos there. We didn't encounter any evidence that suggested that they were complicit in illegal activities. We concluded, and they, I think, would acknowledge, that it is a very difficult situation doing business there because of everything I just described. I think that beyond that, I think we were not in a position to go farther. But Carolyn may want to say something more about it.

Ms. BARTHOLOMEW. Yeah. It was—I think we come into this with a lot of different viewpoints on this Commission. And I think, Dr. Heck, that, you know, when you look at the percentage of revenues that the three U.S. companies who are involved in gaming in Macau are getting from Macau, it does raise some questions. We did not deal with those questions specifically. But you know, what, 60 percent or 70 percent of the revenues of some of these companies is now coming from Macau gaming. I came away from the

hearing that we had and the additional information concerned about the ability of regulators to get access to the kind of information that they need to ensure that the U.S. gaming companies that are working in Macau are not being adversely affected by the organized crime that we know permeates the industry generally. But I think Nevada needs to be thinking about this and looking at this effort.

Dr. HECK. Thank you. Thank you very much, Mr. Chair. I yield back.

Mr. WILSON [presiding]. Thank you very much, Dr. Heck. We proceed now to Congressman Austin Scott of Georgia.

Mr. SCOTT. Thank you, Mr. Chairman. Ma'am, gentlemen, thank you for being here today. And I was glad to hear you speak of our friend Taiwan, and making sure that they know that we are going to continue to be their friend. I had the opportunity to visit there a year or so ago with some of my staff and discuss different issues with regard to trade relations for agriculture as well as military-related issues. My question gets back to kind of that whole region with regard to China. They have a lot of borders with other countries, countries that we have been involved in, countries that we are involved in because of terrorism. Those terrorists don't seem to want any type of trade with any outside country. So my question gets back to, if we look at Afghanistan, and Al Qaeda, the other terrorist groups that operate in that region, China essentially stayed out of those conflicts that we were engaged in. But now, as they try to expand trade into those other countries, are they starting to become more aware of—that might not be the right term. What approach are they taking to terrorism? And are they starting to see increases in threats from Al Qaeda and others to them?

Mr. REINSCH. We have looked at this in the past. We didn't spend a lot of time on it this year, Mr. Scott. Let me defer to Carolyn in a minute. I think what I would say is that they are acutely aware of it, because they have a problem in Xinjiang in western China, a problem primarily with the Uighurs, which are of the Muslim culture. So the Chinese are very sensitive to it. And again, as always with China, for reasons of self-interest, not a larger interest. And their concern about terrorism elsewhere is spillover primarily, and people either moving into China, moving into Xinjiang and causing the same troubles that they are causing somewhere else, or providing some aid and comfort flowing back and forth across borders. That has let them in some limited circumstances to be cooperative and share some of our concerns with fighting these efforts in other parts of the world, again, because they see a direct relationship to them.

They have also begun to, at least in one notable case, move into Afghanistan with a significant investment, economic investment, a mine that they are building. I don't have a lot of current information on how that is going, and whether it has been subject to terrorist attack, or whether it has become a volatile political issue. Somebody else might want to comment on that. So, you know, they are sensitive, but they are sensitive, again, for very specific internal reasons.

Mr. SHEA. I will just make two observations. China is the largest foreign investor in Iraq's oil fields today. I don't know if the committee knows that.

Mr. SCOTT. Say that again.

Mr. SHEA. China is the largest foreign investor in Iraq's oil fields. This is outlined on page 301. We have some information about that. Secondly, China, this is an issue we looked at a couple of years ago, owns—Chinese entities, state-owned enterprise owns the largest copper mine in Afghanistan. And it is called the Aynak mine. I have not kept up to date as to whether it is up and running or—I think it is the single largest investment in natural resources in Afghanistan's history.

Mr. SCOTT. And if I may, before he answers, and that is one of the issues that I have a hard time with as a member of the Armed Services Committee, just before you answer please, ma'am, because we are sending our men and women over there to provide security when it is China that is receiving the economic benefits and the industrial relations in that country. Quite honestly, they should be paying the cost, not the United States taxpayer and the U.S. soldier. Ma'am.

Ms. BARTHOLOMEW. Mr. Scott, I think that is a very important point that you made, which is that our young men and women died in Afghanistan and in Iraq.

Mr. SCOTT. Still are.

Ms. BARTHOLOMEW. And the Chinese are getting economic benefit out of both of those. So I think that is an important issue, an issue of concern. I just wanted to go back and revisit on the issue of terrorism, I think it is important to recognize that in China, where the people of China are so repressed, the Chinese Government has a tendency to indicate—to characterize any uprising or any attempt to try to challenge them, they sometimes call it terrorism. And so it becomes complicated in terms of understanding and looking at it.

And then also, and I don't know, Larry, whether this was actually ever really documented, but particularly in the 1990s, there was some sense that the Chinese might have been providing missile technology and some nuclear technology and things to Pakistan in this kind of a, we will help you, but you make sure that you keep your problems outside of Xinjiang Province. This kind of, I doubt it was ever actually stated that way, but some sense of some of their dealings in parts of the world where some of these problems are kind of a, almost a quid pro quo. I don't know that there was actually any ever documentation of that, but I think that there was some concern among analysts.

Mr. SCOTT. I am out of time, so if you speak, be very brief.

Dr. WORTZEL. Their concern is pan-Turkic and Uighur separatism. And they will permit literally anything to go on inside a country, regardless of who else it threatens, and assist any country with weapons, as long as they think they are getting a quid pro quo in controlling what they see as pan-Turkic and Uighur separatism.

Mr. SCOTT. Thank you for those answers. Thank you for the work you are doing and for being here.

Mr. WILSON. Thank you, Mr. Scott. We now proceed to Congresswoman Tammy Duckworth of Illinois.

Ms. DUCKWORTH. Thank you, Mr. Chairman. My question, I am not sure which of you would be the right person to answer, has to do with China's cybersecurity, their cyber attacks and how—I would like a greater discussion on the Chinese Government's role in cyber theft and espionage using Chinese companies or on behalf of Chinese companies.

Ms. BARTHOLOMEW. I was just going to say we are lucky we have one of the country's experts on that issue sitting right here at the table, Dr. Wortzel.

Dr. WORTZEL. I think the three things that have really helped document that this, for the most part, is a centrally directed effort, are the two reports by the Northrop Grumman Corporation for our Commission, and the Mandiant report that went as far as to identify an organization of the Third Department of the People's Liberation Army that does this.

So it is an extensive effort. It involves the electronic warfare and countermeasures department of People's Liberation Army that cracks into computer systems, takes control of them, documents important nodes, and then they turn it over to the Third Department, the equivalent of our National Security Agency, which extracts information and can replace information, so that a large part of it is government directed.

Ms. DUCKWORTH. And is that information then turned over to their corporate entities? Cybertheft?

Dr. WORTZEL. Absolutely. It goes right to corporate entities. It is used to short-step research and development, it is used to supplement research and development, particularly in areas that they are unable to do themselves. And it supports directly their own comprehensive strategic industries that they want to develop.

Ms. DUCKWORTH. What about the opposite flow of information? That is, I have Huawei in my district. One of their North American locations is actually in my district. I have real concerns, especially with them and ZTE and the reports that have been generated about how they are actually turning over information from their work with U.S. entities as telecommunications corporate networks back to the Chinese Government. Do you still think that that is still existing, that the information is actually flowing from their corporate entities back to—

Dr. WORTZEL. When the Director of National Intelligence sees that as a problem, the commander of the U.S. Cyber Command sees that as a huge problem, our Commission sees that as a problem, and despite all the denials, that the genesis of some of these companies out of the People's Liberation Army says to me that there is very close cooperation.

Ms. DUCKWORTH. I know the DOD [Department of Defense] is still putting into place rules concerning country of origin for some of the components that are being used, not just in U.S. munitions purchases, but also for telecommunications and the like. Is there anything else that we here on this side on the dais should be thinking about that would help further protect our national security in terms of, you know, I am thinking about procurements. Because this is not just us dealing with the Chinese Government, this is ac-

tually with their corporate entities that are providing services and goods to U.S. companies.

Dr. WORTZEL. Well, first of all, given the structure of power in China and the penetration of the Chinese Communist Party into literally all industries, I don't think you can separate any industry in China from the government. I think the Department of Defense is beginning to recognize that there are problems, particularly in information technology supply chains. And they are really fighting internally over the Federal Acquisition Regulations on what they can do to provide security. The State Department had the same problem. So I think the National Defense Authorization Act of 2011 in what was it, section 806?

Ms. DUCKWORTH. 806.

Dr. WORTZEL. 806. They are just beginning to act on that. So I don't think you can let them off the hook on that.

Ms. DUCKWORTH. Are there other departments? I am sorry, Mr. Shea.

Mr. SHEA. I was just going to recommend a book to you—

Ms. DUCKWORTH. Okay.

Mr. SHEA [continuing]. By James Mulvenon, and Anna Puglisi, and William Hannas called Chinese Industrial Espionage: Technology Acquisition and Military Modernization. And it is a comprehensive examination. It is footnote 15 in one of our chapters. But it is a comprehensive examination of how the Chinese use technology theft and transfer it, they have mechanisms and organizations and structures to transfer that information to their commercial enterprises.

Mr. REINSCH. And you ask what you guys could do about it. We have a recommendation simply that you encourage the Pentagon to move faster on the 806 issue. What is happening is directionally correct, but it is very slow.

Ms. DUCKWORTH. Thank you. I am out of time. Thank you, Mr. Chairman.

Mr. WILSON. Thank you, Congresswoman Duckworth. And we now proceed to Congressman Rich Nugent of Florida.

Mr. NUGENT. I thank you, Mr. Chairman. And I do appreciate the candor of this panel. While I heard, you know, the terminology challenges versus threat, but when you look at the spectrum of what is going on with China, particularly as it relates to our allies in the China Sea area, what we have done in Afghanistan and Iraq and how the Chinese have moved in behind us, even though it was our sons' and daughters' blood and our treasure that went there to pacify or correct issues going on, I wonder, I mean—and then you hear about the cyber threat that we face from China. And it is not just—I mean.

And I think you have articulated very well that the government and its industries are one and the same. But it goes even further than that in regards to the cyber threat as it relates to our national security, particularly as it relates to our military. And I would really like to hear about the relationship between China's cyber attack capability and their military advancements over the years, particularly as it seems to be that what they are developing specifically counters some of our abilities. And I think it has become more of a threat than it is necessarily a challenge. And I appreciate the

wordsmansmith of it. But if any of you would like to talk to that issue.

Dr. WORTZEL. Well, first of all, I think you have to look at the way they think about us. When they analyze their security environment and the general trends, which is what they call it, they see us as the main threat. That is their writing. And Russia and India and Japan are secondary threats. So they have got to deal with the main threat. And they see us as heavily dependent on space and cyber over really extended distances of lines of communication.

Now, for us, we tend to put these things into little cones. You know, we have got a Cyber Command and a Space Command. Hopefully, they are working together at STRATCOM [U.S. Strategic Command]. But the Chinese have adopted an approach that was very close to what the Soviets used in radio electronic combat.

So across all the military services, and across all the domains of war they have integrated the use of counterspace, their own space systems, cyber penetration, and precision fires. They practice it several times a year. And they are still struggling with making it more effective. But it is a comprehensive approach that is designed to attack what they see as our greatest weaknesses and our dependence on all of these command and control and surveillance systems.

Mr. NUGENT. And it would seem that Mr. Scott hit on an issue that is near and dear to my heart, having had sons both in Iraq and Afghanistan. It seems that, you know, we could force an effort—and the Chinese, you have to give them credit, they are pretty sharp actors to come in behind us, and then on an economic viewpoint, and I think it has been well discussed by this committee, is that they do things, obviously, that are in the best interests of China and could care less about anything else. So how do we counteract that? I mean, how do we counteract the ability, when we go in, let's say, just in Afghanistan while we are still there, what do we do?

Dr. WORTZEL. I think, first of all, they were there before us. They didn't care about the Taliban.

Mr. NUGENT. Right. And I think they can operate, obviously.

Dr. WORTZEL. They are happy to operate in these environments. And they won't take a necessary security interest—I mean, the one thing you could do that would get them involved is stop protecting their areas. They start losing people, they start losing equipment, they have people captured, and what they are developing already as a force insertion capacity for hostage rescue, they will have to put into effect. And then they will have their own little problem.

Ms. BARTHOLOMEW. I would just add that I think that our diplomacy needs to be perhaps more, I will use the word "vigorous" in ensuring that American companies have access to some of these opportunities too.

Mr. NUGENT. Well, I am out of time. And I want to thank this panel and the committee for holding this briefing. It is very important to all of us to hear what you have to say. Thank you very much. I yield back.

Mr. WILSON. Thank you, Sheriff Nugent. And we now proceed to Congressman Joaquin Castro of Texas.

Mr. CASTRO. Thank you, Chairman. And thank each of you for coming and joining us this morning, and for your testimony. Sometimes when you are this low in seniority, a lot of the great questions have already been asked. Plus, I was late to the hearing. So if you have already been asked this question, I apologize. But I am reading through the executive summary on this report, and on page 10, it describes the U.S.—I am sorry, on page 4 first, it describes the U.S.-China trade deficit over the years. And as you can tell, it went up markedly in the 13 years, or actually the 12 years between 2000 and 2012, from about, it looks like about \$90 billion to over \$300 billion. And during that time our economy has been up and down, we have had a Republican and a Democratic President, and actually a Democrat and then a Republican and then a Democrat. So how do you all account for that incredible growth?

Mr. REINSCH. Well, I think in the first instance, the single event—well, there were two events, I suppose you could say, that triggered it. First was the decision by the Chinese some years earlier to embark on their own program domestically of economic liberalization and growth. This was the 1978 decision by Deng Xiaoping and others to essentially change policy and to abandon a lot of the Maoist policies, and to put China on a different course.

It took a long time for that to evolve and develop and turn them into an economic unit that was capable of exporting to the extent they are now. But that is where that began. The other seminal event, if you will, was when they joined the WTO [World Trade Organization] in 2001. That created a network of, first of all, lower tariffs of our exports going there, but also, you know, their exports coming here were reduced.

Mr. CASTRO. And I would point out what is a little bit confounding is that on page 10 it shows, for example, that our agricultural exports have actually increased at the same time. So it seems as though we have been sending more stuff over there, and yet that trade deficit just keeps getting bigger.

Mr. REINSCH. Yes. And actually, they are, I think—we export more to them now I think than anybody else, except maybe Canada. But their imports to the United States have been growing faster than our exports to China. So the deficit continues to get worse. There are two bright spots. The main one, our agriculture, although if you look at the rest of our report, we have—we think we could be doing a lot better in agriculture. They focus their purchases largely on soybeans, commodity animal feeds, and not in some other areas. They continue to create market access barriers for our meat, for example, beef, pork, and poultry. There are significant issues there. We also do fairly well in services, but also encounter significant obstacles at their end to the use of U.S. services.

Ms. BARTHOLOMEW. Mr. Castro, this is one of the issues on which I think some of the members of this Commission might not necessarily agree on sort of causes and effects. From my perspective, the Chinese Government certainly did not open their markets the way that those who in the U.S. Government promoted China's accession to the WTO was supposed to happen. And so when you look at the numbers, and if you go back to 1989 we had a minuscule trade deficit with China, and it grew over the course of the 1990s,

but it took off exponentially after China's accession to the WTO. And so there was this promise that was made that this was supposed to be opening up new opportunities for American goods and services, and it just hasn't turned out that way. And it is a huge problem for our economy.

Mr. REINSCH. And as she said, we don't all agree with that analysis.

Mr. CASTRO. Sure. And then I would ask you this as a general question because it is one that I have been thinking about. China's economy is still markedly smaller than ours, right? You have a lot of folks there that live in poverty. You don't have the same middle class that we have. But in your best estimation, in about 45 seconds, what—if they stay on the same course, how long would it take China to catch up with the United States?

Mr. SHEA. I will just say that they can't stay on the same course. This investment-led, export-led economy, I think, is ultimately unsustainable. And the challenge for China is to move their economy more towards a consumer-oriented one.

Mr. REINSCH. If they do everything right, which is what Dennis just said, I agree with him, how long will it take until they reached the level of per capita income—and I say per capita, because that is the important distinguishing feature here—where we are now, I would say probably 20, 25 years. But then we will have gone beyond that by that time.

Mr. CASTRO. Sure. Thank you all.

Ms. BARTHOLOMEW. Just note that a growing problem they have with inequity. So per capita income is important, but who is getting the benefit out of the growth is going to be really important, too.

Mr. CASTRO. Thank you all very much.

Mr. WILSON. Thank you, Congressman Castro. And following the roster, I now recognize myself. And I want to thank each of you for your extraordinary work on the Commission report. It is of particular interest to me. I grew up with a great appreciation of the Chinese people. My dad served in the Flying Tigers during World War II. And so all my life, I heard how industrious and how hard-working the people of China are. And then I appreciate, I have been to Taipei to see the remarkable recognition of the Flying Tigers, and appreciation by the Chinese people of the service of the American military.

I had the opportunity to serve on a delegation with Congressman Curt Weldon to Beijing. We were at the presidential compound with President Jiang Zemin, where as I was introduced, he yawned when I was introduced as a Member of Congress, but he stopped the meeting when it was announced Joe is a son of a Flying Tiger. And so then he announced the American military is revered in China, which was then front page of China Daily the next day.

And then I have seen as recently as last month I was at the Chinese embassy for the recognition of the new museum which is being built at the site of the Flying Tigers operations cave in China. Again, recognition of affection and appreciation. So I am really hopeful long term indeed that we can have a positive relationship.

With that in mind, too, I have also had the opportunity, with Congressman Jeff Miller of Florida, to visit Pyongyang. We saw the

enigma of this country, the bizarre circumstance. What is the relationship, each of you, to North Korea at this time of the People's Republic?

Dr. WORTZEL. Well, to start, they do have a peace and friendship treaty that, at least People's Liberation Army officers have said still contains a secret protocol to provide for security support. So it is very close. And as frustrated as they may be with some of the behaviors there, they are still doing what they can to prop up North Korea with fuel and food. Although the government says it won't sell weapons, they tend to treat their government-owned industries, state-owned enterprises that may be engaged in weapons trade as separate entities that they can't control. So I think it is a frustrated relationship. It is certainly not one where they can control what North Korea does. But they won't let it collapse.

Mr. SHEA. I would say, as Larry, Dr. Wortzel mentioned, their key objective is stability. They won't let the regime collapse. Why do they want stability? They want it because they don't want a refugee problem around the border. They don't want thousands of North Koreans coming into the country through the border. They don't want a U.S. ally, potential U.S. ally on their border. That could be the case if the current regime fell. And I think there is some business interests that—resource development in North Korea, particularly at the provincial level in the provinces near North Korea, they have significant business interests in North Korea that affect—those interests may affect Chinese policy-making.

Mr. WILSON. And as we go to another country, it just struck me that the relationship China has developed with South Korea has been so mutually beneficial. I can't even think of trying to compare how South Korean investments, the jobs created, the economic opportunity, and then the bottomless pit that they are in in North Korea. I also had the opportunity last year, with Congresswoman Bordallo, to visit Vietnam. It is extraordinary to see the relationship of the people of Vietnam to the people of the United States. And a great concern about China. So what is the relationship between China and Vietnam?

Mr. REINSCH. We were there in 2009, I guess, and I was struck that 2 weeks before we got there, they had, after 30 years of negotiation, settled the land border with China. They had fought a war with the Chinese in 1979 over that question. It took them 30 years to settle the border. There is a long, multi-thousand-year adversarial relationship between the two parties, and a great deal of suspicion in Hanoi about Chinese intentions. And I don't see that changing any time soon.

Ms. BARTHOLOMEW. Yeah. We haven't talked at all today about some of the challenges certainly that Vietnam is facing because of China. Things like water. The Mekong River serves as a rice basket. And as the Chinese dams upriver, it is having an impact on all of the countries downstream. So there is that. There is the issues in the maritime arena that the Vietnamese are dealing with. We had, as my chairman said, you know, we had a very interesting visit when we were there. I think that the Vietnamese were particularly pleased to see people from the United States coming over and talking to them about these issues. And I remember asking

one of the generals there, you know, I understand that you want diplomacy to solve these problems. But what are you going to happen if diplomacy fails? And he looked and he smiled very politely and he said to me, well, as you well know, we know how to fight and win. I took that away as something.

I mean, I think we would all hope that there aren't any conflicts that take place on this. But that is going to really require the Chinese Government, too, to make some concessions and be concerned about what its neighbors downstream are thinking.

Mr. WILSON. Well, thank you all. And again, who would ever imagine a positive relationship between the people of Vietnam and the United States. Really, I saw a deep friendship in my role to work with MIA-POW [Missing in Action-Prisoner of War] issues. We now proceed to Congressman Mark Veasey of Texas.

Mr. VEASEY. Thank you, Mr. Chairman. I wanted to ask you about just the Chinese culture overall as it relates to cyberspace and some of the things in the past that they are known for, like imitation and what have you. Has the culture in China changed enough to where they know that a lot of the more serious cyberspace issues are very serious? The reason why I ask that question is that I recall a story that I read many, many years ago about an American executive from Detroit that happened to be in China, and they saw a car that looked just like, I believe it was a Jeep Cherokee. And he said, hey, that—at first the guy was like, hey, that looks like our car. He was excited. Then when he got closer, he noticed that the emblem was slightly different. And the guy explained to him who was on the tour with him that, no, that he should see that as—you know, imitation is the highest form of flattery, that he should be impressed by that.

I mean, do the Chinese seriously understand that a lot of the hacking and the cyberspace issues that have been going on, that is really like serious business?

Ms. BARTHOLOMEW. You know, there are some people who believe that Chinese intellectual property protection will happen as the Chinese become more inventive and have things to protect, though there is this whole thing that is going on about patent filing. I think you have to look at the economics of this. And I just wanted to go back to something that Ms. Duckworth asked. The IP [intellectual property] Commission report assesses that the damage to the U.S. economy annually from intellectual property theft is \$300 billion a year. Now, that is from all places. But they also assess that about 50 to 80 percent of that is coming from China. That is a loss to us of \$150 to \$200 billion a year. And it has been the way that—one of the ways that the Chinese Government has built their economy.

I wish I could say that things are getting better. But they have been able to bypass all sorts of R&D [research and development] costs. So why would they stop doing this when they get this economic benefit, which is a huge cost to our own companies? We might have some differences here.

Mr. REINSCH. Well, no, I would put myself in the category of this is a situation that is getting better, but it is getting better very, very slowly and unacceptably slowly. One large American company at one point reported that—they were in the software business—

the rate of piracy of their product had fallen from 94 percent to 88 percent. Now, I don't construe that as a victory. On the other hand, it is directionally correct. I think the more interesting piece of data, and I think that it is not—I think it is more than what some people believe, I think it is really axiomatic that countries get interested in protecting IP when they have some of their own to protect, because then they have constituencies within their own country demanding that their own government take steps.

One of the interesting things that has happened there is that there has been a kind of an explosion of intellectual property litigation in China. I think 95 percent of the cases are between Chinese parties suing each other, or one suing another for exactly the thing you are talking about. But it is all about Chinese IP, it is not—you know, it is not Ford suing—I mean, there is some of those, too. But to me, this is a good sign, because it has forced the Chinese Government, one, to improve their court system and to develop. It is still not an independent rule of law system, but at least they are developing now an infrastructure that is able to take these cases and decide them in decent periods of time. And they are developing an infrastructure, and they are developing—they are responding to a demand that is domestic for better practices here. It is going to take a long time.

Two years ago we did a road trip from Nanjing to Shanghai and stopped along the way at Suzhou and Changzhou and met with American companies there, and asked every single one of them do you have an IP problem? And everyone but one said yes. The one that said no said, well, of course we don't. You know, we are number four in the marketplace. They are all stealing from number one, which was a German company. What intrigued me about that, though, was a couple of them said we have solved our problems simply by getting our lawyers to send cease and desist letters to the offending Chinese party. I thought that was extraordinary. That was only a couple of cases. But, you know, baby steps is something I said earlier. This is moving in the right direction. It is going to take 20 years, you know, before it reaches an acceptable level.

Ms. BARTHOLOMEW. I want to add one thing, though, which is that, again, my chairman is talking about big companies that might be able to take this 85 percent hit on intellectual property. But our innovative, small and medium enterprises in this country whose IP is being stolen can't survive that kind of theft. They can't afford the lawyers who can do this. They can't survive it. So it is huge opportunity costs for our economy that this kind of theft continues. And the slowness might work for some companies, but I am afraid that we are going to have a lot of companies that will go belly up because they can't deal with the slowness in terms of the protections.

Mr. VEASEY. Mr. Chairman, could I ask one more question?

Mr. BRIDENSTINE [presiding]. Without objection.

Mr. VEASEY. There was a recent acquisition of a large American pork producer by a Chinese company. And of course whenever a Chinese company acquires something, obviously, they are in business with the Chinese Government in some sort or fashion. What sort of concerns, you know, looking long term at deals like this, and

obviously in order to keep the economy going strong worldwide, you know, we need to be able to do business with the Chinese and other countries that may not necessarily share all of our same business, I guess, morays as it relates to, you know, cybersecurity and what have you. But, you know, when you talk about an American pork producer and you are talking about a company that is going to have to be interacting with the USDA [United States Department of Agriculture] and other Federal agencies, you know, what sort of security concerns, you know, might that sort of a deal, you know, have for the American public?

Ms. BARTHOLOMEW. I think that this is another issue where we are going to have some differences on here. But I would just note, Congressman, that our colleague, Congressman Slane, who is sitting in the audience, testified on the Senate side expressing concerns about what this acquisition might be. Of course, it has since gone through. But we will ask our staff to get you a copy of his testimony. We have food security concerns, food safety concerns. And I have been interested to see that since that acquisition has happened, that particular company is doing a lot of advertising on TV, that I don't recall seeing, all about their good products. But we have a number—some of us have a number of concerns about it.

Mr. REINSCH. I would just say this is probably an issue that has divided the Commission more than most issues. There were different views on that specific transaction, which I think Carolyn has addressed, and I won't say anything more about that. And Dan has addressed it in his own testimony, which we can get you. I think there is also a debate amongst commissioners on the larger issue of how to deal with this issue.

It happens to be the same debate that Congress has had on several previous occasions. And that is what are the authority to prohibit an acquisition? Should we base solely on national security, or whether it should also be based on what might be called economic security, or cost-benefit, or whatever the Canadians, for example, use what they refer to as a net economic benefit test in going to a similar process to ours.

Congress has considered that question twice in 1987 and then again in 2007 and, on both occasions, decided not to go down that road, and so we have a statute that is a national security statute only and permits the President to block a transaction based on national security.

In this particular case, CFIUS [Committee on Foreign Investment in the United States], the group that oversees this, which is an interagency committee, concluded that there was not a national security issue with respect to pork. People don't—not everybody agrees with that, but that was the conclusion they came to. It wouldn't surprise me if at some future point Congress takes this issue up again and debates it again.

I would just say the politics of it are complicated because at one level these acquisitions do raise all the issues that you mentioned. Another issue with these acquisitions particularly, or a green field investment particularly, creates jobs and brings new economic activity, so you often find that whereas, you know, military officials and national security officials in Washington have one view, you know, the Governor of Alabama or the Governor of Texas may have

a very different view about the economic advantage that an acquisition might bring.

Mr. SHEA. Just to add to that, there is another issue that, frankly, we are divided on the Commission is the issue that is raised by the Smithfield purchases. It is the issue of reciprocity. It is unlikely that an American company could turn around and buy a pork-producing company in China.

Mr. VEASEY. That is correct.

Mr. SHEA. And there are multiple markets, multiple sectors in the Chinese economy that are essentially off limit for foreign investment, including U.S. investment, so the Smithfield purchase also raises the issue of reciprocity.

Mr. VEASEY. Thank you.

Thank you, Mr. Chairman.

Mr. BRIDENSTINE. The gentleman's time has expired.

The Chair now recognizes the gentleman from Arizona, Mr. Franks.

Mr. FRANKS. Thank you, Mr. Chairman.

First, thank all of you for being here, and I wanted to kind of direct this question, if I could, Mr. Reinsch, to you.

Obviously, a lot of us concerned about China building such a robust naval offensive capability at a time when we are facing a readiness crisis in our own country and to respond, and of course, they are, I think, probably looking at our rapidly downgrading force capabilities across the spectrum of our military. Can you talk a little bit about the JL-2 as well as the first anti-ship ballistic missile, the Dong-Feng or the DF-21, and how the Commission assesses our missile defense apparatus as postured to respond to these missiles in the defense of our homeland and our allies abroad?

Mr. REINSCH. I really can't, Mr. Franks, but Mr. Shea can and Mr. Wortzel can.

Mr. FRANKS. All right. Well, we will talk to—

Mr. REINSCH. I would prefer to have them speak for us.

Mr. FRANKS. Okay.

Dr. WORTZEL. It has been a painful program for them, Mr. Franks. They have spent decades blowing out the bottom of test submarines trying to perfect a submarine-launched ballistic missile that they couldn't get to pop out of the water, and although they have worked at it for a very long time, it looks like finally they may be nearing operational capability in one ballistic missile submarine, and if that becomes operational, then I would expect two or three more. That will allow them to target the United States with some 16 more ICBMs [intercontinental ballistic missiles], but it also complicates our problem of locating a submarine.

Now, we think they will operate it in bastion as the Soviets did and the Russians do, and that is perhaps not as great a problem because if it operates in bastion, it is still launching over an area that we are protecting with ballistic missile defenses; but they don't have to operate it in bastion. If they move it into the deep South Pacific, which they explored with hydrographic ships and undersea mapping ships in the late 1970s and 1980s, it complicates our ability to find it, and it literally flanks any ballistic missile defenses and radar systems that we have. So if you are worried about a couple of launches out of northeast China or North Korea across

kind of a polar route to the United States, we are probably in good shape. If they have three of them out there, you are in real trouble.

Mr. FRANKS. I understand, and I assume blowing out the bottom of the submarines they classify as a negative result most of the time.

Dr. WORTZEL. Only reselling.

Mr. FRANKS. Quickly, I am going to try to get two other quick questions in if I can. Can you just elaborate in general on what progress China has made in developing and testing EMP [electromagnetic pulse] weapons or enhanced nuclear weapons for purposes of EMP?

Dr. WORTZEL. They have worked on it. They have also worked on tactical neutron enhanced radiation warheads. We know that they have worked on electrical generating EMP as well.

Mr. FRANKS. EMI [electromagnetic interference].

Dr. WORTZEL. Right. I think they are aware of what the footprint of an EMP blast inside their own second island chain would probably do to cripple themselves, so it is something they have looked at, and they are capable of doing it.

Mr. FRANKS. Well, I hope we keep an eye on that.

Last question. The Burmese Government and military has, you know, obviously a very ingrained relationship with China, and we also know that democratic civil society within Burma is sort of upset about that with how much support that China has given to the Burmese Government's oppressive military. What do you think the future of the Chinese-Burmese bilateral relationship is? How do you think that the Chinese will deal with their setback in influence in Burma, and how do they adjust to that, and what is our role?

Ms. BARTHOLOMEW. Well, that is a big question, and it is actually not a topic that we have looked at in the past couple years and certainly since the change has happened. I think some—I guess I would say about Burma that the question about a distinction between what the people of Burma are thinking and what the Government of Burma is thinking and doing remains to be—it is unfolding, shall we say it that way? And I think another interesting dynamic I am just going to throw into the mix on Burma is the India-Burma relationship, and how does India-Burma-China end up working out? I don't really have any observations to make yet, but it is something that perhaps we should look at over the course of the year.

Mr. FRANKS. I hope you will because I can tell you the Burmese people and the Burmese military have a widely disparate view.

Ms. BARTHOLOMEW. Yes.

Mr. FRANKS. Thank you.

Ms. BARTHOLOMEW. Thank you.

Mr. BRIDENSTINE. The gentleman's time has expired.

You know, if you are a freshman and you sit in these committee hearings long enough, sometimes they give you the gavel, and so I have the gavel, and I have a question I would like to follow up on.

Mr. Joaquin Castro asked a very insightful question, and he and I are on opposite sides of the aisle. Our political philosophies are very different, but he does have some very good insights. And he

asked about the trade deficit. And from my perspective, when you see a trade deficit the size that we have, usually what would happen, as long as we have, you know, floating currencies, their currency should strengthen as we are demanding more and more of their goods. That means their currency would strengthen relative to ours, and that would enable our exports to increase while their exports decreased. And what we have seen is that while their exports have increased and increased and increased, we haven't seen their currency strengthen the way we would expect relative to ours. I was wondering if the panel could share with me their thoughts on why that has occurred.

Mr. REINSCH. This has also been a subject of some debate in the Commission. We addressed this in our report. We have addressed it in our report I think the last 5 years, and I apologize, Mr. Chairman, my statement actually had a sentence or two on it which I skipped in the interest of time, but if you go back to the full statement, it references the Chinese currency manipulation.

The RMB [renminbi] does not float freely, and so its rate is effectively set by the Chinese Government. I think most economists out there have concluded that over a long period of time, the Chinese have set the rate at levels that allow them to achieve the results that you have described as far as trade is concerned. Over the last 5 or 6 years, they have allowed the RMB to appreciate; it has appreciated significantly. I think there has always been a debate amongst economies over the extent to which it has been undervalued. Five years ago, the argument was between people who said zero and people who said upwards of 40 percent. I think now the argument is more between—there is always some people who say zero—but the argument is more between 10 and 20 percent, so there clearly has been progress made. And I think it is shown in the extent to which our exports have increased. At the same time, their exports to us have increased faster, so this does not show up in the bilateral trade data.

This is an issue that the last two administrations, meaning the Bush administration and the Obama administration, have pressed the Chinese on very, very hard, never with as much success as we would like. They continue to press. As you well know, it is an issue that Members of Congress have raised on both sides of the aisle frequently via letter and occasionally via amendment and bill. I have no doubt it is not going to go away.

Ms. BARTHOLOMEW. Yeah, I will just add, and this is interesting since the chairman and I come from the same party, but we have some disagreements on this issue, among other economic issues that, you know, I think that to call what this administration and the previous administration and the administration before that have accomplished as progress is really just not acceptable.

And, you know, I think that it would be, this is my views, it would be an important step for the U.S. Treasury to actually acknowledge that the Chinese Government is manipulating its currency rather than giving it the pass that it has consistently done, including most recently in September.

Mr. BRIDENSTINE. To follow up on that, when you talk about the manipulation of the Chinese yuan, what capacity would they have to manipulate the U.S. dollar based on how many Treasury securi-

ties they own of ours and how many dollars they own of ours? Do they have a capacity there at all?

Mr. REINSCH. Well, it is—yes, I mean, if they dump them, but they would be the biggest loser if they did that.

Mr. BRIDENSTINE. So if they were to dump U.S. dollars, then they would lose exports, or they wouldn't have the strength of the dollar for their own export economy.

Mr. REINSCH. The value of their holding, their dollar-denominated holdings would go down dramatically.

Mr. SHEA. We had a hearing, sir, a couple of years ago I believe, where we brought in some experts who shared their views as to whether, you know, China was America's banker and they had us over a barrel, and I think the most, the overwhelming majority of the experts said no, as Bill explained, that, you know, it is sort of—China would hurt itself if it took a drastic action dumping its dollar-based reserves. My understanding is China owns about 10 percent, I may be wrong, but about 10 percent of U.S. Treasurys. The staff will correct me if I am wrong.

Dr. WORTZEL. Some years ago, we actually had a hearing and went up to the financial industry in New York and asked some of these questions, and I can't remember the percentages, but my colleagues have given you the arguments on why it really doesn't pay to dump your U.S. securities, but the other assessment by the financial industry is if it did, it might cause an increase of a couple of percent in interest rates in the U.S., but the whole market is so big, the whole securities market is so big that it is really not a fatal problem.

And I guess the other thought I would leave you with is that you have many people that say you can't go to war against your banker. Well, we are their banker. They are not our banker. And if you go to war, all your assets are immediately seized.

Mr. BRIDENSTINE. So when we experienced—I don't know if you would call it dumping, but they had a massive sale of U.S. Treasury securities I think back in 2007 or 2008, can you guys share what—how that reflected on our currency and on our markets?

Dr. WORTZEL. I don't think you could then because we had our own financial crisis at about the same time and the banking crisis, so I think it would be—I think what they did was a reaction to that, and it would be very difficult to separate their action from the bigger domestic banking crisis, and that is from a guy that don't know much about it.

Ms. BARTHOLOMEW. Right, exactly. He is doing an excellent job talking about economics in this hearing. But another point I just want to make is they have us over a barrel if we think that they have us over a barrel, and again, I have been concerned over the years that there might be people within the U.S. Government who are afraid to take certain actions on perhaps other issues in the U.S.-China relationship because they are concerned about the impact of, you know, dot, dot, dot, and so it becomes a negotiation tactic rather than necessarily the reality. And I always find myself even saying in a context like this what—if they dumped it, where are they going to put their money? I don't think they are going to be buying euros. I mean, it is—

Mr. BRIDENSTINE. I have one final follow-up on this, and that is when you think about the risk of China selling U.S. Treasury bonds or making an effort to potentially weaken the U.S. dollar, when you think about this risk, the follow-up is usually, they would never do that because it would hurt their own export market, and their export market is the backbone of their economy. But what we have seen in the last probably 7 or 8 years, and I would like to hear if you guys agree with this, they have really diversified their exports across the world such that they don't rely so much on us for their export economy anymore. Can you follow up on that?

Mr. SHEA. Well, I think their biggest market is the European Union, and I think we come in second place, so we are still a very substantial market for Chinese exports.

Ms. BARTHOLOMEW. The power of the American consumer still, I mean, I think that 2008, the financial crisis of 2008 really demonstrated both to the United States and to China how intertwined our economies are and that it has always been ironic to me that as the Chinese have built their economy on exports, they have been having an adverse impact on the very sector of our economies where the workers would be consuming Chinese goods, but it doesn't seem that that has had as much of a difference.

But they are, indeed, diversifying their exports all over the world. In Africa, for example, you know, they are displacing African markets and African workers, and there is some growing concern in countries in Africa about what is happening to their own indigenous businesses as cheap Chinese goods are flying into—going into Africa.

Mr. BRIDENSTINE. One final line of questioning, and this is regarding—I am a Navy pilot. I flew combat in Iraq and Afghanistan, spent a lot of time in the Persian Gulf. Given the position that we are in with the sequester right now, our presence in the Gulf and around the world is lacking, and that is unfortunate. My concern is that if we are not securing shipping lanes in the Persian Gulf or in other market sectors around the world, there is a void, and of course, the Middle Eastern countries that export oil and rely on that for their economies, they are going to find a replacement for our security. And in order to hedge their bets, they will export oil to whoever wants to provide that security. Is there a risk that because we are not there and we have left a void, that China might fill that void, and might that explain why China is now investing so heavily in the Middle East and why the Middle Eastern countries are now exporting oil so heavily to China?

Ms. BARTHOLOMEW. Well, first, I think that lots of countries around the world are hedging in their own ways. Certainly for the Middle Eastern countries, especially also as the United States talks about energy independence, they need to be thinking, they are thinking about where are there going to be reliable purchasers of oil who are also not going to be pressuring them on things like democratic reforms and human rights, so it is that issue that I mentioned earlier about economic growth with authoritarian government that goes hand in hand, but there are complications and there are risks for China involved in this, so Saudi Arabia has far greater oil production than Iran, and yet China has a really close relationship with Iran, and how it manages that balance of main-

taining relationships or expanding relationships with countries that have their own challenges, their own problems, their own battles I will use the word, is going to be a really interesting dynamic. I mean, it is a Middle Eastern quagmire so that as the countries themselves are interested in engaging more with China and selling more to China, the Chinese Government very well might get pulled more into some of the difficult dynamics that we are trying to deal with in the Middle East.

Mr. REINSCH. This is a new—if I could just add, getting pulled into this has been a new and kind of unsettling experience for them. They have encountered occasional difficulties in Africa. I think what really set them back was the need to conduct a massive evacuation from Libya during the revolution. They suddenly had 35,000 people that they needed to get out of the country, and they weren't—we are prepared for that kind of situation. We know what to do, we have a Navy. We have capabilities of dealing with it. They weren't. They ultimately did it, but I think it was a wake-up call for them that if you are going to be involved in this region in any capacity, you need to have a whole level of commitment and activity beyond anything that they have experienced and beyond anything that is comfortable for them. This is going to be a difficult transition for them to do the kinds of things you are talking about.

Dr. WORTZEL. The scenario you suggest that the United States couldn't or wouldn't creates a lot of other competitions, that suddenly Japan has to rethink, which has a very capable navy, has to rethink how far it lets it go out to protect sea lines of communication. They would probably be a natural—India is developing a navy that, you know, it hopes can do those kind of things. Japan and India and Vietnam and India look to each other for that sort of stuff. So—and there is no love between the Indians, the Japanese, and the Chinese, so it does create the potential for competitions, but none of those nations, except possibly Japan if it chose politically to do so, is capable of undertaking those missions at this time or for a good 5 to 10 years.

Mr. BRIDENSTINE. Any other thoughts before we adjourn?

Is there anybody else that would like to ask a question? No?

All right.

Well, I would like to thank the witnesses so much for your testimony, and this hearing is adjourned.

[Whereupon, at 12:14 p.m., the committee was adjourned.]

A P P E N D I X

NOVEMBER 20, 2013

PREPARED STATEMENTS SUBMITTED FOR THE RECORD

NOVEMBER 20, 2013

**Statement of Hon. Howard P. “Buck” McKeon
Chairman, Committee on Armed Services**
**Hearing on “2013 Report to Congress of the U.S.-China Economic and Security
Review Commission”**
November 20, 2013

I would like to welcome everyone to today’s hearing on the 2013 Report to Congress of the U.S.-China Economic and Security Review Commission. This hearing is part of a larger oversight effort focus on the Asia-Pacific rebalance led by Mr. Forbes and Ms. Hanabusa—who are providing strong bipartisan leadership on this important topic.

We’ve met with U.S. Pacific Command officials and last week heard from key ambassadors representing allied and partner nations. However, we cannot consider the rebalance without examining China.

The Commission has undertaken a comprehensive assessment of Chinese military capabilities, economic developments, and political and foreign policy objectives. Their annual report—which was released earlier this morning—is a superb resource for Congress and the public.

While we continue to warn about our military’s readiness, and the dangerous effects of budget cuts and sequestration, China’s military spending continues to rise and its new leadership seeks to increase combat readiness. Its current pace of military modernization shows that Beijing is developing the ability to project power and influence further abroad. I look forward to hearing the Commission’s assessment of the key military and foreign policy developments made by China in the past year and the implications for our own policies and posture in the region.

China can play a constructive role in the region and the world, but for those of us focused on security issues, recent trends—in their anti-access and area denial capabilities, and cyber espionage campaigns, in particular—give us cause for concern.

I appreciate all the work they and their staff has done, and I look forward to hearing their testimony.

Statement of Hon. Adam Smith
Ranking Member, Committee on Armed Services
Hearing on “2013 Report to Congress of the U.S.-China Economic and
Security Review Commission”
November 20, 2013

I would like to welcome our witnesses and to thank them for being here with us this morning. I look forward to hearing their views on the important topic of our economic and security relationship with China.

For more than a decade, the U.S.-China Economic and Security Review Commission has reviewed the national security implications of the bilateral trade and economic relationship between the United States and the People’s Republic of China. The commission’s annual reports to Congress are valuable resources for assessing China’s dynamic rise.

While some observers have expressed alarm over China’s military modernization efforts, I do not believe that an adversarial relationship with China is inevitable. We must carefully monitor and evaluate Chinese military developments, but it is my hope that the United States and China will be able to cultivate a mutually beneficial relationship that promotes growth and prosperity throughout the Asia-Pacific region. The United States can help China to become a more open and cooperative participant in the international community. The United States should work with China, in close coordination with our many allies and partners in the region, to: provide and maintain collective security; peaceably address concerns and mitigate disputes; further shared interests and objectives; and perpetuate healthy multilateral exchange.

The United States will continue to lead in the Asia-Pacific and to offer assurances through its strong forward presence in the region, but we should also welcome China’s cooperation on matters of communal interest. For instance, I hope that China will exert its unique influence on the North Korean regime, in concert with the efforts of other concerned states, to facilitate denuclearization of the Korean peninsula. Transnational threats, such as violent extremism and illicit trafficking in persons, narcotics, and weapons also continue to menace the region, while disease, malnourishment, environmental degradation, resource scarcity, and natural disaster persist. China could be

instrumental in helping the international community to combat these common difficulties. The more we can do to defuse tensions through cooperative efforts, the more we can help to realize the immense potential for growth and prosperity throughout the Asia-Pacific region.

I look forward to our witnesses' testimony and to expanding the dialogue on China. I would especially appreciate our witnesses' views on how the United States might enhance its relationship with China as it proceeds to rebalance its presence in the Asia-Pacific region.

“U.S.-China Economic and Security Review Commission 2013 Report to Congress”

Testimony of the Honorable William A. Reinsch

Chairman, U.S.-China Economic and Security Review Commission

before the

Armed Services Committee, U.S. House of Representatives

Hearing on “2013 Report to Congress of the U.S.-China Economic and Security Review Commission”

November 20, 2013

INTRODUCTION

While 2013 has been a year of leadership change for China, it is too early to say that the initial economic policy pronouncements will lead to quick reforms. Less heralded but longstanding and continuing improvements in China’s military capabilities, however, could have a major impact on the region.

The Chinese leadership accomplished a peaceful turnover during the past year, complicated by factional political maneuvering. The handoff for the new five-year term took place with both ceremony and caution. In the absence of immediate policy changes from the newcomers, the government in Beijing coasted on the momentum from the previous decade. While China’s economy slowed from a 30-year double-digit sprint to a more sustainable pace of 7.66 percent growth, Beijing’s new economic policymakers appear to be clinging to the old formula of exports and infrastructure projects and a strong state-controlled sector to boost employment and maintain the regime’s political control.

The Chinese renminbi continued to appreciate against the dollar but remains undervalued. The rise in the Chinese currency did not jeopardize China’s expanding trade surplus with the United States nor its growing foreign exchange reserves, which hit \$3.66 trillion at the end of September. China’s new leaders, President and Party General Secretary Xi Jinping and Premier and Party Secretary of the State Council Li Keqiang, reaffirmed the government’s long promised goal of shifting the economy to one more driven by domestic consumption. However, the major market based tools and reforms that China could use to empower Chinese workers and consumers remain unused: opening China’s financial services sector to foreign investment; shrinking the size and number of state-owned enterprises; and expanding opportunities for private investment and savings beyond low interest-bearing deposits in state-owned banks or risky speculation in the volatile real estate market. Such moves by China would help reduce the growing trade imbalance with the United States and boost employment in America.

Also troublesome were the press reports in April 2013 of an official but secret party-approved directive known as “Document No. 9” that seeks to enhance party authority. Widely attributed to President Xi, the memo lists seven perils to be avoided, among them “Western constitutional democracy,” “universal values” of human rights, press freedom and independence from the government, pro-market “neo liberalism,” an independent judiciary, and “nihilist” criticisms of the Chinese Communist Party.

U.S. companies investing in China reported the same problem areas as the year before. In a survey of the top ten problems experienced by the foreign affiliates of U.S. companies, the majority were of the Chinese government’s making. U.S. companies cited competition with Chinese government-owned

companies, onerous licensing procedures, lax intellectual property protections, discriminatory laws and standards, and restrictions on foreign investment.

After announcing with some fanfare a free trade zone in Shanghai, Beijing diluted its potential impact by exempting segments of 18 different sectors, such as construction, finance, and manufacturing, from foreign investment and imposing a variety of other restrictions, highlighting continued disputes within the government over the pace and direction of economic reform. Beijing's leadership also reacted haltingly to the emerging problems in China's lightly regulated shadow banking system, particularly the buildup of unsecured, off-balance sheet loans. The system has proliferated because China's state-owned banking system still heavily favors government-run enterprises over the efforts of Chinese entrepreneurs and small- and medium-sized business owners. Without fundamental banking reform and expanded credit to private industry and consumers, China's goal of economic diversification will remain stuck in low gear.

One positive development in bilateral trade has been agriculture, the only sector in which the United States enjoys a substantial trade surplus with China. U.S. food producers stand to benefit from China's growing demand for consumer foods, especially meat products. But at present, China concentrates its imports on lower value-added bulk commodities while exporting consumer foods to the United States that pose significant safety risks.

Under its new political leadership, China's actions in the East and South China Seas continued to increase tensions in the region. It is becoming clear China does not intend to resolve its maritime disputes through multilateral negotiations or the application of international laws and adjudicative processes but prefers to use its growing power in support of coercive tactics that pressure its neighbors to concede China's claims.

Since the Commission's 2012 Report, strong evidence has emerged that the Chinese government is directing and executing a large-scale cyber espionage campaign against the United States. China to date has compromised a range of U.S. networks, including those of the Department of Defense and private enterprises. These activities are designed to achieve a number of China's broad security, political, and economic objectives, such as gathering intelligence, providing Chinese firms with an advantage over their competitors worldwide, advancing long-term research and development objectives, and gaining information that could enable future military operations.

Meanwhile, China continued to develop and field advanced military platforms and weapon systems. China's comprehensive military modernization is altering the balance of power in the Asia Pacific, challenging decades of U.S. military preeminence in the region.

China in 2013 expanded and diversified its arsenal of weapon systems capable of placing U.S. ships, aircraft, and bases in the Western Pacific at risk. The People's Liberation Army (PLA) also continued to pursue cyber, electronic warfare, and counterspace capabilities that will enable Beijing to degrade or disrupt the command, control, communications, computers, intelligence, surveillance, and reconnaissance that are essential to U.S. military power projection on behalf of its interests in the region. As these capabilities mature, the costs and risks to the United States of intervention in a potential regional conflict involving China will increase.

Furthermore, the PLA enhanced its regional power projection capabilities, improving Beijing's ability to use force against Taiwan, Japan, and rival claimants in the South China Sea. This could increase China's willingness to respond militarily to a perceived provocation or to consider preemptive attacks in a crisis involving Taiwan or China's maritime sovereignty claims. Many of these scenarios could require the U.S. military to protect U.S. regional allies and partners as well as to maintain open and secure access to the air and maritime commons in the Western Pacific.

Most Asian countries welcomed the U.S. rebalance to Asia when it was announced by the Obama Administration in 2011. However, there is growing concern among U.S. allies and partners that the Department of Defense will be unable to follow through on its commitment to the rebalance due to declining defense budgets and continuing security challenges elsewhere.

The Commission's Report addresses these and other issues in depth as it continues to monitor the evolving economic and security relationship between our two countries.

EXECUTIVE SUMMARY (USCC 2013 Report to Congress)

Chapter 1: The U.S.-China Trade and Economic Relationship

Trade and Economics Year in Review

China's economy grew at a 7.66 percent annualized rate in the first three quarters of 2013, continuing a three-year trend of decelerating output. This marked a significant decline from the three decades of growth in the 1980s, 1990s, and 2000s averaging 10 percent annually. Demand for China's exports stalled, and the domestic economy adjusted to a drop in government spending on massive infrastructure projects—undermining the two main pillars of China's economic surge over the previous decade.

China underwent a leadership change with a new president and premier and several new members of the Politburo and Standing Committee. No prominent political or economic reformers were elevated to the Politburo Standing Committee, China's highest decision-making body, though the backgrounds of Wang Qishan and Zhang Gaoli suggest that they might be open to further economic reform. There is uncertainty over the prospects for economic reform as a result of contradictory statements and actions by the new leadership. While there are signs that President Xi Jinping and Premier Li Keqiang are preparing a package of reforms to be unveiled at the Third Plenary Session of the 18th Central Committee, expected to take place in November 2013, President Xi has also been reaffirming the role of the state in the economy and introducing Maoist-style ideological campaigns aimed at stamping out political liberalization. In recent months, the government has introduced some important initiatives aimed at addressing some of the country's growing inequalities of wealth and opportunity. One initiative has been a focus on urbanization. The hope is that urbanization will become the next growth engine, initiating a new wave of investment, adding to the consumer class, and creating a surge in demand for housing and infrastructure. The urbanization drive may also boost Chinese efforts to make more land available for agriculture and improve farming efficiency.

Growing demand from China has supported exporters in certain sectors of the U.S. economy, such as aerospace, the auto industry, and agricultural products. However, the U.S. trade deficit with China continues to widen. In July 2013, the monthly deficit exceeded \$30 billion for the first time. Moreover, the Chinese government policies driving economic growth have resulted in what the International Monetary Fund (IMF) calls a "pattern of growth [that] has become too reliant on investment and an unsustainable surge in credit, resulting in rising domestic vulnerabilities." The most important—and most challenging—element of domestic rebalancing is increasing household consumption as a share of gross domestic product (GDP), which has declined as a share of China's GDP for decades while the share of fixed-asset investment has grown.

China continues to intervene in foreign exchange markets to keep its currency undervalued. Such interventions, combined with China's subsidies to exporting industries, have helped China accumulate the world's largest foreign currency reserves—\$3.66 trillion by the end of September 2013. While

maintaining a preference for government securities, China continues to diversify its foreign exchange assets. China's nonfinancial outbound foreign direct investment (FDI) for the first half of 2013 totaled \$45.6 billion, up 29 percent from the prior year. China rapidly accumulated foreign currency in 2013, but the pace of currency inflows varied during the course of the year. In the first quarter, currency inflows surged, followed by outflows in the second quarter as the country's banks encountered a liquidity crisis. These movements caused volatility in China's external accounts that carried over into the domestic financial sector.

Trends in Chinese Investment in the United States

China has amassed the world's largest trove of dollar-denominated assets. Although the true composition of China's foreign exchange reserves, valued at \$3.66 trillion, is a state secret, outside observers estimate that about 70 percent is in dollars. In recent years, China has become less risk averse and more willing to invest directly in U.S. land, factories, and businesses. This trend appears to be accelerating. In June 2013, China announced its largest purchase of a U.S. asset to date: a \$7.1 billion acquisition of Virginia-based Smithfield Foods, Inc. Given China's large holdings of U.S. dollars, China has a huge potential for FDI, particularly if China should substitute or abandon portfolio investment for direct investment.

The 12th Five-Year Plan (2011–2016) called for a three-pronged approach for increasing China's investment abroad. First, Chinese manufacturing companies should invest overseas in order to establish international networks and globally recognized brands. Second, Chinese companies should invest in research and development outside of China. Lastly, the plan set goals for shifting acquisitions toward sectors that promote a high-tech economy. This policy focused on investment goals in which domestic state-owned or state-controlled firms were already intended to be dominant by policy. These sectors included energy, machinery, construction, and information technology. The Chinese government wields many tools to drive these goals, including requiring permission for overseas investments by Chinese firms.

Despite China's large holdings of portfolio investment, China's FDI is still relatively modest. According to the U.S. Bureau of Economic Analysis, in 2012, the United States attracted \$174.7 billion of global FDI, of which only \$219 million came from China. Official estimates of Chinese FDI in the United States are too low, because they do not account for flows of FDI through Hong Kong and other offshore financial centers, among other things. Chinese FDI in the United States has emphasized services, energy, and technology and is notable for its focus on brand acquisition.

State-owned enterprises (SOEs) have dominated Chinese FDI in the United States, making investments that follow the industrial policies of the Chinese government. Chinese SOEs receive substantial benefits from the central and provincial governments that are not available to their foreign competitors, including preferential policies and low cost of capital. Furthermore, SOEs investing in the United States may engage in particular predatory or anticompetitive behavior that U.S. trade remedies cannot address.

Trade-related aspects of foreign investments often intersect with national security concerns. For example, foreign intelligence collection efforts and espionage that target U.S. technology, intellectual property, trade secrets, and other proprietary information can be concealed under the pretext of foreign investment in cleared government contractors. The United States has a limited screening process for determining the potential national security threat from a specific foreign investment. The Committee on Foreign Investment in the United States (CFIUS) is an interagency committee that reviews certain mergers, acquisitions, and takeovers of U.S. businesses by foreign persons, corporations, or governments for national security risks. China presents new challenges for CFIUS, because investment by SOEs can blur the line between national security and economic security. The possibility of government intent or

coordinated strategy behind Chinese investments raises national security concerns. For example, Chinese companies' attempts to acquire technology track closely the government's plan to move up the value-added chain. There is also an inherent tension among state and federal agencies in the United States regarding FDI from China. The federal government tends to be concerned with maintaining national security and protecting a rules-based, nondiscriminatory investment regime. The state governments are more concerned with local economic benefits, such as an expanded tax base and increased local employment, rather than national strategic issues, especially as job growth has stagnated.

Governance and Accountability in China's Financial System

China's 12th Five-Year Plan calls for less dependence on exports and state-funded infrastructure projects and more domestic consumption to support China's economy. A shift from government-led to private-led growth requires that Chinese families and private sector businesses have sufficient access to credit and capital. Bank lending, the traditional source of credit for entrepreneurs and startups in most countries, is largely inaccessible to Chinese individuals and small- to medium-sized enterprises (SMEs), because China's financial system is dominated by large, state-owned banks that mainly service government-directed projects.

Banks hold a unique position in China and are even more important to the national economy than banks in Europe or North America, where alternate sources of financing are available. China's financial sector is dominated by five massive, state-owned commercial banks that account collectively for about 50 percent of all deposits and loans. Additionally, three policy banks were established in 1994 to take over government-directed spending functions like financing of major development projects. China's policy banks are funded primarily by selling bonds to the big commercial banks, and all are ultimately back-stopped by the Chinese government. The incestuous relationship between the government; the large, state-owned policy banks; and their state-owned commercial cousins provides borrowers a considerable benefit: artificially low interest rates. The banks' depositors, meanwhile, are paid very low rates, sometimes below the rate of inflation, to help hold down the rates charged to borrowers. Thus, the state-owned corporate sector receives a subsidy from the bank's depositors (Chinese households) in the form of low interest rates.

A "shadow banking system" of unofficial credit has sprung up to fill the gaps left by the big banks' lending practices. China's shadow banking system can broadly be defined as lending that falls outside of the official banking system. It can involve both traditional and nontraditional institutions and is best understood not in terms of the institutions engaged in the system but in terms of the activities that they undertake. Because shadow banking activity occurs outside of formal banking channels, it does not appear on bank balance sheets and is far less transparent than official lending activity. Chinese demand for shadow banking is largely driven by the growth of China's private sector, a sector with limited access to official bank credit; and the Chinese government's tolerance of shadow banking in recent years has been tied to the reality that the private sector is the increasingly dominant source of the nation's employment.

Demand for credit has led Chinese companies to seek capital overseas even as its shadow banking system has expanded. In the late 1990s, Chinese companies began raising capital on major international stock exchanges. This trend has been driven by large Chinese companies, many state owned, that have sought to broaden their shareholder base, increase the liquidity of their shares, and enhance the visibility of their brand names. U.S. stock markets are among the most popular global exchange destinations for Chinese firms.

Initially, U.S. investors purchased stock in U.S.-listed Chinese companies in hopes of profiting from China's rapid growth rate. However, investors in U.S.-listed Chinese companies have increasingly

found that insufficient corporate governance standards make these companies high-risk investments. Many have been implicated in frauds and accounting scandals, and U.S. regulators have deregistered about 50 Chinese companies in the past two years following fraud probes. During recent probes, the Securities and Exchange Commission (SEC) has sought audit work papers from Chinese branches of multinational accounting firms that service U.S.- listed Chinese companies, a common request during fraud investigations. To date, the firms have refused to produce these documents, arguing that doing so would put them in violation of Chinese state secrets laws and subject them to criminal liability in China. In December 2012, the SEC charged five firms with breaking U.S. securities laws by refusing to turn over the requested audit work papers.

In May 2013, the United States and China announced a deal for limited information-sharing between their regulatory agencies when there are questions regarding audits of U.S. listed Chinese companies. In July, Chinese regulators agreed to turn over certain requested documents of some listed Chinese companies to assist the SEC in ongoing investigations. No agreement has yet been reached that would grant more general direct access to documents for U.S. regulators conducting investigations or inspections. Although it is considered a last resort option, if an agreement is not reached, the SEC and the Public Company Accounting Oversight Board could choose to ban Chinese accounting firms and Chinese branches of multinational accounting firms from auditing U.S.-listed Chinese companies, which could in turn lead to these companies being delisted from U.S. exchanges.

China's Agriculture Policy, Food Regulation, and the U.S.-China Agriculture Trade

China's World Trade Organization (WTO) accession in 2001 was a watershed event for U.S. agriculture. China is now the primary export market for U.S. agriculture products. While the United States ran a \$315 billion trade deficit in goods with China in 2012, it achieved a \$21 billion surplus in agriculture. Since full implementation of the WTO accession in 2005, China's agriculture imports from the United States have risen by an average of \$2.5 billion each year, exceeding the U.S. Department of Agriculture's (USDA) initial estimate of \$2 billion. China must feed a fifth of the world's population with less than a tenth of its arable land and potable water. As China transforms into an urban society with a growing middle class, per capita food consumption is rising and, with it, the demand for higher-protein diets—a demand that U.S. farmers are well positioned to fill.

There remain serious problems within the U.S. China bilateral agriculture trade relationship, however. Many in the U.S. agriculture industry lobbied Congress in 2000 to grant China permanent normal trade relations, because they expected China to become a major purchaser of U.S. food products once it joined the WTO. But farm belt advocates have been disappointed that China has concentrated its purchases on bulk commodities, such as soybeans used as animal feed for China's outsized livestock industry. China's agriculture policy favors domestic production, even when it is unsustainable and nonessential to food security. In trade, China has used nontariff barriers to restrict imports of higher value-added products from the United States, including excessive subsidies; government control over import quotas; discriminatory taxes; and sanitary and phytosanitary restrictions that are not based on proper scientific analysis. These measures have contributed to an imbalanced food trade that has been particularly damaging to U.S. meat producers, who enjoy a comparative advantage over China in terms of resources, quality, and efficiency.

China's agribusinesses have pursued outbound investment in several countries and sectors in recent years. In the United States, this trend came into focus in June 2013, when Shuanghui International Holdings Limited, a subsidiary of Shuanghui Group, proposed to acquire the U.S. pork producer Smithfield Foods, Inc. As the largest U.S. pork producer, Smithfield is a strategic node in the U.S. food industry.

China's WTO accession was primarily envisaged as an opportunity for U.S. exporters. But U.S. consumer food imports from China have surged as well, part of a greater reliance on imported food by U.S. consumers. The bulk of U.S. food imports from China consists of farm raised fish and fruits and vegetables. China also supplies ingredients for U.S.-processed foods, as well as organic foods that are USDA-approved through third-party certifiers. For the United States, these imports from China present significant food safety risks. Over the past decade, China's major trade partners have repeatedly banned its food shipments on the basis of food safety. Current regulation of food entering the United States from China is insufficient. For one, the Chinese government's own food safety regulation is inadequate. The Chinese government in 2009 introduced a comprehensive Food Safety Law to establish a modern framework for food safety regulation and in 2013 created a China Food and Drug Administration to consolidate regulatory authority. However, it is uncertain whether these and other reforms will improve oversight of China's large and fragmented food industry.

In the absence of effective regulation by the Chinese government, U.S. consumers depend on U.S. food safety inspectors to provide protection against the importation of unsafe food products. The Food and Drug Administration (FDA), which is in charge of inspecting all nonmeat imports, is making substantial efforts to dedicate more staff and funding to China, to modernize its regulatory system, and to propose useful policies, such as foreign supplier verification. And yet, there are numerous problems with U.S. food regulation. The FDA still inspects only a fraction of the food that enters through U.S. borders. The agency has also found it difficult to increase on-the-ground inspections on the Mainland, in part because Chinese authorities have delayed visas for FDA inspectors and restricted access to food production sites.

Conclusions

Trade and Economics Year in Review

- China underwent a once-a-decade leadership change with a new president and premier and several new members of the Politburo and Standing Committee. The leadership indicated that China's overall economic policy goal—to transition from an export and investment-led growth model to a greater reliance on domestic consumption, remained the same. In reality, this change proved difficult to implement by a new government concerned about a slowing economy, real estate speculation, stagnating wages, and unemployment. The incoming government issued statements supporting a large and powerful state-owned sector in the economy, disappointing advocates of a larger private sector.
- The new Chinese leadership introduced initiatives aimed at reducing inequality, cracking down on corruption, and promoting urbanization. There are significant impediments to the government's ability to implement these reforms. For example, corruption is endemic at all levels of government, while local governments oppose urbanization due to fear that they will be overwhelmed by a flood of new migrants. China's progress in external rebalancing following the financial crisis was only temporary and largely driven by a weak global demand that reduced the relative size of China's export sector. Trade data for 2012–13 show that Chinese exports are again growing at a higher rate than imports, signaling a continued reliance on exports to fuel economic growth and a reversal in reducing China's massive trade surplus. As a result of failed measures to rebalance its economy, China has continued to expand its already record foreign currency reserves, reaching \$3.66 trillion by the end of September 2013.
- China's trade surplus with the United States in goods in 2012 was \$315 billion, a record. For the first seven months of 2013, China's trade surplus with the United States was \$178 billion, also a

record. China continues to manipulate the value of its currency, the RMB, to achieve a competitive advantage with the United States. China also continues to follow mercantilist policies to foster a trade surplus with the United States.

- China has had little success transitioning toward a consumption- led growth model and reducing its reliance on massive infrastructure projects to boost economic growth. Consequently, China's high investment levels have led to overcapacity in multiple industries, including steelmaking, shipbuilding, and solar panel manufacturing. A slowdown in urban household disposable income growth and an increase in the household savings rate have cut into consumer purchasing power and contributed to a decline in total retail sales growth.
- Chinese officials have played down the significance of lower growth, saying the slowdown is partly due to economic rebalancing. However, the government continues to stimulate the economy through a variety of small steps. For example, the State Council, China's cabinet, instituted a temporary tax cut (scrapping all value-added and operating taxes) for more than 6 million small- and medium-sized enterprises; reduced approval procedures and administrative costs for exporting companies; and provided more investment in railway construction in China's central and western regions. In a similar vein, securities regulators and the central bank issued record amounts of investment approvals to the Qualified Foreign Institutional Investors program.
- Due to its restrictive monetary policy, China's central bank has accumulated the world's largest foreign exchange reserves. The bulk of these reserves are invested in U.S. Treasury securities, so that Chinese ownership accounts for nearly one-quarter of foreign-owned U.S. Treasuries. In addition, China's two largest sovereign wealth funds, China Investment Corporation and SAFE Investment Company, have expanded their equity and real estate investments in the United States.
- The People's Republic of China (PRC) has concluded 13 trade agreements, the latest with Iceland and Switzerland this year—the first signed with European governments. China is in the process of negotiating six additional trade agreements, which include the ASEAN-led Regional Comprehensive Economic Partnership, an initiative to link ASEAN member states and preferential trade agreement partners to form the world's largest trading bloc. The Regional Comprehensive Economic Partnership, which excludes the United States, is competing with the U.S.-led Trans-Pacific Partnership, which excludes China. Formal negotiations of the Regional Comprehensive Economic Partnership began in May 2013 and are scheduled to conclude by the end of 2015.
- China's attempts to keep the value of the RMB artificially low while strictly limiting the flow of RMB from the country, coupled with its efforts to control a large state banking sector, led to a banking crisis. The collapse in liquidity threatened economic growth in China and demonstrated the difficulty of conducting a monetary policy so at odds with its trading partners and international norms.
- The fifth round of the U.S.-China Strategic and Economic dialogue was held on July 10–11, 2013, in Washington, DC. There were no significant achievements in the strategic track. On the economic front, the most relevant announcements were (1) resumption of bilateral investment treaty talks; (2) the launch of the Shanghai Free Trade Zone; and (3) new measures to liberalize China's financial sector. In the multilateral arena, the United States successfully challenged China's improper imposition of antidumping and countervailing duties at the WTO.

- China continues to take incremental steps toward RMB internationalization, but the goal of making the RMB a major international currency remains out of reach as the government continues to maintain strict controls on cross-border capital flows.
- Beijing's efforts to reform the financial system continue to be hampered by risky off-balance-sheet lending by banks and nonbank financial institutions. Beijing has undertaken efforts to curb these risky lending practices, removing the floor on lending rates and imposing a short-term credit crunch in a clumsy effort to send a strong signal to the financial sector. However, there is little evidence so far that these efforts have succeeded. The ceiling on rates paid to depositors remains low, and some risky lending actually increased during the credit crunch.

Trends in Chinese Investment in the United States

- Chinese foreign direct investment (FDI) in the United States continues to grow, though from a very low base. According to official U.S. statistics, in 2012 the United States attracted \$174.7 billion of global FDI, of which \$219 million came from China. An estimate by country of ultimate beneficiary owner, which better tracks actual investors, put stock of Chinese FDI in the United States at \$9.5 billion at the end of 2011. For the same year, China's Ministry of Commerce put the flows of Chinese FDI to the United States at \$1.8 billion, with stock of FDI estimated at around \$9 billion.
- Official statistics underestimate the true volume of Chinese investment, because they do not account for flows of FDI through Hong Kong and other offshore financial centers, which are likely transit points for Chinese money on the way to the real investment destination. Official data are also provided after a significant delay, which hinders analysis.
- To date, state-owned enterprises (SOEs) have dominated Chinese FDI in the United States measured by the value of deals, though private companies lead by the number of deals. One reason is that the biggest investments so far have been made in the oil and energy fields, which are dominated by Chinese state-owned giants.
- Chinese investors have primarily targeted those sectors where China lacks know-how and technology, particularly in the Strategic and Emerging Industries identified in the 12th Five-Year Plan. Energy and services (in particular real estate and financial services) have received the most investment. High-end manufacturing is another important destination for China's investments, particularly when measured in terms of the number rather than the value of deals.
- Due to the considerable government ownership of the Chinese economy, provision by Chinese companies of critical infrastructure to U.S. government or acquisition by Chinese companies of U.S. firms with sensitive technology or intellectual property could be harmful to U.S. national interests. The Committee on Foreign Investment in the United States (CFIUS) investigates the national security implications of mergers and acquisitions by foreign investors of U.S. assets.
- Investigations by CFIUS and other national security review and mitigation mechanisms may be hampered by limited resources or limited statutory authority.
- Investments made by Chinese state-owned or -controlled companies can also pose economic security threats. The Chinese government provides significant financial and logistical support. This puts U.S. firms, which receive no such support, at a competitive disadvantage. When Chinese SOEs invest abroad, they do not necessarily seek profit and may instead pursue government goals such as resource acquisition or technology transfer.

- Chinese investments in the United States are subject to the same set of rules and regulations as investment from other foreign countries in the areas of foreign corrupt practices, export administration, sanctions, and antitrust. If Chinese firms run afoul of these rules, they will be subject to legal sanction. But gaps exist in the U.S. government's ability to address the competitive challenges posed by SOEs.
- In areas where there are no national security considerations, and when the investment is driven by economic rather than strategic rationale, Chinese FDI can benefit the U.S. economy through creation of jobs and other positive spillovers.

Governance and Accountability in China's Financial System

- The Chinese economy weathered the first few years of the global economic downturn by doubling down on its time-tested strategy of funneling capital into domestic development projects. But five years on, global demand for Chinese exports remains too weak to sustain the country's factories, much less new ones, and the merits of massive infrastructure projects have more than run their course. The policy decisions that kept the Chinese economy chugging over the last few years have also sped it closer to a reckoning that economists have long forecast would eventually be necessary. If a rebalancing of the U.S.-China economic relationship is to be achieved, China must reform its financial system to support newer, nonstate sources of economic growth, which will require that China's banks better service its private sector.
- As long as China's official, regulated channels of credit do not possess the flexibility to meet the needs of the Chinese economy's main job creators, China will be at risk of depressed economic growth, which in turn may limit the growth of U.S. exports to China and the prosperity of U.S. investments in China, slowing economic recovery here at home. The shadow banking system that Beijing has allowed to step into this credit gap is insufficiently regulated and, if left unchecked, will pose an increasingly serious threat to Chinese and global economic stability.
- The opacity of Chinese corporate governance and accountability policies, as well as conflicts with U.S. securities laws and regulations, hurts investor confidence in Chinese companies trading on U.S. exchanges. The current situation threatens U.S. investors with unforeseeable and unmanageable losses and may lead to a broad delisting of Chinese companies. China's lack of sophisticated banking, corporate governance, and auditing policies and practices also hinders much-needed growth and opportunity for the very U.S. financial services firms that could help China to restructure its system if they were allowed greater access to the Chinese market.
- Insufficient transparency and accountability in China's financial sector put U.S. firms at risk of violating laws in both China and the United States; pose unreasonable hazards for U.S. investors with shares in Chinese companies; and render some U.S. laws and regulations unenforceable. Without greater regulatory transparency and assurance of China's regulatory, oversight and enforcement capabilities, Chinese firms also risk curtailment or even revocation of access to the U.S. market.

China's Agriculture Policy, Food Regulation, and the U.S.-China Agriculture Trade

- For the past three years, China has been the largest export market for U.S. agricultural goods. However, trade is far from free, and enormous opportunities are being withheld. China's

- WTO accession has not been as productive to the United States as initially expected. In contrast to U.S. agricultural exports to the rest of the world, most U.S. exports to China are bulk commodities, particularly raw soybeans that supply China's outsized livestock sector. Conversely, processed commodities, meat products, consumer foods, and other higher value-added products have not kept pace with the overall growth in bilateral trade.
- Since the 1980s, China has developed into the world's largest agricultural economy, producing a fifth of the world's grains, a quarter of its meat, and half of its vegetables. But demand in China is beginning to outstrip supply. As more people move to cities and earn higher incomes, China's population is demanding safer food and a more diverse, protein-rich diet at an affordable cost. The United States is well-positioned to meet that demand. U.S. farmers enjoy a comparative advantage in resources, productivity, and quality, particularly in meat production.
- China's agriculture policy favors domestic production over imports. China maintains ambitious self-sufficiency targets that are unsustainable and unjustifiable in terms of food security. This policy is now being challenged by the decline in China's farm labor surplus, deteriorating land and resource endowments, and fragmented producer and land use systems. A related problem is that efforts to modernize agriculture conflict with rural welfare aims. Millions of rural migrants continue to rely on farmland and smallholder agriculture for insurance in the absence of a functioning welfare state.
- China has failed to fully perform its obligations under the WTO. It has erected a series of nontariff barriers that include state trading; excessive domestic subsidies and stockpiling of commodities; discriminatory taxes; uncalled-for antidumping duties; and slow approvals of biotechnology applications for U.S. crops. Damaging to U.S. interests as well are sanitary and phytosanitary restrictions, especially BSE-based bans on beef and zero tolerance for ractopamine in pork. Although China has significantly lowered its tariffs and increased its agricultural imports since accession, numerous trade restrictions remain in place.
- U.S. companies, universities, and government agencies are helping China to improve the quantity and quality of its food output. In a sign of deepening bilateral ties, the United States and China signed the first U.S.-China Plan of Strategic Cooperation in Agriculture (2012–2017) in February 2012, and in March of that year the largest-ever U.S. agricultural trade mission visited China. However, U.S. companies operating in China are hamstrung by regulatory uncertainty, restricted market access, and weak intellectual property enforcement.
- China is fostering globally competitive agribusinesses, in the process becoming an active acquirer of agricultural assets overseas. In June 2013, China's largest pork producer, Shuanghui, proposed a \$7.1 billion acquisition of Smithfield, the leading pork producer in the United States. While the deal has been approved by CFIUS and Smithfield's shareholders, it raises critical issues regarding net economic benefits, intellectual property, reciprocal market access, and the treatment of quasi-private Chinese companies that maintain links to the Chinese government.
- China accounts for a large share of the fruits, vegetables, fish, and processed foods that Americans consume, but the United States has little assurance that the food imports coming into the United States from China are safe. China's own food safety regulation is still ineffective, in spite of recent efforts to consolidate agencies and improve legislation. U.S. consumers rely on U.S. food safety inspectors to do their jobs, but U.S. regulation is also fragmented and underfunded. U.S. regulators have increased their presence within China but have struggled to obtain work visas and to gain access to food production facilities. Although the United States

does not permit raw meat imports from China, the USDA has granted equivalence status to Chinese poultry processors, which will permit them to process poultry raised in the United States and Canada and ship it to the United States.

Chapter 2: China's Impact on U.S. Security Interests

Military and Security Year in Review

China's late 2012 leadership transition brought the largest turnover to the Central Military Commission (CMC) in a decade. Xi Jinping assumed the position of both CMC chairman and Chinese Communist Party (CCP) general secretary at the CCP's 18th Party Congress on November 15, 2012. President Xi then completed his accession as China's senior leader by becoming the People's Republic of China (PRC) president on March 14, 2013. Although President Xi was widely expected to eventually assume all three of China's top leadership posts, many observers were surprised by the speed of his elevation to CMC chairman. Mr. Hu broke with the pattern established by his two predecessors, who retained the CMC chairmanship for two years after finishing their terms as CCP general secretary.

Since becoming CMC chairman, President Xi has used public speeches and visits to People's Liberation Army (PLA) units to reaffirm China's long-term military modernization goals; emphasize the importance of a strong military to the fulfillment of the "China Dream," his new political slogan and party campaign; and signal his intent to focus on increasing combat readiness and reducing corruption in the PLA.

In November 2012, President Xi introduced the "China Dream" concept, which envisions the "great renewal of the Chinese nation" and the advancement of an international system in which China's successful rise provides an attractive alternate political model to Western ones. Achieving the dream means building a "moderately prosperous society" by 2021 and a "modern socialist society that is strong, democratic, cultured, and harmonious" by 2049. Although President Xi emphasizes that "peaceful development" and a stable regional environment are essential to create the conditions for this vision, he linked its fulfillment to a strong military in a December 2012 speech while aboard a PLA Navy destroyer. In June 2013, official PLA media explained, "To the armed forces, the China dream is the strong-army dream, the China dream leads the strong-army dream, and the strong-army dream supports the China dream."

During his first reported visit to a PLA base as CMC chairman in December 2012, President Xi called for the PLA to increase "combat readiness" through "realistic training." Combat readiness has been a central theme of subsequent speeches to the military by President Xi and now features prominently in official PLA statements and documents. For example, official PLA media in January 2013 said the military needs to prevent and overcome the "harmful" practice of training "for show." Furthermore, describing the PLA's 2013 training priorities, a PLA official said: "The 'scent of gunpowder' in the 'fighting' will be stronger. The entire military will make 'training like real war' . . . the main theme of the entire year's training, powerfully strengthening training of mission topics, ensuring that as soon as there is a situation, the military will be able to go forward and fight to victory."

In a meeting shortly after becoming the CMC chairman, President Xi urged senior PLA officers "to take a firm stand against corruption" and to maintain a "strict work style" and "iron discipline." Since then, reducing corruption and waste in the PLA has been one of President Xi's most consistent messages in his public speeches to the military. In addition to rhetoric, President Xi has announced stronger anticorruption regulations for the PLA, including restrictions on military personnel holding banquets, drinking excessive amounts of alcohol, and using luxury hotels.

In March 2013, China announced its official defense budget for 2013 rose 10.7 percent to 720.168 billion RMB (approximately \$117.39 billion), signaling the new leadership's support for the PLA's ongoing modernization efforts. This figure represents 5.3 percent of total government outlays and approximately 1.3 percent of estimated GDP. China's official annual defense budget now has increased for 22 consecutive years and more than doubled since 2006. The Institute of International Strategic Studies assesses China's actual defense spending is 40 to 50 percent higher than the official figure. The U.S. Department of Defense (DoD) estimated China's actual defense spending in 2012 fell between \$135 and \$215 billion, which was approximately 20 to 90 percent higher than China's announced defense budget.

In April 2013, China released the latest version of its biennial defense white paper. This is the first defense white paper published since President Xi became CMC chairman. Although Chinese military leaders likely began to draft the document before President Xi assumed the position, official Chinese press suggests it contains strategic priorities specific to him. Official Chinese media hailed the 2012 defense white paper as a milestone in transparency, citing the "declassification" of military information. However, most of this was widely-known information that Beijing had never officially acknowledged. Furthermore, as in previous iterations, the 2012 defense white paper offers no substantive information on important defense issues.

Since commissioning its first aircraft carrier, the *Liaoning*, in September 2012, the PLA Navy has continued to develop a fixed-wing carrier aviation capability for air defense and offensive strike missions. China plans to follow the *Liaoning* with at least two indigenously built carriers. The first likely will enter service by 2020 and the second by 2025. China's Julang-2 (JL-2) submarine-launched ballistic missile (SLBM) is expected to reach initial operations capability by late 2013. The JL-2, when mated with the PLA Navy's JIN-class nuclear ballistic missile submarine (SSBN), will give China its first credible sea-based nuclear deterrent. The SLBN/SSBN weapon system will be able to target the continental United States from China's littoral waters.

The PLA Navy continues to steadily increase its inventory of modern submarines and surface combatants. China is known to be building seven classes of ships simultaneously but may be constructing additional classes. China also recently began developing its first sea-based land attack capability. Modern submarines and surface combatants equipped with land attack cruise missiles (LACMs) will enhance Beijing's flexibility for attacking land targets throughout the Western Pacific, including U.S. facilities in Guam.

China also continues to pursue new space and counterspace capabilities. In May 2013, China fired a missile into nearly geosynchronous Earth orbit, marking the highest known suborbital launch since the U.S. Gravity Probe A in 1976 and China's highest known suborbital launch to date. Although Beijing claims the launch was part of a high-altitude scientific experiment, available data suggest it was intended to test at least the launch vehicle component of a new high-altitude antisatellite (ASAT) capability. If the launch is part of China's ASAT program, Beijing's attempt to disguise it as a scientific experiment would demonstrate a lack of transparency about its objectives and activities in space. Furthermore, such a test would signal China's intent to develop an ASAT capability to target satellites in an altitude range that includes U.S. Global Positioning System (GPS) and many U.S. military and intelligence satellites. Throughout 2013, China also made significant advances in its manned space and regional satellite navigation programs. The PLA's extensive role in China's civilian space programs suggests these activities support the development of PLA space, counterspace, and conventional capabilities in addition to serving China's overall development strategy.

In late January 2013, China conducted the first test flight of its indigenously developed cargo transport aircraft, the Yun-20 (Y-20). China previously was unable to build heavy transports, so it has relied on a handful of Russian aircraft for strategic airlift since the 1990s. Once large-scale deliveries of the new plane begin, the Y-20 aircraft will be able to support a variety of domestic and international military operations. The Y-20 will enhance the PLA's ability to respond to internal security crises and border contingencies, support international peacekeeping and humanitarian assistance operations, and project power in a regional conflict.

In June 2013, the PLA Air Force began to receive new Hongzha-6K (H-6K) bomber aircraft. The H-6K has an extended range and can carry China's new long-range LACM. The bomber/LACM weapon system provides the PLA Air Force with the ability to conduct conventional strikes against regional targets throughout the Western Pacific, including U.S. facilities in Guam. Although the H-6K airframe could be modified to carry a nuclear-tipped air-launched LACM, and China's LACMs likely have the ability to carry a nuclear warhead, there is no evidence to confirm China is deploying nuclear warheads on any of its air-launched LACMs.

In July 2013, the PLA began to deploy peacekeepers to the United Nations (UN) Multidimensional Integrated Stabilization Mission in Mali (MINUSMA). The PLA contingent includes what Beijing calls a "security force" from a PLA group army. This marks the first time Beijing has deployed infantry to support a peacekeeping operation since it began participating in UN missions in 1990. China previously had limited the PLA's participation in peacekeeping operations to noncombat troops.

China's Cyber Activities

In 2013, strong evidence emerged that the Chinese government is directing and executing a large-scale cyber espionage campaign against the United States. Mandiant, a private U.S. cybersecurity firm, issued a report that provides evidence that the PLA since 2006 has penetrated the networks of at least 141 organizations, including companies, international organizations, and foreign governments. These organizations are either located or have headquarters in 15 countries and represent 20 sectors, from information technology to financial services. Of the organizations penetrated, 81 percent were either located in the United States or had U.S.-based headquarters.

The Mandiant report was followed by DoD's first direct accusation that the Chinese government and military are conducting cyber espionage against U.S. networks. DoD's 2013 annual report to Congress on China's military stated: "In 2012, numerous computer systems around the world, including those owned by the U.S. government, continued to be targeted for intrusions, some of which appear to be attributable directly to the Chinese government and military." Previously, DoD had stopped short of attributing cyber espionage to the Chinese government or military, instead merely acknowledging cyber espionage "originated" in China.

There are no indications the public exposure of Chinese cyber espionage in technical detail throughout 2013 has led China to change its attitude toward the use of cyber espionage to steal intellectual property and proprietary information. It is clear naming and attempting to shame will not be sufficient to deter entities in China from engaging in cyber espionage against U.S. companies. Mitigating the problem will require a multifaceted approach. Many potential actions to address the problem are being discussed by Congress, the Obama Administration, and outside experts. These actions include linking economic cyber espionage to trade restrictions, prohibiting Chinese firms using stolen U.S. intellectual property from accessing U.S. banks, and banning U.S. travel for Chinese organizations that are involved with cyber espionage. To date, Washington has not implemented a comprehensive framework for addressing China's ongoing cyber espionage.

China's Maritime Disputes

Although sovereignty disputes in the East and South China Seas are not new, China's growing diplomatic, economic, and military clout is improving China's ability to assert its interests. It is increasingly clear that China does not intend to resolve the disputes through multilateral negotiations or the application of international laws and adjudicative processes but instead will use its growing power in support of coercive tactics that pressure its neighbors to concede to China's claims. Viewing a public defense of its maritime claims as central to political legitimacy, leaders in Beijing exploit deep-seated popular nationalism to support foreign policy aims in the East and South China Seas. China also views sovereignty over the East and South China Seas as critical to its national security, territorial integrity, and economic development. China has been more assertive since the publication of the Commission's 2012 Report, offering counterclaimants the choice of either facing the brunt of Chinese power as a result of challenging Chinese claims or benefitting from economic and political rewards for moderating their positions or even acquiescing to China's claims. Chinese official statements and use of maritime law enforcement rather than military forces suggest Beijing prefers to avoid direct military conflict over its maritime disputes and rely on the shift in the balance of regional power in its favor to resolve its maritime disputes in the long term.

The East China Sea dispute involves China, Japan, and Taiwan. The dispute can be divided into two distinct issues: territorial sovereignty over the Senkaku Islands (known as the Diaoyu Dao in China, and Diaoyutai in Taiwan), and demarcation of maritime zones that have implications for natural resource rights. Given the historical animosity between China and Japan and the strong nationalist sentiment on both sides regarding the sovereignty of the islands, the Senkaku Islands dispute is especially intense. The Japanese government's September 2012 purchase of three of the islands from a private Japanese owner angered China, sparking an escalation in tensions between China and Japan. PLA Navy and Chinese maritime law enforcement activity near the Senkaku Islands, previously irregular and sporadic, increased to a robust and near-persistent presence following Japan's purchase of the islands. Tensions continued to simmer throughout 2013 as both sides enhanced their naval and maritime law enforcement presence in the disputed waters to assert their claims.

The South China Sea dispute involves China, Taiwan, Vietnam, the Philippines, Malaysia, and Brunei. Beijing denotes its claim on its South China Sea maps using a nine-dash line, with an additional dash off the coast of Taiwan to demonstrate its sovereignty over Taiwan. China's diplomatic preference on the South China Sea is to "divide and conquer" by negotiating the issue on a bilateral basis rather than under the auspices of multilateral forums such as ASEAN.

In addition to boosting its presence in the East and South China Seas, Beijing has taken a number of steps since mid-2012 to address shortcomings in its coordination of maritime policy to better align China's maritime activity with national policy. In an effort to streamline its maritime policy-making bureaucracies to manage its maritime disputes more effectively, China created a high-level policy advisory group on maritime security issues in mid-2012 and consolidated multiple maritime law enforcement agencies into a single China Coast Guard in mid-2013. Beijing discourages and seeks to prevent the diplomatic involvement of the United States in the East and South China Seas because Beijing considers these disputes bilateral issues between China and each claimant. However, U.S. treaty commitments and forward-deployed military presence bind the United States to the region in ways that link its security interests to the peaceful resolution of China's maritime disputes. Despite a generally improving military-to-military relationship, mutual mistrust about one another's long-term intentions continues to pervade the overall security relationship. This strategic backdrop poses challenges for the operational environment at sea, especially as the maritime operating areas of the two countries increasingly overlap.

Conclusions

Military and Security Year in Review

- PLA modernization is altering the security balance in the Asia Pacific, challenging decades of U.S. military preeminence in the region.
- The PLA Navy is in the midst of an impressive modernization program. China's acquisition of naval platforms, weapons, and systems has emphasized qualitative improvements, not quantitative growth, and is centered on improving its ability to strike opposing ships at sea and operate at greater distances from the Chinese mainland. Today, the PLA Navy is able to conduct high-intensity operations in China's immediate periphery as well as low-intensity operations beyond the region. Trends in China's defense spending, research and development, and shipbuilding suggest the PLA Navy will continue to modernize. By 2020, China could have approximately 60 submarines that are able to employ submarine-launched intercontinental ballistic missiles or antiship cruise missiles and approximately 75 surface combatants that are able to conduct multiple missions or that have been extensively upgraded since 1992.
- The PLA is rapidly expanding and diversifying its ability to strike U.S. bases, ships, and aircraft throughout the Asia Pacific region including those that it previously could not reach, such as U.S. military facilities on Guam.
- The PLA's expanding involvement in real world missions allows it to field-test equipment and obtain hands-on experience in areas such as addressing unconventional threats in harsh and potentially hostile environments, satisfying expeditionary logistics requirements, and integrating into multilateral operations.
- The PLA is improving its day-to-day readiness levels and conducting longer-range and more frequent, robust, and realistic training. As these reforms continue, the PLA will become more proficient and confident operating its advanced platforms and weapon systems and better able to rapidly respond to regional contingencies.
- The PLA Navy's growing presence in foreign EEZs contradicts its longstanding policy on military activities in its own EEZ. Rather than resolve the inconsistency between its actions and policy, Beijing likely will continue to assert its authority to regulate U.S. military activities in its EEZ.

China's Cyber Activities

- The Chinese government is directing and executing a large-scale cyber espionage campaign against the United States and to date has successfully targeted the networks of U.S. government and private organizations, including those of DoD and private firms. These activities are designed to achieve a number of broad economic and strategic objectives, such as gathering intelligence, providing Chinese firms with an advantage over their competitors worldwide, advancing long-term research and development objectives, and gaining information that could enable future military operations.
- China has not reduced its cyber intrusions against the United States despite recent public exposure of Chinese cyber espionage in technical detail. This suggests Beijing has decided to continue its cyber campaign against the United States.

- Developments in cloud computing in China may present cybersecurity risks for U.S. users and providers of cloud computing services. The relationship between China's Ministry of State Security and the Chongqing Special Cloud Computing Zone represents a potential espionage threat to foreign companies that might use cloud computing services provided from the zone or base operations there. In addition, the plan to link 21Vianet's data centers in China and Microsoft's data centers in other countries suggests the Chinese government one day may be able to access data centers outside China through Chinese data centers.
- There is an urgent need for Washington to take action to prompt Beijing to change its approach to cyberspace and deter future Chinese cyber theft. Actions and policies under discussion include the following: passing new legislation or modifying existing legislation; changing the cost-benefit calculus of Chinese cyber actors and China's leaders through sanctions and counterintelligence tactics; undertaking multilateral measures; appointing a Cabinet-level official to oversee an interagency process regarding the protection of intellectual property; and enhancing cooperation between the U.S. government and the private sector. These would be more effective if used in combination, as they probably would lead Beijing to make only temporary or minor changes to its cyber espionage activities if used in isolation.

China's Maritime Disputes

- China relies on a coercive and persistent maritime law enforcement and naval presence to gain control of disputed territory in the East and South China Seas. A consolidated maritime policymaking bureaucracy and streamlined maritime law enforcement fleets could increase Beijing's confidence in its capability for coercion in the ongoing maritime disputes.
- Two key drivers shape China's approach to its maritime disputes: First, China encourages ardent popular nationalism, which it exploits to support its foreign policy aims in the East and South China Seas. Second, China views sovereignty over claims in the East and South China Seas as central to its national security, territorial integrity, and economic development.
- China uses legal and administrative measures to assert de jure governance over its disputed maritime regions; it deploys maritime law enforcement and naval vessels to its claimed waters to demonstrate and lay the groundwork for de facto governance.
- Beijing's tendency to demonstrate resolve in its maritime disputes; its large and complicated political, foreign affairs, and military bureaucracy; and its inconsistent adherence to internationally accepted norms of air and maritime operations may contribute to operational miscalculations in the East and South China Seas. Unyielding positions on sovereignty and nationalist sentiment surrounding these maritime disputes increase the risk of escalation from a miscalculation at sea to a political crisis.

Chapter 3: China and the World

China and the Middle East and North Africa

China employs a multifaceted foreign policy approach to the Middle East and North Africa (MENA). It is characterized by growing economic (and particularly energy) ties; the pursuit of friendly relations with all countries (as well as the Palestinian territories) in the region; the protection of domestic stability and control in China; and the promotion of regional stability in support of China's own domestic

economic, political, and security priorities. China has in recent years faced challenges in the region, particularly in responding to political upheaval and regime changes during and after the Arab Spring. China also has taken positions in support of regimes in Syria and Iran that put it at odds with the United States and other regional and international communities.

China is expanding and deepening its trade and investment ties with countries in the region. Between 2003 and 2012, China-MENA annual trade increased more than twelvefold, from \$20.8 billion to \$262.1 billion. In 2009, China overtook the United States to become the world's largest exporter to the region. China's energy demand is the primary driver of these economic ties. MENA accounts for more than 50 percent of China's crude oil imports; these imports are projected to grow in the coming decades. China's leaders view the country's growing reliance on MENA oil imports as a strategic vulnerability. This sense of vulnerability appears to drive Beijing's efforts to enhance the security of its imports by strengthening its relations with the region's largest oil producers, particularly Saudi Arabia and Iran, but also Iraq, Oman, and others.

China seeks to develop and maintain friendly ties with all MENA countries without being drawn into the region's conflicts and power struggles. As such, China has more or less successfully maintained positive relationships with the major powers in the region, simultaneously strengthening ties with regional rivals like Israel and Iran, Saudi Arabia and Iran, and the Israelis and Palestinians. Beijing's approach generally has been well-received in the region, where China enjoys mainly positive views among leaders and the public.

China also seeks to leverage its relations in MENA in support of its own domestic security, particularly in the Xinjiang Uighur Autonomous Region, home to many of China's ethnic Turkic Muslims. Episodic ethnic and political unrest in Xinjiang has in the past attracted support from overseas Muslim groups in MENA. Beijing fears these overseas groups could encourage or exacerbate what it refers to as "separatist insurgencies" in Xinjiang. To mitigate this perceived risk, China solicits support from countries in the region for its policies to suppress "separatist" activities in Xinjiang.

In addition, China has taken steps to promote stability within MENA. Offers of support for the Israeli-Palestinian peace process, counterpiracy operations in the Gulf of Aden, and participation in UN peacekeeping operations in MENA are among China's contributions to regional security and stability. However, China also has undermined security in the region with its support for the Assad regime in Syria and its continued economic and political ties to Iran.

As China's interests and presence in MENA grow, they inevitably will impact U.S. objectives and influence. Although Beijing has in the past avoided directly opposing Washington on issues related to MENA, this appears to be changing. Beijing's relationship with Tehran and its position on the Syrian conflict seem to indicate that, when key interests are at stake, China is willing to challenge the United States.

Taiwan

Cross-Strait economic ties continue to expand and deepen. From January through July 2013 (the most recent months for which official statistics are available), the total value of trade between China and Taiwan was \$71.8 billion. The total value of cross-Strait trade during this period grew by 2.79 percent compared to the same period in 2012. Through the first seven months of 2013, China remained Taiwan's largest export market, accounting for approximately \$47.3 billion worth of exports (26.9 percent of Taiwan's total exports). China followed behind Japan as Taiwan's second-largest source of imports, accounting for approximately \$24.5 billion worth of imports (15.5 percent of Taiwan's total imports). Although China remained the top destination for Taiwan FDI in 2012, Taiwan's approval of \$10.9 billion

in investments in China in 2012 represented a 16.6 percent decrease from the previous year and a three-year low. From January through July 2013, the value of Taiwan FDI to China continued to decrease, slipping 17.23 percent from the previous year. Officials at the American Institute in Taiwan (AIT), which serves as the de facto U.S. embassy in Taiwan, told the Commission that Taiwan businesses increasingly are looking for investment opportunities in Southeast Asia, Africa, and Latin America as manufacturing costs in China continue to rise. Mainland investment in Taiwan continued to grow in the first seven months of 2013, with the value of investments increasing 79.34 percent compared to the same period in 2012.

In 2013, Taiwan used creative diplomacy to secure participation in a key international organization and to sign two free trade agreements despite China's continued efforts to restrict Taiwan's full participation in the international community. The president of the UN's International Civil Aviation Organization (ICAO) in September 2013 invited a Taiwan delegation to attend the upcoming ICAO assembly as his "guests." Furthermore, Taiwan and New Zealand signed a free trade agreement in July 2013, which marks Taiwan's first such deal with a country with which it does not have official diplomatic relations; Taiwan and Singapore agreed in principle to a free trade agreement in May 2013; and Taiwan is participating in negotiations with 22 other WTO members, including the United States, on a multilateral Trade in Services Agreement. Taiwan's Ministry of Economic Affairs told the Commission that Taiwan's efforts to expand its trade ties with the Asia Pacific region are part of Taiwan President Ma Ying-jeou's larger push to diversify Taiwan's economic partners to avoid overreliance on China. Other Taiwan officials explained to the Commission that the agreements will help promote Taiwan's inclusion in Asia's broader economic integration, including participation in multilateral trade pacts such as the Trans-Pacific Partnership and the Regional Comprehensive Economic Partnership.

In April 2013, Taiwan and Japan signed a fisheries agreement after 17 years of intermittent negotiations. President Ma said the agreement demonstrates Taiwan's constructive role in reducing tension in the East China Sea without compromising Taiwan's maritime claims and could be used as a blueprint and impetus for a similar agreement between Taiwan and other countries with claims in the South China Sea.

In March 2013, the Philippine Coast Guard opened fire on a Taiwan fishing boat operating in disputed waters in the South China Sea, resulting in the death of a Taiwan fisherman and sparking a diplomatic row with Taiwan. Manila and Taipei both assert the incident took place within their respective exclusive economic zones in the South China Sea. After Taiwan claimed that the Philippines failed to adequately address its demands in the aftermath of the shooting, Taiwan stopped accepting new Filipino labor applications; suspended trade, fishery, and technology exchanges with the Philippines; and removed the Philippines from Taiwan's visa waiver program. Taiwan removed the sanctions in August after the Philippines offered an official apology on behalf of the Philippine president, agreed to pay compensation to the victim's family, and recommended homicide charges for the Philippine Coast Guard personnel who opened fire on the Taiwan fishing boat. Taiwan and the Philippines also are discussing measures to reduce the risk of future incidents and working to establish a bilateral fisheries mechanism.

Taiwan's ability to defend against China's growing military capabilities is declining. The key shortcoming in Taiwan's defensive capabilities is its inability to survive initial Chinese air and missile strikes due to insufficient infrastructure hardening and lack of mobile systems. China's overwhelming quantitative and qualitative advantage over Taiwan also will challenge the Taiwan military's ability to sustain high-intensity operations during a conflict. Nevertheless, Taiwan's defense budget continues to decline. Taiwan's official defense budget contracted to \$10.5 billion in 2013 from \$10.6 billion in 2012. Taiwan's 2013 defense spending represents 2.1 percent of its GDP, a record low matched only in 2006 and 2011. This is less than 3 percent of GDP—the level at which President Ma pledged to maintain defense spending—and marks a substantial decrease from 3.8 percent of GDP in 1994. In response to

concerns about Taiwan's declining defense budget relative to GDP, President Ma has explained defense spending cannot be expected to keep pace with Taiwan's GDP growth. Taiwan's GDP growth rate was 10.7 percent in 2010, 4 percent in 2011, and 1.3 percent in 2012.

Despite warming cross-Strait ties, China continues to engage in aggressive espionage activities against Taiwan. Since September 2012, Taiwan has arrested at least six former or active Taiwan military officers, including one flag officer, for espionage. In one case, a former Taiwan Navy officer may have provided to China classified submarine nautical charts as well as hydrographic information about the waters surrounding Taiwan. These cases underscore the breadth and depth of China's espionage activities against Taiwan and highlight the increasing counterintelligence risks to Taiwan and U.S. military information shared with Taiwan.

The recent cross-Strait rapprochement benefits the United States by reducing the likelihood of a U.S.-China conflict over Taiwan; contributing to peace, prosperity, and stability in East Asia; and allowing U.S. policymakers to focus their time and attention on other priorities in the U.S.-China and U.S.-Taiwan relationships. At the same time, warming ties between China and Taiwan raise concerns for Washington and Taipei. Increasing cross-Strait economic integration will continue to tie Taiwan closer to China. This could strengthen China's bargaining power over Taiwan and allow China to make progress toward its long-term goal of unification. Responding to these concerns, officials from Taiwan's National Security Council insisted to the Commission that Taipei's economic engagement with Beijing is carefully calibrated to promote both Taiwan's economic growth and continued autonomy.

Macau

The gaming sector is the most important element of the Macau Special Administrative Region (SAR) economy and is the highest-grossing gambling location in the world. Tax collections from the gaming sector in 2012 totaled \$13.9 billion, which accounted for 87.5 percent of total government revenue. Macau's casino-oriented economy and its proximity to the PRC present a significant risk of money laundering. The main channel for money laundering is in the gaming sector through underregulated junket operators and their affiliates, which include the underground banking system that supports their operations. Junket operators in Macau are significantly more involved in gambling operations than is common throughout the world, operating with far fewer restrictions. Macau's independent junket operators and independent VIP rooms are not subject to the same regulatory requirements as casinos. There is a risk of money laundering within the independent VIP gaming room operations which are physically conducted within the casinos but can remain outside of the casino's official oversight. The risk is enhanced because so much of the money that is wagered in Macau goes through the loosely regulated independent VIP rooms. In 2012, VIP baccarat rooms in Macau casinos accounted for 69.3 percent of total revenue from games of chance.

A 2007 evaluation by the Financial Action Task Force recognized the risk of money laundering in Macau's gaming sector and noted multiple deficiencies in its anti-money-laundering and counter-terrorist-financing framework. The evaluation also discovered several specific deficiencies in Macau's compliance with the Financial Action Task Force recommendations, including the refusal to respond to foreign requests to freeze assets, the inability to effectively implement UN Security Council resolutions on the financing of terrorism, and the inability of Macau's Customs Service to investigate money-laundering cases.

Since the report was published in 2007, there remain significant vulnerabilities with unlicensed junket operators and the junket affiliates that play an integral role in Macau's gaming system. Macau's junket operators are not subject to the same transparency requirements as casinos, and strict privacy controls prevent U.S. regulators from obtaining information on individuals operating in Macau

subsidiaries of U.S. parent casinos. The Macau SAR Gaming Inspection and Coordination Bureau, Macau's gaming regulator, does not disclose financial information. The lack of information presents difficulties in determining the origin of money flowing through such operations, and U.S. state regulators do not have the authority or resources to independently conduct investigations in Macau or other foreign jurisdictions.

The PRC's capital controls have caused more money to cycle through Macau due to Macau's thriving VIP gaming industry, which relies on junket operators and their affiliates to facilitate cross-border money transfers for clients via underground banks. However, Beijing is beginning to take some measures to restrict illicit cross-border transfers and money laundering in Macau as part of the nationwide crackdown on corruption promoted by PRC President Xi.

Hong Kong

The most significant problem for democratic rights activists is the Hong Kong government's lack of progress toward ensuring universal suffrage in the election of the Legislative Council and the chief executive (Hong Kong's highest office). At present, the chief executive is chosen from a slate of nominees by a 1,200-person election committee. The Basic Law states that the ultimate aim for chief executive elections is through universal suffrage, and current Chief Executive Leung Chun-ying (CY Leung) has indicated that the city is working toward this goal. In March 2013, Chief Executive Leung said in meetings with Chinese President Xi that he was committed to the process of achieving universal suffrage in Hong Kong by 2017. In July he also promised free and open elections for the Legislative Council by 2020.

Despite these stated goals, the dominance of the Hong Kong government by politicians allied to Beijing has stymied progress in achieving universal suffrage. The current election committee is heavily populated with business figures as well as politicians and labor leaders with strong connections to Beijing, giving it a distinctly pro-Beijing slant. Beijing effectively controls roughly 950 of the 1,200 election committee votes for chief executive. Currently, 30 members of the 70-person Legislative Council are elected by traditional functional constituencies, in which professionals in specific fields such as insurance, transportation, health care, finance, and tourism are allowed to cast a vote in addition to their vote in their geographic constituency. The greater representation of some segments of society as a result of the functional constituencies, combined with the dominant support for pro-Beijing candidates among functional constituency voters, ensures that the Legislative Council remains controlled by pro-Beijing representatives.

Between 2005–2012, Hong Kong's Freedom House ranking for press freedom fell from a status of "free" to "partly free." The Hong Kong press itself reports a sense of diminishing freedom. Following the election of Mr. Leung to chief executive in 2012, press freedom advocates reported an escalation in government efforts to censor and control media access to official information. Free press advocates contend that the government has reduced the number of full press conferences it holds for Hong Kong media, thereby denying journalists the opportunity to ask questions. Media self-censorship is also a pervasive concern. A poll conducted in May 2013 by the Public Opinion Program of the University of Hong Kong found that 48 percent of respondents believed that the local news media practiced self-censorship. Self-censorship has increased as the Chinese central government has co-opted media company owners. According to the 2013 annual report of the Hong Kong Journalists Association, roughly 50 percent of Hong Kong media owners have been appointed to the National People's Congress or the Chinese People's Political Consultative Conference.

Newly proposed legislation would further limit journalists. An antistalking bill that may be considered this year could hinder journalists' ability to seek out information from sources. Another law

would limit personal data that corporate directors must make public. While supporters argue that this law is important for enhancing protections of individual personal data, detractors are concerned that it will unduly shield directors from media scrutiny.

Police surveillance is also a growing concern in Hong Kong. The 2006 posthandover Interception of the Communications and Surveillance Ordinance granted police broader and more explicit authority to conduct physical and communications surveillance for the sake of public security. The introduction of police cameras comes at a time when protests against the Hong Kong leadership are up sharply. In addition to the Occupy Central efforts and the rallies against the national education proposal, thousands of Hong Kong residents have participated in protests calling for the resignation of Chief Executive Leung. Pan-Democratic legislators meeting with Commissioners in Hong Kong reported that police are now monitoring and arresting prodemocracy demonstrators as much as 12 to 24 months after their participation in political events. In July 2013, for example, Yau Ka-yu was reportedly arrested and charged with illegal assembly in relation to her 15-month-old participation in an April 2012 protest outside the China Liaison Office in Hong Kong.

Conclusions

China and the Middle East and North Africa

- China is expanding and deepening its trade and investment ties with countries in MENA. More than half of China's crude oil imports are from MENA producers, and China increasingly looks to the region as an export market for manufactured goods and services.
- Energy security is a key driver of China's engagement in MENA. As China's continued economic growth becomes more dependent on a steady supply of oil and natural gas from the region, Beijing likely will augment already robust economic ties with stronger political and security engagement.
- China, driven primarily by its growing demand for energy, seeks to promote a framework for stability in MENA that supports its own economic, political, and security interests. These efforts include supporting the resolution of the Israeli-Palestinian conflict, conducting counterpiracy operations, and participating in UN peacekeeping missions. Conversely, China's position on the Syrian conflict and its support for Iran undermine peace and stability in the region.
- China struggled to diplomatically adapt to regime changes across MENA during and after the Arab Spring. Beijing's instinct has been to support sitting regimes in Egypt, Libya, and Syria and to oppose international intervention in these countries.
- Most MENA governments appear to judge China plays a positive role in the region. Oil- and natural gas-producing states in particular look to China as their future primary market. Moreover, governments in China and some MENA countries appear to share similar stances on issues of sovereignty, human rights and democracy, and the role of the state in the economy. However, many MENA countries have criticized China for its support for the Assad regime in Syria.
- Historically, China largely has avoided challenging U.S. influence and power in the Middle East. In recent years, however, when key Chinese interests are at stake, China has made use of its permanent membership in the UN Security Council to oppose U.S. policies and objectives in the region.

Taiwan

- Cross-Strait economic, cultural, and educational ties continue to expand and deepen. However, domestic political dynamics and priorities in China and Taiwan still constrain movement on political and security issues.
- Since the Commission's 2012 report, Taiwan has used creative diplomacy to sign two free trade agreements and secure participation in a key international organization. Taiwan's expanding international space helps the country counterbalance its economic reliance on China by increasing its competitiveness in the world economy, raises the cost to Beijing of military coercion against Taiwan, and promotes regional stability.
- President Ma since his reelection in January 2012 has accelerated efforts to increase Taiwan's economic engagement with the United States and gain U.S. support for expanding Taiwan's international space, while continuing to advocate for future U.S. arms sales.
- Taiwan's military over the last decade has improved its ability to conduct joint operations and has developed some asymmetric capabilities. However, China's rapid military modernization during this time has outpaced these improvements and negated many of the military advantages Taiwan previously held over China.

Macau and Hong Kong

- The rapid inflow of money to Macau, its casino-oriented economy, and its proximity to the PRC present a significant risk of money laundering and financing of terrorism, particularly in the underregulated shadow banking and junket system supporting the VIP gaming business in Macau.
- A combination of the PRC's strict capital controls and restrictions on the collection of gambling debts has given rise to grey market alternatives to facilitate the movement of gambling funds into Macau. Gambling debt collection conducted by unregulated third-party affiliates in the Mainland is susceptible to organized crime and violence.
- Macau's junkets with alleged criminal affiliations present legal risks for U.S.-licensed casinos operating VIP rooms in Macau. Casinos found to be working with junkets directly or indirectly associated with Asian organized crime may be subject to revocation of their state-issued license to operate in the United States.
- Macau's loose regulation of the junket system and its strict privacy law prevent U.S. regulators from accessing information they are accustomed to, and U.S. state regulators lack the authority and resources to independently conduct investigations in foreign jurisdictions. This prevents U.S. regulators from accurately assessing the situation in Macau and effectively stops them from evaluating individuals conducting business with U.S.-licensed casinos.
- Macau's anti-money-laundering and counter-terrorist-financing framework has fallen short in complying with internationally recognized standards. Numerous vulnerabilities remain in its regulations, including deficiencies relating to Macau's inability to effectively freeze financial assets and its inadequate inspection and oversight of casinos and junket operators and promoters.
- Despite reports that the PRC aims to more closely monitor Macau's gaming industry as part of its nationwide initiative to crack down on corruption, there is no substantial evidence to suggest that Beijing intends a crackdown on illicit money transfers and money laundering in Macau.
- To protect their licenses to do business in the United States, American casinos have adopted a number of measures designed to prevent illegal activities in their VIP rooms. The Commission is

not in a position to evaluate whether those measures are fully adequate to insulate the operations of those rooms from illegal activity.

- Despite official statements of support from Beijing and the Hong Kong chief executive, the continued lack of meaningful progress calls into question Beijing's real intentions. Prospects for universal suffrage by 2017 are dimming. Political interference, government restraints on access to information, and self-censorship continue to take a toll on press freedom in Hong Kong. Public perceptions of media credibility have declined since the handover. Violent attacks on prodemocracy news outlets and their owners are on the rise, and the totality of the evidence suggests that Beijing does not intend to allow real democracy to develop in Hong Kong.
- Prodemocracy activists express alarm over stepped-up police surveillance at protests, which they fear may be aimed at chilling public discourse or quelling public dissent.
- All of these trends run counter to the Basic Law's assurances that Hong Kong's traditional democratic and civil rights would be preserved for the first 50 years following the handover.
- The systematic disenfranchisement of those who support greater democratic freedoms and civil liberties has created a climate of political polarization that may undermine Hong Kong's fundamental governability.

THE COMMISSION'S KEY RECOMMENDATIONS

The Commission believes that ten of its 41 recommendations to Congress are of particular significance.

The Commission recommends:

- Congress fund the U.S. Navy's shipbuilding and operational efforts to increase its presence in the Asia Pacific to at least 60 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 Western Pacific, offset China's growing military capabilities, and surge naval assets in the event of a contingency.
- Congress ensure that the Food and Drug Administration (FDA) makes it a priority to increase the number of physical inspections of Chinese food imports at the border; to increase the rigor of those inspections to include testing for pathogens and chemical, pesticide, and drug residues, and processed food ingredients; and to conduct more frequent and thorough inspections in food facilities in China. Congress should also urge the U.S. Department of Agriculture (USDA) to permanently assign inspection personnel to China so that the exporting plants receive regular visits by USDA inspectors.
- Congress direct the Department of Commerce to develop a comprehensive, ongoing inventory of Chinese foreign direct investment (FDI) in the United States and, on an annual basis, update the inventory. The inventory should identify the ownership structure of the entity engaging in the investment. In preparing the inventory, the department should call on private sector entities engaged in monitoring Chinese investments in the United States and such other entities to ensure that its report is complete and accurate. The department should prepare a comprehensive report to Congress on an annual basis identifying the FDI by Chinese entities that were made in the previous calendar year. In its report, the department should indicate those investments that received any assistance from the "Select USA" program. The department should also identify, on an ongoing basis, the lines of commerce that each of the investments are engaged in.

- Congress direct the Administration to prepare an inventory of existing federal use of cloud computing platforms and services and determine where the data storage and computing services are geographically located. Such inventory should be prepared annually and reported to the appropriate committees of jurisdiction.
- Congress assess whether to amend the Committee on Foreign Investment in the United States (CFIUS) statute to allow review of greenfield investments for threats to U.S. national security.
- Congress require the USDA and the U.S. Trade Representative (USTR) to conduct a comprehensive review of China's agricultural subsidies, discriminatory taxes, state trading, and procurement practices; take account of the damages incurred by U.S. farmers and downstream industries; and suggest appropriate remedies.
- Congress fund departments of Defense and State efforts to improve the air and maritime capabilities of U.S. partners and allies in Asia, particularly with regard to intelligence, surveillance, and reconnaissance, to improve maritime domain awareness in the East and South China Seas.
- Congress assess the extent to which existing laws provide for inadequate or ineffective remedies against the anticompetitive actions of Chinese state-owned or state-invested enterprises operating in the U.S. market. Additional remedies may be required to account for the fact that these enterprises may not be operating based on commercial considerations.
- Congress empower the Securities and Exchange Commission (SEC) to set minimum standards for companies listing and maintaining listings on U.S. exchanges and enable the SEC to directly delist foreign companies not in compliance with these standards.
- Congress urge the Administration to expedite progress in its implementation of Section 806 of the National Defense Authorization Act for Fiscal Year 2011 (Public Law 111-383), which was intended to enhance the Department of Defense's ability to address supply chain risks.

COMPREHENSIVE LIST OF THE COMMISSION'S RECOMMENDATIONS

Chapter 1: The U.S.-China Trade and Economic Relationship

Section 2: Trends in Chinese Investment in the United States

The Commission recommends:

1. Congress assess the extent to which existing laws provide for inadequate or ineffective remedies against the anticompetitive actions of Chinese state-owned or state-invested enterprises operating in the U.S. market. Additional remedies may be required to account for the fact that these enterprises may not be operating based on commercial considerations.
2. Congress assess whether to amend the Committee on Foreign Investment in the United States (CFIUS) statute to allow review of greenfield investments for threats to U.S. national security
3. Congress direct the Department of Commerce to develop a comprehensive, ongoing inventory of Chinese foreign direct investment (FDI) in the United States and, on an annual basis, update the inventory. The inventory should identify the ownership structure of the entity engaging in the investment. In preparing the inventory, the department should call on private sector entities engaged in monitoring Chinese investments in the United States and such other entities to ensure that its report is complete and accurate. The department should prepare a comprehensive report to

Congress on an annual basis identifying the FDI by Chinese entities that were made in the previous calendar year. In its report, the department should indicate those investments that received any assistance from the “Select USA” program. The department should also identify, on an ongoing basis, the lines of commerce that each of the investments are engaged in.

Section 3: Governance and Accountability in China's Financial System

The Commission recommends:

4. Congress direct the Administration to press China for more cooperation with the international community in order to address the global economic risks of unregulated and underregulated shadow banking and ask the Department of the Treasury to provide an annual report to Congress on the risks of shadow banking. VerDate Mar
5. Congress direct the Administration, in any bilateral investment treaty negotiations, to make fair and equitable market access and treatment for financial services firms a priority.
6. Congress direct the Administration to assist the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board by encouraging China to develop better regulatory oversight enforcement capabilities and more transparent markets, during annual and biannual bilateral dialogues, as well as multilateral dialogues.
7. Congress empower the SEC to set minimum standards for companies listing and maintaining listings on U.S. exchanges and enable the SEC to directly delist foreign companies not in compliance with these standards.

Section 4: China's Agriculture Policy, Food Regulation, and the U.S.-China Agriculture Trade

The Commission recommends:

8. Congress monitor the implementation of the U.S.-China Plan of Strategic Cooperation in Agriculture (2012–2017) to ensure that U.S. funding is being allocated in such a way as to improve the safety, sustainability, efficiency, and security of food production in China and the United States.
9. Congress require the U.S. Department of Agriculture (USDA) and the U.S. Trade Representative to conduct a comprehensive review of China's agricultural subsidies, discriminatory taxes, state trading, and procurement practices; take account of the damages incurred by U.S. farmers and downstream industries; and suggest appropriate remedies.
10. Congress urge the Secretary of Agriculture to engage, as part of the Joint Committee on Commerce and Trade and the Strategic and Economic Dialogue, with his/her Chinese counterparts to address those Chinese policies and practices that limit U.S. exports of value-added products.
11. Congress direct the Interagency Trade Enforcement Center (ITEC) to conduct a review of the selective use of value added tax (VAT) rebates by China and determine whether they have a trade-distorting effect and whether the selective use of VAT rebates is consistent with the original intent of the General Agreement on Tariffs and Trade (GATT) provision allowing for VAT rebates. The ITEC should prepare a report for the U.S. Trade Representative and the relevant Committees of jurisdiction and identify what steps should be taken to address any GATT inconsistencies, should they be found.

12. Congress direct the USDA to negotiate with China to synchronize approvals of biotechnology to ensure stable and predictable market access for U.S. seed companies and crop growers in the Chinese market.
13. Congress require that the USDA prepare an annual report on competitive factors in the pork industry. In preparing such reports, the department shall evaluate the impact, if any, of the recent purchase of Smithfield Foods on the ability of other U.S. producers to export pork products to China. In addition, the report shall identify any changing pricing structures throughout the pork production chain to determine whether there is price or profit suppression as a result of the Smithfield transaction.
14. Congress direct the USDA to exercise extreme caution in negotiating equivalency status for Chinese exports of processed poultry using Chinese-origin birds. Congress should also increase its support of USDA's Food Safety and Inspection Service in its role as protector of meat and poultry food safety so that the United States serves as a world model for high-quality, science-based regulations.
15. Congress ensure that the Food and Drug Administration makes it a priority to increase the number of physical inspections of Chinese food imports at the border; to increase the rigor of those inspections to include testing for pathogens and chemical, pesticide, and drug residues, and processed food ingredients; and to conduct more frequent and thorough inspections in food facilities in China. Congress should also urge the USDA to permanently assign inspection personnel to China so that the exporting plants receive regular visits by USDA inspectors.
16. Congress require the Secretary of Agriculture to prepare a report to Congress identifying those organic food products being imported into the United States from China. The report should include a comprehensive evaluation of the different methodologies employed by the United States and China to certify that a product is organic and what steps, if any, are being taken to harmonize any discrepancies that might exist.
17. Congress evaluate whether a requirement that U.S. food importers purchase insurance against food-borne illnesses and pathogens from Chinese imports would improve food safety. Such a program would involve private sector risk insurance with insurance companies evaluating the safety of various sources and charging risk-based premiums based on the methods employed by Chinese exporters to address food-borne illnesses and pathogens.

Chapter 2: China's Impact on U.S. Security Interests

Section 2: China's Cyber Activities

The Commission recommends:

18. Congress adopt legislation clarifying the actions companies are permitted to take regarding tracking intellectual property stolen through cyber intrusions.
19. Congress amend the Economic Espionage Act (18 U.S.C. § 1831–1839) to permit a private right of action when trade secrets are stolen.
20. Congress support the Administration's efforts to achieve a high standard of protection of intellectual property rights in the Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership.

21. Congress encourage the Administration to partner with other countries to establish an international list of individuals, groups, and organizations engaged in commercial cyber espionage. The Administration and partner governments should develop a process for the list's validation, adjudication, and shared access.
22. Congress urge the Administration to continue to enhance its sharing of information about cyber threats with the private sector, particularly small- and medium-sized companies.
23. Congress direct the Administration to prepare an inventory of existing federal use of cloud computing platforms and services and determine where the data storage and computing services are geographically located. Such inventory should be prepared annually and reported to the appropriate committees of jurisdiction.
24. Congress urge the Administration to expedite progress in its implementation of Section 806 of the National Defense Authorization Act for Fiscal Year 2011 (Public Law 111-383), which was intended to enhance the Department of Defense's ability to address supply chain risks.

Section 3: China's Maritime Disputes

The Commission recommends:

25. Congress fund the U.S. Navy's shipbuilding and operational efforts to increase its presence in the Asia Pacific to at least 60 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 Western Pacific, offset China's growing military capabilities, and surge naval assets in the event of a contingency.
26. Congress fund Departments of Defense and State efforts to improve the air and maritime capabilities of U.S. partners and allies in Asia, particularly with regard to intelligence, surveillance, and reconnaissance, to improve maritime domain awareness in the East and South China Seas.
27. Congress urge the Department of Defense to continue to develop the U.S.-China maritime security relationship in order to strengthen strategic trust. The relationship should be within the bounds of the National Defense Authorization Act for Fiscal Year 2000 (Public Law 106-65) and based on the principles of reciprocity and transparency.
28. Congress fund U.S. Coast Guard engagement efforts with coast guard and maritime law enforcement agencies in the Western Pacific to increase understanding among civilian maritime bodies in the Asia Pacific.

Chapter 3: China and the World

Section 1: China and the Middle East and North Africa

The Commission recommends:

29. Congress support efforts by the Department of Defense to strengthen cooperation with China on counterpiracy in the Gulf of Aden and elsewhere.
30. Congress consider the merits of including fuel oil purchases in the current sanctions regime prohibiting countries from purchasing crude oil from Iran.

31. Congress work with the Departments of State, Commerce, and the Treasury to utilize the full range of incentives and disincentives to encourage China to reduce its ties with Iran, including exploring conditioning Chinese energy companies' future investments in the United States on limiting commercial ties with Iran.
32. Congress urge the Department of State to elevate the U.S.- China Middle East Dialogue to include an annual meeting at the Cabinet level and to increase meetings at the undersecretary level from once to twice per year.
33. Congress direct the Administration to provide a report to Congress on China's enforcement of its export controls, to include an assessment of the level of scrutiny the Chinese government applies to end users in transfers that are of proliferation concern.

Section 2: Taiwan

The Commission recommends:

34. Congress direct the Administration to transmit an unclassified report to Congress on U.S. arms sales to Taiwan from 2001 to 2013. It should detail each of Taiwan's requests for purchase of U.S. weapons, defense items, or defense services during the immediately preceding one-year period; describe Taiwan's justification for each request; report on any Administration decision to reject, delay, or alter each request; and provide an update on the status of sales that have been previously approved.
35. Congress encourage the Administration to continue discussions between the United States and Taiwan concerning a bilateral investment agreement.
36. Congress urge Cabinet-level officials to visit Taiwan to promote commercial, technological, and people-to-people exchanges and direct the Administration to permit official travel to Taiwan for Department of State and Department of Defense personnel above the rank of office director or, for uniformed military personnel, above the level of O6.

Section 3: Macau and Hong Kong

The Commission recommends:

37. Congress urge the State Department to negotiate with the Macanese government to fix the shortcomings in its regulatory framework. Potential reforms would include implementing an effective asset-freezing mechanism, an increase in due diligence procedures in casinos, reduction in the high threshold for reporting suspicious transactions within casinos, establishing more transparent cross-border reporting requirements, and a requirement that junket operators and their affiliates disclose detailed financial information and implement stricter licensing requirements.
38. Congress reconvene a congressional caucus on Hong Kong to ensure continuous attention to the region's democracy and civil rights issues.
39. Congress adopt a resolution urging China to keep its commitments to universal suffrage as articulated in the 1984 Sino- British Joint Declaration on the Question of Hong Kong and the Basic Law of the Hong Kong Special Administrative Region.
40. Congress reaffirm its support for human rights and the rule of law in Hong Kong.
41. Congress renew the biennial reporting requirements of the U.S.-Hong Kong Policy Act of 1992.

The Honorable William A. Reinsch, Chairman

Chairman William Reinsch was reappointed to the Commission by Senate Majority Leader Harry Reid for a seventh two-year term expiring December 31, 2013. He was elected as Chairman of the Commission for the 2013 Report cycle effective January 1, 2013, and previously served as Chairman of the Commission for the 2011 Report cycle. Chairman Reinsch served as Under Secretary for Export Administration in the U.S. Department of Commerce. As head of the Bureau of Export Administration, later named the Bureau of Industry and Security, Chairman Reinsch was charged with administering and enforcing the export control policies of the U.S. government, including its antiboycott laws. Major accomplishments during his tenure included refocusing controls regarding economic globalization, most notably on high-performance computers, microprocessors, and encryption, completing the first revisions of the Export Administration regulations in over 40 years. In addition, he revised the interagency process for reviewing applications and permitted electronic filing of applications over the Internet.

During this time, Chairman Reinsch delivered more than 200 speeches and testified 53 times before various committees of the Congress. Before joining the Department of Commerce, Chairman Reinsch was a senior legislative assistant to Senator John Rockefeller and was responsible for the senator's work on trade, international economic policy, foreign affairs, and defense. He also provided staff support for Senator Rockefeller's related efforts on the Finance Committee and the Commerce, Science, and Transportation Committee.

For over a decade, Chairman Reinsch served on the staff of Senator John Heinz as chief legislative assistant, focusing on foreign trade and competitiveness policy issues. During that period, Senator Heinz was either the chairman or the ranking member of the Senate Banking Committee's Subcommittee on International Finance. Senator Heinz was also a member of the International Trade Subcommittee of the Finance Committee. Chairman Reinsch provided support for the senator on both subcommittees. This work included five revisions of the Export Administration Act and work on four major trade bills. Prior to joining Senator Heinz's staff, Chairman Reinsch was a legislative assistant to Representatives Richard Ottinger and Gilbert Gude, acting staff director of the House Environmental Study Conference, and a teacher in Maryland.

Today Chairman Reinsch is president of the National Foreign Trade Council. Founded in 1914, the council is the only business organization dedicated solely to trade policy, export finance, international tax, and human resources issues. The organization represents over 200 companies through its offices in New York City and Washington.

In addition to his legislative and private sector work, Chairman Reinsch served as an adjunct associate professor at the University of Maryland's University College Graduate School of Management and Technology, teaching a course in international trade and trade policy. He is also a member of the boards of the Executive Council on Diplomacy and the Center for International Private Enterprise (CIPE). Chairman Reinsch's publications include "Why China Matters to the Health of the U.S. Economy," published in *Economics and National Security*; "The Role and Effectiveness of U.S. Export Control Policy in the Age of Globalization" and "Export Controls in the Age of Globalization," both published in *The Monitor*. In addition, Chairman Reinsch has published "Should Uncle Sam Control U.S. Technology Exports," published in *Insight* magazine; "Encryption Policy Strikes a Balance," published in the *Journal of Commerce*, and "Building a New Economic Relationship with Japan," published with others in *Beyond the Beltway: Engaging the Public in U.S. Foreign Policy*.

**“U.S.-China Economic and Security Review Commission 2013 Report to Congress: China’s
Maritime Disputes in the East and South China Seas, and the Cross-Strait Relationship”**

Testimony of the Honorable Dennis C. Shea

Vice Chairman, U.S.-China Economic and Security Review Commission

before the

Armed Services Committee, U.S. House of Representatives

Hearing on “2013 Report to Congress of the U.S.-China Economic and Security Review Commission”

November 20, 2013

Chairman McKeon, Ranking Member Smith, distinguished Members of the Committee, thank you for the opportunity to testify here today on China’s maritime disputes and the cross-Strait relationship. As Vice Chairman of the U.S.-China Economic and Security Review Commission, I am pleased to share some of the Commission’s findings on these topics, which we made public today in our *2013 Report to Congress*.

OVERVIEW

Although China’s strategic center of gravity has been largely land-based for centuries, modernization of China’s People’s Liberation Army (PLA), particularly its naval force, has enabled a seaward shift since the mid-1990s. The PLA’s growing range of missions – now far wider than the singular goal of Taiwan unification that once dominated Beijing’s military planning – has resulted in increasingly capable naval and maritime law enforcement fleets. Despite warming China-Taiwan ties, China remains committed to maintaining a cross-Strait balance of power that allows for the eventual unification of Taiwan with the mainland. Moreover, China’s military modernization, rising economy, and growing diplomatic influence are improving China’s ability to assert its interests in its “near seas” – the Yellow Sea, East China Sea, and South China Sea.

The Commission continues to maintain a focus on these developments in our *2013 Report to Congress*. Our fact-finding trip to the Philippines last year informed a section on the South China Sea in the *2012 Report*. This year, Commissioners met with the leaders of the armed forces and political bodies in Japan and Taiwan to sharpen our understanding of the East China Sea dispute as well as the current state of the cross-Strait relationship. Those conversations served as the basis of two sections in this year’s report – one on China’s maritime disputes and one on developments in Taiwan. My testimony focuses on these two areas.

China’s interest in defending its near seas is encompassed in China’s overarching maritime defense strategy, Offshore Defense. This strategy seeks to achieve the following objectives:

- Deter and defend China against foreign military intervention in Chinese affairs, such as peacetime foreign military operations near China that Beijing judges threaten its interests and foreign amphibious invasions, blockades, and strikes against the Chinese mainland.
- Deter and reverse any moves by Taiwan toward *de jure* independence.

- Develop a sea-based nuclear submarine force to support Beijing’s nuclear deterrence strategy.⁷
- Deter and defend against threats to China’s maritime trade routes.
- Deter and defend against challenges to China’s maritime territory, sovereignty, and resources.
- Protect China’s interests abroad.¹

During peacetime, the strategy emphasizes gaining control of China’s near seas and steadily expanding the maritime perimeter out to China’s Second Island Chain.¹ During wartime, the strategy calls for engaging opposing naval forces as far from the Chinese coast as possible and, if necessary, overwhelming those forces as they approach China. The most important wartime task is to prevent foreign military forces from interfering with China’s wartime objectives.² The U.S. Department of Defense characterizes these operations as “antiaccess/area denial.”³ China, however, uses the term “counterintervention,” reflecting its perception that such operations are reactive.³

China’s claims in the South China Sea overlap those of Vietnam, the Philippines, Malaysia, Brunei, and Taiwan. The South China Sea claims of China and Taiwan are generally coextensive due to their origins from a shared political heritage. China also has disputes in the East China Sea with Japan and Taiwan. Here, China claims not only the Senkaku Islands (known as Diaoyu in China and Diaoyutai in Taiwan) as Taiwan does, but also an extended continental shelf off its eastern coastline into the Okinawa Trough.⁴ Largely due to Beijing’s perception of its growing political and economic clout in the region and its modernizing maritime force, China since 2009 - 2010 has grown increasingly assertive in pressing these maritime claims. As interactions between Chinese forces and other maritime forces operating in the region – including the U.S. military – become more regular, China’s adherence to international protocols at sea will become increasingly important for the safety of all air and maritime operations in the region as well as the stability of the security situation in the East and South China Seas.

U.S. treaty alliances and forward-deployed military presence in Asia bind the United States to the region in ways that link its security interests to the peaceful resolution of sovereignty disputes in the East China Sea, South China Sea, and across the Taiwan Strait. The United States maintains treaty alliances with two of the claimants – Japan in the East China Sea and the Philippines in the South China Sea – and maintains a substantive relationship with its longtime friend and partner, Taiwan. A crisis involving any of these parties could trigger U.S. treaty and legislative commitments. The United States also has an interest in maintaining peace and stability in the maritime commons across the Asia Pacific, which serve as crucial global and regional trade routes.

* The primary objectives of China’s nuclear deterrence strategy are to deter nuclear and conventional attacks; should deterrence fail, survive a nuclear attack and conduct a nuclear counterstrike; prevent an adversary from using the threat of nuclear weapons to coerce China or compel it to back down; and strengthen China’s global image. U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People’s Republic of China 2013* (Washington, DC: 2013), pp. 29-31.

¹ The Second Island Chain refers to a line that stretches from the Kurile Islands through Japan, the Bonin Islands, the Mariana Islands, the Caroline Islands, and Indonesia. It encompasses maritime areas out to approximately 1,800 nautical miles from the Chinese mainland.

² “Antiaccess” (A2) actions are those intended to slow deployment of adversary forces into a theater or cause the forces to operate from distances farther from the locus of conflict than they would otherwise prefer. A2 affects movement into theater. “Area denial” (AD) actions are those intended to impede an adversary’s operations within areas where friendly forces cannot or will not prevent access. AD affects movement within theater. U.S. Air-Sea Battle Office, *Air Sea Battle: Service Collaboration to Address Anti-Access & Area Denial Challenges* (Arlington, VA: May 2013), pp. 2-4.

As the U.S. defense budget tightens, the United States will face difficult choices in implementing its “rebalance” to Asia. A major challenge ahead for Washington, therefore, will be to stand firm on its security commitments while allocating sufficient resources to achieve its overall foreign policy and security goals in the Asia Pacific region.⁵

CHINA’S MARITIME DISPUTES: The East China Sea and South China Sea

China’s strategy in the East and South China Seas involves delaying the actual resolution of its maritime disputes while strengthening its maritime and air forces to better assert its claims.⁶ China probably judges that as a result of its growing power and influence vis-à-vis other claimants to the East and South China Seas, time is on its side with regard to consolidating control over its maritime claims.

How Beijing Asserts and Enforces its Maritime Claims

Maritime Law Enforcement and Naval Forces: China employs its maritime law enforcement ships to monitor, protest, and in some cases harass foreign vessels engaging in activities that it believes violate its maritime sovereignty in the East and South China Seas. Beijing likely views this approach as less provocative than deploying its navy and a means to reinforce its maritime claims by allowing China to present the confrontation as a domestic law enforcement issue rather than a foreign defense issue requiring the military. Nevertheless, the PLA Navy still plays a role by backing up maritime law enforcement patrols from a distance, visibly training and transiting through disputed waters, and resupplying Chinese-controlled land features in the South China Sea.⁷

Beijing also opportunistically uses its maritime law enforcement and its naval fleets to react to perceived attempts by rival claimants to challenge China’s sovereignty, and has exploited tactical errors by some of these claimants to change the status quo of its maritime disputes in its favor. Through a highly visible and persistent maritime presence, China has obtained *de facto* control of some disputed land features and waters in the East and South China Seas, including most recently Scarborough Reef in the South China Sea. When the Philippines deployed a naval vessel in response to a fishing dispute last May, Beijing used the opportunity to patrol the reef’s vicinity with superior maritime forces and rope off its entrance to prevent Philippine vessels from operating there.⁸ Today, over a year after the conclusion of the months-long standoff, China continues to maintain control over the reef.

China also has applied this approach with some success in the East China Sea’s Senkaku Islands. Viewing the Japanese government’s September 2012 purchase of several of the Senkaku Islands from a private Japanese citizen as a deliberate attempt to change the status of the disputed territory, China used the opportunity to advance its claim to the islands.⁹ Following the purchase, China’s maritime law enforcement and naval forces sharply increased maritime and air activity near the islands. By doing so, Beijing seeks to underscore its own claim to the islands as well as pressure Japan into officially acknowledging a territorial dispute, which Tokyo refuses to do. Likely due in part to a more formidable balance of power in the East China Sea than in the South China Sea, China has not sought to obtain *de facto* control over the Senkaku Islands as it did at Scarborough Reef.

Legal and Administrative Measures: China uses legal mechanisms to demonstrate *de jure* governance over disputed waters.¹⁰ In an effort to justify its claims under the UN Convention on the Law of the Sea, China has submitted its own claims to the UN and contested competing claims through UN mechanisms. China also has passed domestic laws declaring rights in its claimed territorial sea and exclusive economic zone and outlining regulations for mapping and surveying its claimed waters. For example, in its southernmost province of Hainan, China established fishing regulations that enable Hainan authorities to board, inspect, and expel foreign vessels “illegally” operating in China’s claimed waters.¹¹

Drivers of China's Maritime Disputes

Sovereignty and "Core Interests": China's position of "indisputable sovereignty" with regard to its claims in the East and South China Seas underlies its overall policy approaches to those issues. As tensions involving China's maritime disputes in the East China Sea and South China Sea have grown since 2009, official and unofficial Chinese sources indicate China views the East and South China Seas as central to its "core interests,"¹² which authoritative Chinese speeches and documents define as China's (1) national security, (2) sovereignty and territorial integrity, and (3) sustained economic and social development.¹³ Beijing makes core interest declarations to signal to other countries that China is unwilling to compromise on particular policy issues and to imply that China would use force to defend these interests.

Much to the concern of the Commission's Japanese interlocutors, China appeared to designate the Senkaku Islands a core interest this April.¹⁴ Subsequent official Chinese statements have not clarified the status of the islands, allowing Beijing to maintain flexibility in its approach to the dispute, prevent any domestic accusations that China is adopting a weaker stance, and deny that it is taking unilateral actions or escalating tensions.¹⁵

Nationalism: China exploits popular nationalism to support its foreign policy goals in the East and South China Seas. China's official and popular historical narrative with regard to the East and South China Seas is a product of China's education system and official media, which cultivate and promote the notion of China's victimization by Japan and the West during what China calls its "century of humiliation" from the mid-19th to the mid-20th centuries.¹⁶ Due to the strength of popular nationalist and anti-Japanese sentiments in China, Beijing sees East China Sea sovereignty as a political legitimacy issue: Whereas a robust public defense of China's sovereignty could satisfy popular demands and strengthen the legitimacy of Chinese leaders, measures popularly viewed as weak against foreign insults and provocations could undermine legitimacy.¹⁷

Economic Development: China views the East and South China Seas as central to its economic development, due to their resource potential and significant role as maritime transit routes. The development of natural resources – especially fishing – is closely linked to nationalism in the context of the maritime disputes because these activities can quickly galvanize popular nationalist sentiment.¹⁸ These types of responses to perceived foreign encroachments upon national or historic fishing grounds are typical across the region. For example, when the Philippine Coast Guard fired shots at a Taiwan fishing boat in disputed waters in May of this year, the resulting death of a Taiwan fisherman set off nationalist outpourings across Taiwan. The incident led to three months of strained relations between Taiwan and the Philippines that ended only after Manila offered an official apology, agreed to pay compensation to the victim's family, and recommended homicide charges for the Philippine Coast Guard personnel who opened fire on the Taiwan fishing boat.¹⁹

China also has a critical interest both in the seaborne trade of energy supplies via the South China Sea and the potentially significant oil and gas resources that lay beneath it. Currently, nearly one third of global crude oil and over half of global liquefied natural gas pass through the South China Sea, much of it en route to China's eastern provinces, the powerhouses of China's export- and manufacturing-driven economy.²⁰ In addition to the role the South China Sea plays in China's energy trade, China and the other claimants seek to exploit subsea oil and gas resources projected to lie beneath disputed waters.²¹

CHINA AND TAIWAN: The Changing Cross-Strait Balance of Power

China and Taiwan in 2013 enjoyed relatively positive relations, characterized by growing economic ties and relatively amicable political relations. Since the Commission's 2012 *Report to Congress*, the two

sides established reciprocal trade promotion offices across the Strait,²² enacted a trade in goods agreement, signed a trade in services agreement,²³ signed a currency clearing agreement,²⁴ and continued discussions on a cross-Strait trade dispute settlement mechanism.²⁵ Taiwan President Ma Ying-jeou told the Commission that his agenda for cross-Strait diplomatic relations during his second term includes securing additional economic agreements, expanding cross-Strait educational exchanges, and establishing reciprocal representation offices.

Despite these generally positive trends, China's cross-Strait policy remains focused on pursuing a balance of economic, political, and military power that heavily favors China with the goal of eventual unification of Taiwan.

Since the late 1990s, China's military modernization has focused on improving its capabilities for Taiwan conflict scenarios. This modernization program likely is designed to hedge against a failure of Beijing's cross-Strait diplomatic strategy; deter Taipei from taking steps toward official independence; signal to the United States that China is willing to use force against Taiwan if necessary; and enhance China's ability to deter, deny, or delay any U.S. intervention in a cross-Strait conflict. The PLA is more prepared than in the past to conduct several different military campaigns against Taiwan, including a partial naval blockade and a limited air and missile campaign.

- China has a large and sophisticated short-range ballistic missile (SRBM) force, including over 1,100 mobile SRBMs that are positioned in southeast China and able to strike Taiwan. China continues to improve the range, accuracy, and payloads of its SRBMs with the introduction of new missiles or variants and component upgrades.²⁶
- The PLA has approximately 2,300 combat aircraft capable of participating in large-scale air operations, 490 of which are based within range of Taiwan. By contrast, Taiwan's air force has approximately 410 combat aircraft, many of which will reach the end of their useful service life in the next five to 10 years.²⁷
- The PLA has approximately 75 major surface combatants, 85 missile patrol boats, and 60 conventional and nuclear submarines. These units are available for a range of missions, such as enforcing a blockade of Taiwan. As China's naval modernization continues, an increasing percentage of these ships and submarines will feature advanced weaponry. In contrast, Taiwan has 26 major surface combatants, 45 missile patrol boats, and two operational submarines.²⁸
- The PLA Navy has three total amphibious transport docks (LPD), all of which were commissioned after 2008. These LPDs – which can carry a mix of air-cushion landing craft, amphibious armored vehicles, helicopters, and marines – improve China's ability to seize and hold Taiwan's offshore islands.²⁹ However, China at this time does not appear to be pursuing the amphibious lift capability necessary to conduct a full-scale invasion of Taiwan; China still only has about one third of the lift it would need to conduct such an operation.

In addition to its military buildup against Taiwan, China continues to work to isolate Taiwan politically and diplomatically. Beijing's insistence on the "one China principle" precludes any country or international organization from simultaneously recognizing China and Taiwan. This effectively restricts Taiwan's participation in international organizations and activities and prevents Taiwan from promoting its sovereignty. In addition, China in a subtle yet significant effort to demonstrate its sovereignty over Taiwan introduced an inflammatory new passport design in May 2013 that includes images of two

popular tourist sites in Taiwan and a map depicting Taiwan as part of China.²⁹ Nevertheless, Taiwan made important progress in strengthening its role as an international actor this year. For instance, Taiwan signed free trade agreements with New Zealand and Singapore.³⁰ Taiwan also was invited to send a “guest” delegation to a United Nations International Civil Aviation Organization assembly.^{31†}

RECOMMENDATIONS

The United States has committed itself to rebalancing its foreign policy to Asia, but now faces the possibility of being unable to implement ambitious diplomatic, economic, and security initiatives due to declining resources. Out of a total of 41 recommendations, the Commission highlighted ten, believing them to be of particular significance. At the top of the list this year is a recommendation that Congress fund the U.S. Navy’s shipbuilding and operational efforts to increase its presence in the Asia Pacific to at least 60 ships and rebalance homeports to 60 percent in the region by 2020. The intent is to provide the United States with the capacity to maintain readiness and presence in the Western Pacific and surge naval assets in the event of a contingency. As Lt. Gen. Wallace “Chip” Gregson, Jr., currently Senior Director, China and the Pacific at the Center for the National Interest stated in testimony to the Commission, “no matter how capable the ship, it can only be in one place at a time. And power projection that stays is about ships.”³²

This recommendation addresses what has been a growing concern of mine: that resources available to the Department of Defense for realizing the Asia rebalance will be insufficient to lend credibility to its security commitments or to counter the changing balance of power in the region. PLA modernization efforts, many of which are designed to limit U.S. freedom of action throughout the Western Pacific, could undermine U.S. interests and security. As a result, it will be important for the United States to remain deeply engaged in the region and demonstrate that it has the capacity and resolve to actively shape – and offset – China’s growing maritime capabilities.³³ In my view, a strong U.S. military presence in the Western Pacific, and the deterrent effect it provides, is critical to preserving peace and stability in the region.

In addition to strengthening our own capabilities in the Asia Pacific, the United States should build the capacity of our partners and allies to improve maritime domain awareness in the East and South China Seas. For this reason, the Commission recommends Congress fund Department of Defense and State efforts to improve the air and maritime capabilities of our partners and allies, particularly with regard to intelligence, surveillance, and reconnaissance. In another recommendation aimed at building maritime domain awareness, we recommend Congress fund U.S. Coast Guard engagement efforts with counterparts in the West Pacific, given that most of the operational burden among East and South China Sea claimants tends to fall on their maritime law enforcement forces.

The need to deepen strategic trust between the United States and China is reflected in our fourth recommendation regarding maritime disputes. We recommend Congress urge the Department of Defense to continue to develop the U.S.-China maritime security relationship. In operational environments as tense and potentially explosive as the East and South China Seas, strategic trust provides the foundation to reduce the potential of miscalculation at sea.

²⁹ Taiwan does not recognize PRC passports. Chinese citizens visiting Taiwan must apply for a “compatriot pass” issued by the National Immigration Agency.

³⁰ In July 2013, President Obama signed legislation directing the U.S. Secretary of State to “develop a strategy to obtain observer status for Taiwan in the ICAO.” Public Law 113-17. “To direct the Secretary of State to develop a strategy to obtain observer status for Taiwan at the triennial International Civil Aviation Organization Assembly, and for other purposes.” 113th Cong., 1st sess. July 12, 2013. <http://beta.congress.gov/bills/113th/congress-bills/1151>.

Turning to Taiwan, the U.S.-Taiwan relationship continues to be a key component of peace and security in the Asia Pacific. But while Taiwan remains our close partner, the role of Taiwan in the U.S. rebalance to Asia is not entirely clear. In October 2011, then Assistant Secretary of State for East Asian and Pacific Affairs Kurt Campbell testified to the U.S. House of Representatives Foreign Affairs Committee that “an important part of this turn to Asia is maintaining a robust and multidimensional unofficial relationship with Taiwan.”³⁴ Since then, U.S. officials have not explicitly referred to Taiwan’s actual or potential role in the U.S. rebalance to Asia in public statements. However, Taiwan should be considered a strong potential component in U.S. defense planning in the Asia Pacific. Taiwan’s extensive knowledge of the PLA and its ability to contribute to situational awareness in the region make it an ideal partner for the United States in an antiaccess/area denial scenario.³⁵

To support the strengthening of the U.S.-Taiwan relationship, the Commission recommends Congress urge Cabinet-level officials to visit Taiwan in order to promote commercial, technological, and people-to-people exchanges. We further recommend Congress direct the Administration to permit official travel to Taiwan for Department of State and Department of Defense personnel above the rank of office director or, for uniformed military personnel, above the level of O-6. With regard to deepening economic relations, the Commission recommends Congress encourage the Administration to continue discussion between the United States and Taiwan concerning a bilateral investment agreement.

Finally, I’d like to highlight the Commission’s recommendation to Congress to direct the Administration to transmit an unclassified report to Congress on U.S. arms sales to Taiwan from 2001 to 2013. As one of the largest buyers of U.S. arms in the world, and the largest in Asia, Taiwan continues to advocate for more advanced weapons from the United States, most notably submarines and fighter aircraft. However, progress on such deals remains elusive, threatening the long-term readiness of Taiwan’s military and further tipping the cross-Strait balance of military power in China’s favor.

Although the United States approved Taiwan’s request to purchase diesel-electric submarines in 2001, to date, there has been no progress on that sale due to a number of factors on both sides. These include partisan political gridlock in Taiwan’s legislature, delays in Taiwan’s commitment of funds, and protracted cost negotiations. Furthermore, the United States has not built a diesel-electric submarine since the 1950s, or operated one since 1990s. The Commission’s *2013 Report* dispels the notion that Taiwan is no longer interested in these submarines. In fact, earlier this year, Taiwan Ministry of Defense officials emphasized to the Commission that the Taiwan Navy’s ability to counter China’s expanding and modernizing submarine fleet will continue to erode as Taiwan’s aging submarine force increasingly is unable to support Taiwan Navy antisubmarine training.

Moreover, while U.S. support of Taiwan’s fighter program should be applauded, planned U.S. upgrades to Taiwan’s existing fleet of F-16 A/B aircraft do not adequately address all of Taiwan’s air defense requirements. The Obama Administration in April 2012 committed to deciding on a “near term course of action on how to address Taiwan’s fighter gap,” but has yet to announce further concrete details.³⁶ Without additional acquisitions, Taiwan’s fighter force will face substantial numerical shortfalls as Taiwan’s fighters are retired over the next five to 10 years.

Taiwan’s diminishing ability to maintain a credible deterrent capability may provide incentives and create opportunities for China to take on greater risk in its approach to cross-Strait relations, including pressuring Taiwan to move toward political talks or using military force to achieve political objectives. Bearing that in mind, directing the Administration to provide a report on U.S. arms sales to Taiwan would not only provide accountability on the progress – or lack thereof – of planned sales, it also would support our own strategic interests in the Taiwan Strait.

Chairman McKeon, Ranking Member Smith, thank you again for the opportunity to testify, and for the Committee's focus on these important topics. I look forward to your questions.

¹ Andrew Erickson, "China's Modernization of Its Naval and Air Power Capabilities," in Ashley J. Tellis and Travis Tanner, eds., *Strategic Asia 2012-13: China's Military Challenge* (Seattle, WA, and Washington, DC: The National Bureau of Asia Research, 2012), pp. 60-125; Daniel Hartnett and Frederic Vellucci, "Toward a Maritime Security Strategy: An Analysis of Chinese Views Since the Early 1990s," in Phillip C. Saunders et al., eds., *The Chinese Navy: Expanding Capabilities, Evolving Roles* (Washington, DC: National Defense University Press, 2011), pp. 81-108; Thomas Bickford, *Uncertain Waters: Thinking About China's Emergence as a Maritime Power* (Alexandria, VA: Center for Naval Analyses, September 2011), pp. 20-28; and U.S. Office of Naval Intelligence, *The People's Liberation Army: A Modern Navy with Chinese Characteristics* (Suitland, MD: 2009), pp. 5-11.

² U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013* (Washington, DC: 2013), pp. 1, 31-33; Andrew Erickson and Gabe Collins, "Near Seas 'Anti-Navy' Capabilities, not Nascent Blue Water Fleet, Constitute China's Core Challenge to U.S. and Regional Militaries," *China SignPost*, March 6, 2012. <http://www.andreweirickson.com/2012/03/china-signpost-55-near-seas-anti-navy-capabilities-not-nascent-blue-water-fleet-constitute-chinas-core-challenge-to-us-and-regional-militaries/>; Thomas Bickford, *Uncertain Waters: Thinking About China's Emergence as a Maritime Power* (Alexandria, VA: Center for Naval Analyses, September 2011), pp. 28-29; Toshi Yoshihara and James Holmes, *Red Star Over the Pacific: China's Rise and the Challenge to U.S. Maritime Strategy* (Annapolis, MD: Naval Institute Press, 2010), pp. 14-44; U.S. Office of Naval Intelligence, *The People's Liberation Army: A Modern Navy with Chinese Characteristics* (Suitland, MD: 2009), pp. 5-10; and Roger Cliff et al., *Entering the Dragon's Lair: Chinese Antiaccess Strategies and Their Implications for the United States* (Santa Monica, CA: RAND, 2007), pp. 3-12.

³ http://www.rand.org/content/dam/rand/pubs/monographs/2007/RAND_MG524.pdf.

⁴ Jonathan Greenert and Mark Welsh, "Breaking the Kill Chain," *Foreign Policy*, May 16, 2013.

⁵ http://www.foreignpolicy.com/articles/2013/05/16/breaking_the_kill_chain_air_sea_battle?page=full; U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013* (Washington, DC: 2013), pp. 1, 31-33; and Anton Lee Wishik II, "An Anti-Access Approximation: The PLA's Active Strategic Counterattacks on Exterior Lines," *China Security* 19 (2011).

⁶ People's Republic of China, "Submission by the People's Republic of China Concerning the Outer Limits of the Continental Shelf beyond 200 Nautical Miles in Part of the East China Sea: Executive Summary," December 14, 2012.; Ministry of Foreign Affairs (Republic of China), "The Republic of China's Sovereignty Claims over the Diaoyutai Islands and the East China Sea Peace Initiative," <http://www.mofa.gov.tw/EnOfficialTopics/TopicsArticleDetail/fd8c3459-b3ee-4ca6-9231-403f2920090a>.

⁷ U.S.-China Economic and Security Review Commission, *Hearing on China's New Leadership and Implications for the United States*, written testimony of David Lampton, February 7, 2013; U.S.-China Economic and Security Review Commission, *Hearing on China's New Leadership and Implications for the United States*, written testimony of Michael Auslin, February 7, 2013.

⁸ M. Taylor Fravel, "Xi Jinping's Overlooked Revelation on China's Maritime Disputes," *Diplomat*, August 15, 2013.

⁹ <http://thediplomat.com/2013/08/15/xi-jinpings-overlooked-revelation-on-chinas-maritime-disputes/?all=true>; Xinhua, "Xi Jinping Stresses the Need to Show Greater Care about the Ocean, Understand More about the Ocean, and Make Strategic Plans for the Use of the Ocean, Push Forward the Building of a Maritime Power and Continuously Make New Achievements at the Eighth Collective Study Session of the CPC Central Committee Political Bureau," July 31, 2013. OSC ID: CHR2013073144047122. <http://www.opensource.gov>.

¹⁰ U.S.-China Economic and Security Review Commission, *Hearing on China's Maritime Disputes in the East and South China Seas*, written testimony of Michael McDevitt, April 4, 2013; U.S.-China Economic and Security Review Commission, *2012 Annual Report to Congress* (Washington, DC: U.S. Government Printing Office, November 2012), p. 215; U.S.-China Economic and Security Review Commission, *Hearing on China's Maritime Disputes in the East and South China Seas*, testimony of Peter Dutton, April 4, 2013; and U.S. Navy Seventh Fleet senior officers, meeting with Commissioners, July 2013.

¹¹ U.S.-China Economic and Security Review Commission, *2012 Annual Report to Congress* (Washington, DC: U.S. Government Printing Office, 2012), p. 232.

¹² M. Taylor Fravel, "China's Island Strategy: 'Redefining the Status Quo,'" *Diplomat*, November 1, 2012.

<http://thediplomat.com/china-power/chinas-island-strategy-redefine-the-status-quo/>.

¹³ U.S.-China Economic and Security Review Commission, *Hearing on China's Maritime Disputes in the East and South China Seas*, written testimony of Peter Dutton, April 4, 2013.

¹⁴ M. Taylor Fravel, "Hainan's New Maritime Regulations: An Update," *Diplomat*, January 4, 2013.

<http://thediplomat.com/china-power/hainans-new-maritime-regulations-an-update/>; Ben Blanchard and Manuel Mogato,

"UPDATE 4- Chinese police plan to board vessels in disputed seas," Reuters, November 29, 2012.

<http://www.reuters.com/article/2012/11/30/china-seas-idUSL4N0991Z020121130>.

¹⁵ Edward Wong, "Chinese Military Seeks to Extend Its Naval Power," *New York Times*, April 23, 2010.

<http://www.nytimes.com/2010/04/24/world/asia/24navy.html?pagewanted=all>; Michael Swaine, "China's Assertive Behavior: Part One: On 'Core Interests,'" *China Leadership Monitor* 34 (February 22, 2011): 9, 23.

<http://www.hoover.org/publications/china-leadership-monitor/article/67966>; and Alastair Iain Johnston, "How New and Assertive is China's New Assertiveness?" *International Security* 34:7 (Spring 2013): 17-18.

- ¹³Hillary Clinton et al, "Closing Remarks for U.S.-China Security and Economic Dialogue" (Eisenhower Executive Office Building, Washington, DC, July 28, 2009). <http://www.state.gov/secretary/rm/2009a/july/126599.htm>; Michael Swaine, "China's Assertive Behavior: Part One: On 'Core Interests,'" *China Leadership Monitor* 34 (February 22, 2011), p. 4. <http://www.hoover.org/publications/china-leadership-monitor/article/67966>; and Stephanie Kleine-Ahlbrandt (contributor), "Does Promoting 'Core Interests' Do China More Harm than Good?" *ChinaFile Conversation*, May 2, 2013. <http://www.chinafile.com/does-promoting-core-interests-do-china-more-harm-good>.
- ¹⁴Kyodo, "China Says Senkaku Islands are its 'Core Interest,'" April 26, 2013. OSC ID: JPP20130426969071. <http://www.opensource.gov:AsahiShimbu> (Tokyo), "Japanese, Chinese Defense Officials Meet to Ease Tensions Over Senkakus," April 27, 2013. <http://ajw.asahi.com/article/asia/china/AJ201304270049>.
- ¹⁵Caitlin Campbell et al. *China's 'Core Interests' and the East China Sea* (Washington, DC: U.S.-China Economic and Security Review Commission, May 2013), p. 5. <http://www.uscc.gov/Research/china%E2%80%99s-%E2%80%9Ccore-interests%E2%80%9D-and-east-china-sea>.
- ¹⁶Zheng Wang, "Never Forget National Humiliation: Historical Memory in Chinese Politics and Foreign Relations," *Montreal Review*, November 2012. <http://www.themontrealreview.com/2009/Never-Forget-National-Humiliation-Historical-Memory-in-Chinese-Politics-and-Foreign-Relations.php>; "Interview with Zheng Wang, Author of *Never Forget National Humiliation: Historical Memory in Chinese Politics and Foreign Relations*" (New York, NY: Columbia University Press, 2012). <http://www.cup.columbia.edu/static/zheng-wang-interview>.
- ¹⁷U.S.-China Economic and Security Review Commission, *Hearing on China's Maritime Disputes in the East and South China Seas*, written testimony of Jessica Chen Weiss, April 4, 2013.
- ¹⁸U.S.-China Economic and Security Review Commission, *Hearing on China's Maritime Disputes in the East and South China Seas*, written testimony of Lloyd Thrall, April 4, 2013.
- ¹⁹*Taiwan Today*, "Taiwan lifts sanctions against Philippines," August 9, 2013. <http://taiwantoday.tw/ct.asp?xItem=208324&ctNode=1983>.
- ²⁰U.S. Energy Information Administration, *South China Sea* (Washington, DC: February 2013). <http://www.eia.gov/countries/regions-topics.cfm?fips=SCS>; U.S.-China Economic and Security Review Commission, *Hearing on China's Maritime Disputes in the East and South China Seas*, written testimony of Steven Rice, April 4, 2013.
- ²¹U.S.-China Economic and Security Review Commission, *2012 Annual Report* (Washington, DC: U.S. Government Printing Office, 2012), p. 234-5.
- ²²Central News Agency (Taiwan), "Taiwan opens first trade promotion center in China," December 19, 2012. <http://www.wanchinatimes.com/news-subclass-ent.aspx?id=20121219000109&cid=1201>; Xinhua, "Taiwan opens 3rd mainland trade promotion office," September 9, 2013. http://news.xinhuanet.com/english/china/2013-09/05/e_132694723.htm; Ministry of Commerce (China), *Mr. Jiang Yaoping Attended the Opening Ceremony of CCCME [China Chamber of Commerce for Import and Export of Machinery and Electronic Products] Office in Taipei*, February 1, 2013. <http://english.mofcom.gov.cn/article/newsrelease/significantnews/201302/20130200021041.shtml>.
- ²³Elizabeth Hsu, "Publishing sector not included in cross-strait service trade pact," Central News Agency (Taiwan), June 21, 2013. <http://focustaiwan.tw/news/acs/201306210039.aspx>.
- ²⁴Lorraine Luk and Aries Poon, "China, Taiwan Sign Yuan-Clearing Deal," *Wall Street Journal*, January 25, 2013. <http://online.wsj.com/article/SB10001424127887323539804578263451199261528.html>.
- ²⁵Bien Chin-fong and Lillian Wu, "Taiwan's top negotiator says cross-strait talks fruitful," Central News Agency (Taiwan), June 22, 2013. <http://focustaiwan.tw/news/acs/201306220021.aspx>.
- ²⁶U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013* (Washington, DC: May 2013), p. 5.
- ²⁷U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013* (Washington, DC: May 2013), p. 77; U.S.-Taiwan Business Council, *The Looming Taiwan Fighter Gap* (Arlington, VA: October 2012), p. 21.
- ²⁸U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013* (Washington, DC: May 2013), p. 76.
- ²⁹Ronald O'Rourke, *China Naval Modernization: Implications for U.S. Navy Capabilities – Background and Issues for Congress* (Washington, DC: Congressional Research Service, July 5, 2013), pp. 33-37; U.S. Department of Defense, *Annual Report to Congress on China's Military Power, Military and Security Developments Involving the People's Republic of China 2013* (Washington, DC: 2013), pp. 7-8, 39.
- ³⁰Hsieh Chia-chen, Lin Hui-yu and Maia Huang, "Taiwan-NZ deal key to regional economic integration: think tank," Central News Agency (Taiwan), July 11, 2013. <http://focustaiwan.tw/news/aeco/201307110025.aspx>; Ralph Jennings, "Taiwan, Singapore Sign Free Trade Deal as China Relents," *Voice of America*, November 7, 2013. <http://www.voanews.com/content/taiwan-singapore-sign-free-trade-deal-china-relents/1785388.html>.
- ³¹Central News Agency (Taiwan), "ICAO invitation breaks new ground: foreign minister," September 13, 2013.
- ³²U.S.-China Economic and Security Review Commission, *Hearing on China's New Leadership and Implications for the United States*, written testimony of Wallace "Chip" Gregson, February 7, 2013.
- ³³Craig Murray et al., *China's Naval Modernization and Implications for the United States* (Washington, DC: U.S.-China Economic and Security Review Commission, August 2013), p. 8.

³⁴ U.S. House of Representatives Foreign Affairs Committee, *Hearing on Why Taiwan Matters*, testimony of Kurt Campbell, October 4, 2011.

³⁵ Michael Mazza, "Taiwan's Crucial Role in the U.S. Pivot to Asia," American Enterprise Institute, July 9, 2013. <http://www.aei.org/outlook/foreign-and-defense-policy/regional/asia/taiwans-crucial-role-in-the-us-pivot-to-asia/>; Mark Stokes and L.C. Russell Hsiao, "Taiwan's Role in Air-Sea Battle," Project 2049 Institute, April 16, 2012. <http://blog.project2049.net/2012/04/taiwans-role-in-air-sea-battle.html>.

³⁶ Robert Nabors, "Letter to The Honorable Senator John Cornyn," April 27, 2012. <http://www.scribd.com/doc/91542419/WH-Letter-to-Sen-Cornyn-4-27-12>.

The Honorable Dennis C. Shea, Vice Chairman

Vice Chairman Dennis Shea was reappointed by Senate Republican Leader Mitch McConnell for a third two-year term expiring December 31, 2014. An attorney with 25 years of experience in government and public policy, he is the founder of Shea Public Strategies LLC, a public affairs firm based in Alexandria, Virginia. Before starting the firm, he served as Vice President for Government Affairs—Americas for Pitney Bowes Inc., a Fortune 500 company.

Vice Chairman Shea's government service began in 1988, when he joined the Office of Senate Republican Leader Bob Dole as counsel, subsequently becoming the Senator's deputy chief of staff in the Office of the Senate Majority Leader. In these capacities, he advised Senator Dole and other Republican senators on a broad range of domestic policy issues, was involved in the drafting of numerous pieces of legislation, and was recognized as one of the most influential staffers on Capitol Hill. In 1992, Vice Chairman Shea's service with Senator Dole was interrupted when he ran for Congress in the Seventh District of New York. During the 1996 elections, Vice Chairman Shea continued to help shape the national public policy debate as the director of policy for the Dole for President Campaign. Following the elections, he entered the private sector, providing legislative and public affairs counsel to a wide range of clients while employed at BKSH & Associates and Verner, Liipfert, Bernhard, McPherson, and Hand.

In 2003, Vice Chairman Shea was named the Executive Director of the President's Commission on the United States Postal Service. Many of the Commission's recommendations were subsequently adopted in the landmark 2006 postal reform legislation.

In 2004, Vice Chairman Shea was confirmed as Assistant Secretary for Policy Development and Research at the U.S. Department of Housing and Urban Development. As Assistant Secretary, Vice Chairman Shea led a team responsible for conducting much of the critical analysis necessary to support the Department's mission. In 2005, Vice Chairman Shea left to serve as Senior Advisor to Senator Elizabeth Dole in her capacity as chairman of the National Republican Senatorial Committee.

Vice Chairman Shea received a J.D., an M.A. in History, and a B.A. in Government, from Harvard University. He is admitted to the bar in New York and the District of Columbia. The Vice Chairman currently resides in Alexandria, Virginia, with his wife Elizabeth and daughter Juliette.

“U.S.-China Economic and Security Review Commission 2013 Report to Congress: China’s Military Modernization, U.S.-China Security Relations, and China’s Cyber Activities”

Testimony of Dr. Larry M. Wortzel

Commissioner, U.S.-China Economic and Security Review Commission

before the

Armed Services Committee, U.S. House of Representatives

Hearing on “2013 Report to Congress of the U.S.-China Economic Security Review Commission”

Chairman McKeon, Ranking Member Smith, members of the Committee, thank you for the opportunity to testify. As a member of the U.S.-China Economic and Security Review Commission, I will present some of the Commission’s findings on China’s military modernization, U.S.-China security relations, and China’s cyber activities from the *2013 Report to Congress*. The views I present today, however, are my own. I want to acknowledge the fine work of our staff in preparing the *2013 Report to Congress*, and especially the excellent research of our foreign policy and security staff in helping to prepare this testimony.

China’s Military Modernization

China’s military, the People’s Liberation Army (PLA), is undergoing an extensive modernization program that presents significant challenges to U.S. security interests in Asia. This modernization includes creating a surveillance and strike architecture that supports operations at longer distances away from China’s coast. It makes the PLA a more formidable force in all the dimensions of war: air, space, land, sea and in the electromagnetic spectrum. The PLA has new, multi-mission capable combat ships, aircraft, submarines, and new generations of missiles.

First and foremost, major elements of this program – such as the DF-21D antiship ballistic missile and increasing numbers of advanced submarines armed with antiship cruise missiles – are designed to restrict U.S. freedom of action throughout the Western Pacific. The PLA is

rapidly expanding and diversifying its ability to conduct conventional strikes against U.S. and allied bases, ships, and aircraft throughout the region, including those that it previously could not reach with conventional weapons, such as U.S. military facilities in Guam. As the PLA's anti-access/area denial¹ capabilities mature, the costs and risks to the United States for intervention in a potential regional conflict involving China will increase. The Chinese military, of course, sensitive to 19th and 20th century history, thinks of these actions as counter-intervention strategies designed to prevent foreign militaries from intervening in China's sovereign affairs or territory.

Furthermore, the PLA's rapidly advancing regional power projection capabilities enhance Beijing's ability to use force against Taiwan, Japan, and rival claimants in the South China Sea. More seriously, because China's military doctrine emphasizes preemptive attacks, it raises the stakes in any crisis. Many potential security scenarios could require the U.S. military to defend U.S. regional allies and partners as well as to maintain open and secure access to the air and maritime commons in the Western Pacific.

At the same time, rising unease over both China's expanding capabilities and increasing assertiveness is driving U.S. allies and partners in Asia to improve their own military forces and strengthen their security relationships with each other. These trends could support U.S. interests in Asia by lightening Washington's operational responsibilities in the region. On the other hand, if China's neighbors pursue military capabilities that could be used offensively or preemptively due to the perception that the United States will be unable to follow through on its commitment to the rebalance to Asia, this could undermine U.S. interests in the region.

In the Commission's *2013 Report to Congress* we discuss the following developments in China's military modernization:

¹ Anti-access" (A2) actions are those intended to slow deployment of an adversary's forces into a theater or cause the forces to operate from distances farther from the conflict than they would otherwise prefer. A2 affects movement into theater. "Area denial" (AD) actions are those intended to impede an adversary's operations within areas where friendly forces cannot or will not prevent access. AD affects movement within theater. U.S. Air-Sea Battle Office, *Air Sea Battle: Service Collaboration to Address Anti-Access & Area Denial Challenges* (Arlington, VA: May 2013), 2-4.

Navy

Aircraft carriers. Since commissioning its first aircraft carrier, the *Liaoning*, in September 2012, China continues to develop a fixed-wing carrier aviation capability, which is necessary for the carrier to carry out air defense and offensive strike missions. The *Liaoning* is a former Russian aircraft carrier purchased from the Ukraine. It was refitted and modernized in China. The PLA Navy conducted its first successful carrier-based takeoff and landing with the Jian-15 (J-15) in November 2012, certified its first group of aircraft carrier pilots and landing signal officers on the carrier's first operational deployment from June to July 2013, and verified the flight deck operations process in September 2013.¹ The *Liaoning* will continue to conduct short deployments and shipboard aviation training until 2015 to 2016, when China's first J-15 regiment is expected to become operational. The J-15 is a Chinese copy of the Russian Su-33. China likely intends to follow the *Liaoning* with at least two domestically produced hulls. The first of these appears to be under construction and could become operational before 2020.

Submarine-launched ballistic missile. China's Julang-2 (JL-2) submarine-launched ballistic missile is expected to reach initial operational capability very soon.² The missile has been under development for a number of years, which shows that Chinese military industries still have some problems in developing and fielding new systems. The JL-2, when mated with the PLA Navy's JIN-class nuclear ballistic missile submarine (SSBN), will give China its first credible sea-based nuclear deterrent. The JIN SSBN/JL-2 weapon system likely will have a range of over 4,000 nautical miles, allowing the PLA Navy to target the continental United States from China's littoral waters.³ China has deployed three JIN SSBNs and probably will field two additional units by 2020.⁴

Sea-based land attack capability. China currently does not have the ability to strike land targets with sea-based cruise missiles. However, the PLA Navy is developing a land attack capability, likely for its Type-095 guided-missile attack submarine and LUYANG III guided-missile destroyer. Modern submarines and surface combatants armed with land attack cruise missiles (LACM) will complement the PLA's growing inventory of air- and ground-based LACM and

ballistic missiles, enhancing Beijing's flexibility for attacking land targets throughout the Western Pacific, including U.S. facilities in Guam.⁵

Shipbuilding. The PLA Navy continues to steadily increase its inventory of modern submarines and surface combatants. China is known to be building seven classes of ships simultaneously but may be constructing additional classes.⁶ Trends in China's defense spending, research and development, and shipbuilding suggest the PLA Navy will continue to modernize. China already has 65 submarines that can employ intercontinental ballistic missiles, torpedoes, mines, or anti-ship cruise missiles. The PLA Navy's surface combat force has modernized and its 77 major surface combatants are networked and capable of conducting multiple missions.⁷ The combat fleets are supported by a combat logistics force that can conduct underway replenishment and limited repairs. All of these ships will be equipped to take advantage of a networked, redundant command, control, communications, computer, intelligence, surveillance and reconnaissance system (C4ISR) fielded by the PLA.

Submarines. China has a formidable force of 65 conventional and nuclear submarines.⁸ Some are equipped with nuclear and conventional torpedoes and mines as well as antiship cruise missiles. In 2012, China began building four "improved variants" of its SHANG-class nuclear attack submarine. China also continues production of the YUAN-class conventional submarine, some of which will include an air-independent propulsion system that allows for extended duration operations, and the JIN-class SSBN. Furthermore, China is developing two new classes of nuclear submarines and may jointly design and build four advanced conventional submarines with Russia.⁹ China's growing submarine inventory will significantly enhance China's ability to strike opposing surface ships throughout the Western Pacific and to protect future nuclear deterrent patrols and aircraft carrier task groups.¹⁰

Air Force

Fighter aircraft. China also is developing two next-generation fighters, the J-20 and the J-31, which could feature low observability and active electronically scanned array radar.¹¹ The PLA Air Force conducted the first test flights of the J-20 and J-31 in January 2011 and October 2012,

respectively.¹² These aircraft will strengthen China's ability to project power and gain and maintain air superiority in a regional conflict.

Cargo transport aircraft. In January 2013, China conducted the first test flight of its indigenously developed cargo transport aircraft, the Yun-20 (Y-20). China previously was unable to build heavy transport aircraft, so it has relied on a small number of Russian Ilyushin-76 (IL-76) aircraft for strategic airlift since the 1990s. Aircraft specifications provided by official Chinese media indicate the Y-20 can carry about twice the cargo load of the IL-76 and about three times the cargo load of the U.S. C-130.¹³ The Y-20 will enhance the PLA's ability to respond to internal security crises and border contingencies, support military international peacekeeping and humanitarian assistance operations, and project power in a regional conflict.¹⁴ The larger aircraft and expanded fleet will enhance the PLA's capability to employ the 15th Airborne Army, part of the PLA Air Force.

LACM-capable bomber aircraft. In June 2013, the PLA Air Force began to receive new Hongzha-6K (H-6K) bomber aircraft. The H-6K, an improved variant of the H-6 (originally adapted from a late-1950s Soviet design) can carry China's new long-range LACM, the CJ-10. The bomber/LACM weapon system has a range of around 2,400 to 3,100 miles¹⁵ and provides the PLA Air Force with the ability to conduct conventional strikes against regional targets throughout the Western Pacific, including U.S. facilities in Guam.¹⁶ Although the H-6K airframe could be modified to carry a nuclear-tipped air-launched LACM, and China's LACMs likely have the ability to carry a nuclear warhead, there is no evidence to confirm China is deploying nuclear warheads on any of its air-launched LACMs.¹⁷ The H-6K also may be able to carry supersonic antiship cruise missiles.¹⁸

Space and Counterspace

In May 2013, China fired a rocket into nearly geosynchronous Earth orbit, marking the highest known suborbital launch since the U.S. Gravity Probe A in 1976 and China's highest known suborbital launch to date. Although Beijing claims the launch was part of a high-altitude scientific experiment, available data suggest China was testing the launch vehicle component of

a new high-altitude antisatellite (ASAT) capability.¹⁹ If true, such a test would signal China's intent to develop an ASAT capability to target satellites in an altitude range that includes the U.S.'s Global Positioning System (GPS) and many U.S. military and intelligence satellites. In a potential conflict, this capability could allow China to threaten the U.S. military's ability to detect foreign missiles and provide secure communications, navigation, and precision missile guidance.

Furthermore, in September 2013, China launched a satellite into space from the Jiuquan Satellite Launch Center in western China. Our *2013 Report to Congress*, citing commentary from Gregory Kulacki of the Union of Concerned Scientists, suggests this launch may represent a capacity to launch new satellites in the event China suffers losses in space from space combat.²⁰

China also has improved its ballistic missile defense capabilities by fielding the Russian-made SA-20B surface-to-air missile (SAM) system. In some cases, China's domestically produced CSA-9 SAM system should also be capable of intercepting ballistic missiles.²¹

On December 27, 2012, China announced its Beidou regional satellite navigation system is fully operational and available for commercial use. Using 16 satellites and a network of ground stations, Beidou provides subscribers in Asia with 24-hour precision, navigation, and timing services.²² China plans to expand Beidou into a global satellite navigation system by 2020.²³ Beidou is a critical part of China's stated goal to prepare for fighting wars under "informationized conditions," which includes a heavy emphasis on developing the PLA's C4ISR and electronic warfare capabilities. The PLA is integrating Beidou into its systems to improve its command and control and long-range precision strike capabilities and reduce the PLA's reliance on foreign precision, navigation, and timing services, such as GPS.²⁴

Strategic Intercontinental Ballistic Missiles

China is enhancing its nuclear deterrent capability by modernizing its nuclear force. It is taking measures such as developing a new road-mobile intercontinental ballistic missile (ICBM), the DF-41. This missile could be equipped with a multiple-independently targetable reentry vehicle

(MIRV), allowing it to carry as many as 10 nuclear warheads.²⁵ In addition to MIRVs, China could also equip its ballistic missiles with penetration aids and may be developing the capability to transport ICBMs by train.²⁶ Furthermore, according to DoD's 2011 report to Congress on China's military, the PLA uses underground facilities "to protect and conceal [its] newest and most modern solid-fueled mobile missiles."²⁷

Defense Spending

To support its military modernization, China continued to increase its defense spending in 2013. In March, China announced its official defense budget for 2013 rose 10.7 percent in nominal terms to \$117.39 billion, signaling the new leadership's support for the PLA's ongoing modernization efforts. This figure represents 5.3 percent of total government outlays²⁸ and approximately 1.3 percent of estimated gross domestic product (GDP).²⁹ China's official annual defense budget now has increased for 22 consecutive years and more than doubled since 2006. Most Western analysts agree Beijing likely will retain the ability – even with slower growth rates of its GDP and government revenue – to fund its ongoing military modernization.³⁰

It is difficult to estimate China's actual defense spending due to the uncertainty involved in determining how China's purchasing power parity affects the cost of China's foreign military purchases and domestic goods and services as well as Beijing's omission of major defense-related expenditures. For example, some purchases of advanced weapons, research and development (R&D) programs, domestic security spending, and local government support to the PLA are not included in China's official figures on defense spending. The Institute of International Strategic Studies assesses China's actual defense spending is 40 to 50 percent higher than the official figure.³¹ The U.S. Department of Defense (DoD) estimated China's actual defense spending in 2012 fell between \$135 and \$215 billion, or approximately 20 to 90 percent higher than its announced defense budget.³²

U.S.-China Security Relations

U.S.-China military-to-military relations deepened and expanded in 2013 after several years of setbacks. From 2012 to 2013, the number of U.S.-China military-to-military contacts* more than doubled from approximately 20 to 40.³³ In particular, contact between the U.S. Navy and the PLA Navy increased significantly during this timeframe. Key military-to-military contacts in 2013 included the first port visit by a U.S. Navy ship to China since 2009; the first port visit by a Chinese ship to the United States since 2006; and the second ever U.S.-China counterpiracy exercise. Additionally, China in March 2013 accepted the U.S. invitation, first extended by then U.S. Secretary of Defense Leon Panetta in September 2012, to participate in the U.S.-led multilateral Rim of the Pacific Exercise near Hawaii in 2014.³⁴

DoD contends that a strong military-to-military relationship develops familiarity at the operational level. The department argues that this reduces the risk of conflict through accidents and miscalculations; builds lines of communication at the strategic level that could be important during a crisis; contributes to better overall bilateral relations; and creates opportunities to obtain greater contributions from China to international security. U.S. Pacific Command Commander Admiral Samuel Locklear in July 2013 said, “The progress that we’re making between our two militaries is quite commendable ... because we are able to have very good dialogue on areas where we converge, and there are a lot of places where we converge as two nations, and we’re also able to directly address in a matter-of-fact way where we diverge.”³⁵

There have been eight rounds of strategic dialogue between China and the United States, currently managed by the Pacific Forum-CSIS. This is a Track 1.5 dialogue that involves some representatives from the U.S. government in attendance, but virtually all Chinese participants are from some part of the government. The past several rounds of the dialogue have dealt with some of the most important strategic issues facing China and the United States, including nuclear strategic stability; the relationship between cyber attacks, space warfare and nuclear stability; ballistic missile defense and strategic early warning. Officers from China’s strategic missile

* These contacts include high-level visits, recurrent exchanges, academic exchanges, functional exchanges, and joint exercises.

forces have been in attendance at the dialogue. I see this as one of the most productive dialogues that take place with China. The PLA is an active participant. Ideally such discussions should be direct, government-to-government talks, but it is encouraging that the PLA and the Chinese Foreign Ministry are engaged on these matters.

In another positive development, in mid-November 2013, the U.S. Army and the PLA ground forces conducted their first ever field exercise together. The exercise was focused on disaster relief and took place in Hawaii.³⁶

My own experience in direct military-to-military contacts with China leads me to advise caution in what we do with the PLA and what we show it. In my opinion, the wise limitations placed by Congress on military exchanges with China in the National Defense Authorization Act (NDAA) of 2000 should not be lifted. The Commission's *2013 Report to Congress* also reflects this sentiment. Military-to-military contacts with China require careful oversight to ensure that the U.S. does not improve China's capability against our own forces, Taiwan, or our friends and allies in the Asia Pacific region.

Enhanced military-to-military contacts between China and the United States in 2013 took place in the context of China's efforts to re-brand the bilateral relationship as a "new type of major-country relationship." This concept, promoted heavily in 2013 by Chinese President Xi Jinping and other high-level Chinese officials, posits the United States and China should, as two major powers, seek to cooperate on a range of bilateral and global issues while avoiding the kind of harmful competition that often characterizes relationships between dominant powers and rising ones.³⁷ Cooperation is a good thing, but U.S. military leaders cannot lose sight of the PLA's record on human rights. This dictates practical limitations on what we do with China's armed forces. The principal mission of China's military is to keep the Chinese Communist Party (CCP) in power, as we saw in the way that the PLA was used during the June 4, 1989 Tiananmen Massacre and in Tibet.

China's Cyber Activities

While China continues to develop its navy, air force, missile forces, and space and counterspace capabilities, in Chinese military writings, cyberspace is an increasingly important component of China's comprehensive national power and a critical element of its strategic competition with the United States.³⁸ Beijing seems to recognize that the United States' current advantages in cyberspace are allowing Washington to collect intelligence, exercise command and control of military forces, and support military operations. At the same time, China's leaders fear that the U.S. may use the open Internet and cyber operations to threaten the CCP's legitimacy.

Since the Commission's *2012 Report to Congress*, strong evidence has emerged that the Chinese government is directing and executing a large-scale cyber espionage campaign against the United States. China to date has compromised a range of U.S. networks, including those of DoD and private enterprises. These activities are designed to achieve a number of broad security, political, and economic objectives.

There are no indications the public exposure of Chinese cyber espionage in technical detail throughout 2013 has led China to change its attitude toward the use of cyber espionage to steal intellectual property and proprietary information. The report by Mandiant, a U.S. private cybersecurity firm, about the cyber espionage activities of PLA Unit 61398 merely led the unit to make changes to its cyber "tools and infrastructure" to make future intrusions harder to detect and attribute.³⁹ There are about 16 technical reconnaissance (signals intelligence) units and bureaus in the PLA as well as a number of electronic warfare and electronic countermeasures units supporting the military regions and the services.⁴⁰ These organizations focus on cyber penetrations, cyber espionage, and electronic warfare.

When confronted with public accusations from the United States about its cyber espionage, Beijing usually attempts to refute evidence by pointing to the anonymity of cyberspace and the lack of verifiable technical forensic data. It also shifts the media focus by portraying itself as the victim of Washington's cyber activities and calling for greater international cooperation on cyber security.⁴¹ In a press conference on the day after Mandiant released its report in February 2013, a

spokesperson for China's Ministry of Foreign Affairs said, "Groundless speculation and accusations regarding hacker attacks, for various purposes, is both unprofessional and irresponsible and it is not helpful for solving the problem." He also emphasized cyber attacks are a serious problem for China.⁴²

However, a number of public U.S. government reports, admissions by private companies that they have been the target of cyber espionage, investigations by cybersecurity firms, and U.S. press reporting contradict Beijing's longstanding denials. While attribution is difficult and takes great skill, trend analysis is allowing cybersecurity professionals to develop a more comprehensive understanding of Chinese cyber actors, tools, tactics, techniques, and procedures.

Threats to U.S. National Security

China's cyber espionage against the U.S. government and defense industrial base poses a major threat to U.S. military operations, the security and well-being of U.S. military personnel, the effectiveness of equipment, and readiness. China apparently uses these intrusions to fill gaps in its own research programs, map future targets, gather intelligence on U.S. strategies and plans, enable future military operations, shorten R&D timelines for military technologies, and identify vulnerabilities in U.S. systems and develop countermeasures.⁴³

Military doctrine in China also calls for attacks on the critical infrastructure of an opponent's homeland in case of conflict. In July 2013, a threat researcher at Trend Micro, a private Japanese cybersecurity firm, claimed he had detected a Chinese cyber intrusion, commencing in December 2012, of a honeypot.⁴⁴ He had created the honeypot to resemble the industrial control system of a water plant in the United States. The researcher attributed the intrusion to Unit 61398, based on forensic analysis.⁴⁴ If true, this suggests the unit is collecting intelligence on critical infrastructure in addition to other targets. Such activities are consistent with PLA doctrine, which explains that one function of wartime computer network operations is to "disrupt and damage the

⁴⁴ A honeypot is part of a honeynet, which is a fake or diversionary computer network designed to draw in an adversary in order to identify the adversary or give the adversary false information. Honeynets can provide intelligence regarding adversaries' "tools, tactics, and motives." The Honeynet Project, "Short Video Explaining Honeypots." <http://old.honeynet.org/misc/files/HoneynetWeb.mov>.

networks of [an adversary's] infrastructure facilities, such as power systems, telecommunications systems, and educational systems.”⁴⁵

A number of instances of Chinese cyber espionage targeting U.S. national security programs have been identified in recent years. In May 2013, the *Washington Post* described a classified report by the Defense Science Board, which lists more than 24 U.S. weapon system designs the board determined were accessed by cyber intruders. The *Washington Post* reported, “Senior military and industry officials with knowledge of the breaches said the vast majority were part of a widening Chinese campaign of espionage against U.S. defense contractors and government agencies.” The list includes the Patriot missile system, the Aegis ballistic missile defense system, the F/A-18 fighter, the V-22 Osprey multirole combat aircraft, and the Littoral Combat Ship.⁴⁶

Information gained from intrusions into the networks of U.S. military contractors likely improves China's insight into U.S. weapon systems, enables China's development of countermeasures, and shortens China's R&D timelines for military technologies.⁴⁷ In addition, the same intrusions Chinese cyber actors use for espionage also could be used to prepare for offensive cyber operations. Chinese cyber actors could place latent capabilities in U.S. software code or hardware components that might be employed in a potential conflict between the United States and China.

There has been concern in recent years about security risks to DoD's supply chain. In a meeting in May 2013, Commissioners and DoD officials discussed the department's interpretation of U.S. law regarding procurement sources. DoD officials indicated a stricter procurement evaluation standard that includes sourcing concerns could be applied only to items on the United States Munitions List. Items outside this list are judged by a different standard, which some officials believe might preclude concerns about the origin of products. For example, items procured for C4ISR maintenance facilities are not subject to stricter scrutiny. Commissioners raised concerns that this interpretation of the law was limiting the department's ability to address potential risks arising from certain procurement sources. Commissioners urged DoD to expand the purview of the stricter standard to items beyond the munitions list.

DoD is currently moving in this direction. Section 806 of the NDAA for Fiscal Year 2011 (Public Law 111-383), is intended to address the problem, but it has yet to be fully implemented. Section 806 authorizes the Secretary of Defense and the secretaries of the Army, Navy, and Air Force to reject procurement sources for information technology on grounds of protecting supply chain security if they receive a recommendation to do so from DoD.⁴⁸ The department is in the process of implementing Section 806, having conducted table-top exercises and written the Defense Federal Acquisition Regulation Supplement Rule implementing Section 806. As of May the rule was in the process of interagency coordination.⁴⁹ These changes to DoD procurement ultimately may provide officials with the flexibility they need to protect all DoD systems. However, progress has been slow and the problem the Commissioners highlighted will remain until the new policy is implemented, potentially posing a threat to national security. Therefore, in the *2013 Report to Congress* the Commission recommends Congress urge the Administration to expedite progress in its implementation of Section 806 of the NDAA for Fiscal Year 2011.

Developments in cloud computing in China may present cybersecurity risks for U.S. users and providers of cloud computing services and may also have implications for U.S. national security. Based on the findings of a report by Defense Group Inc. (DGI) for the Commission, the relationship between the Ministry of State Security (MSS) and the Chongqing Special Cloud Computing Zone represents a potential espionage threat to foreign companies that might use cloud computing services provided from the zone or base operations there.⁵⁰ In addition, the plan to link 21Vianet's data centers in China and Microsoft's data centers in other countries suggests the Chinese government one day may be able to access data centers outside China through Chinese data centers.⁵¹ With concerns about espionage in mind, in the *2013 Report to Congress*, the Commission recommends Congress direct the Administration to prepare an inventory of existing federal use of cloud computing platforms and services and determine where the data storage and computing services are geographically located. Such inventory should be prepared annually and reported to the appropriate committees of jurisdiction.

Cloud computing also could improve the PLA's C4ISR capabilities. DGI writes that cloud computing "could enable more effective and flexible development and deployment of military equipment, while at the same time improving the survivability of the PLA's information systems

by endowing them with greater redundancy (allowing a system's capabilities to survive the disabling or destruction of any individual node)."⁵²

Threats to U.S. Industry

China's cyber espionage against U.S. commercial firms poses a significant threat to U.S. business interests and competitiveness in key industries. This cyber espionage complements traditional human espionage. Through these efforts, the PLA and China's defense industry are able to leapfrog ahead in technologies and systems and fill in gaps in their own R&D capabilities at a considerable savings in time and money. General Keith Alexander, director of the NSA and commander of U.S. Cyber Command, assessed the cost to U.S. companies of intellectual property theft is about \$250 billion a year, although not all the losses are due to Chinese activity.⁵³ Chinese entities engaging in cyber and other forms of economic espionage likely conclude that stealing intellectual property and proprietary information is much more cost-effective than investing in lengthy R&D programs.⁵⁴ These thefts support national science and technology development plans that are centrally managed and directed by the PRC government.

The Chinese government, primarily through the PLA and the MSS, supports these activities by providing state-owned enterprises information and data extracted through cyber espionage to improve their competitive edge, cut R&D timetables, and reduce costs. The strong correlation between compromised U.S. companies and those industries designated by the Beijing as "strategic" industries⁵⁵ further indicates a degree of state sponsorship, and likely even support, direction, and execution of Chinese economic espionage.⁵⁶ Such governmental support for Chinese companies enables them to out-compete U.S. companies, which do not have the advantage of leveraging government intelligence data for commercial gain.*

It is difficult to quantify the benefits Chinese firms gain from cyber espionage. We don't know everything about the kinds of information that is targeted and taken, nor do we always know

* In the late 1980s and early 90s a debate took place in Congress on whether the U.S. Intelligence Community (IC) should share information and/or intelligence assets with U.S. companies to provide those companies an advantage against foreign competitors. In 1991, then Director of the Central Intelligence Agency Robert Gates, in a speech to the IC, stated clearly that the CIA would limit itself to helping U.S. companies safeguard themselves from foreign intelligence operations. Robert Gates, "The Future of American Intelligence." (Washington, DC: U.S. Intelligence Community, December 4, 2011).

which Chinese actor stole the information. Some thefts may take place that are never detected. In terms of business intelligence, some targets of cyber theft likely include information related to negotiations, investments, and corporate strategies including executive e-mails, long-term business plans, and contracts. In addition to cyber theft, Chinese companies almost certainly are acquiring information through traditional espionage activities, which limits our ability to identify the impact of cyber espionage in particular. Nevertheless, it is clear that China not only is the global leader in using cyber methods to steal intellectual property but also accounts for the majority of global intellectual property theft.⁵⁷ Chinese actors have on several occasions in recent years leveraged cyber activities to gain sensitive or proprietary information from U.S. enterprises:

- In the report by Mandiant that I mentioned earlier, there is evidence that since 2006 PLA Unit 61398 has penetrated the networks of at least 141 organizations, including companies, international organizations, and foreign governments. These organizations are either located or have headquarters in 15 countries and represent 20 sectors, from information technology to financial services. Of the organizations penetrated, 81 percent were either located in the United States or had U.S.-based headquarters. According to Mandiant, Unit 61398, gained access to a wide variety of intellectual property and proprietary information through these intrusions.⁵⁸ Unit 61398 is the Second Bureau of the PLA's technical reconnaissance department, based in Shanghai.⁵⁹
- In another high-profile example of a Chinese company allegedly targeting a U.S. company's intellectual property through cyber espionage, the Department of Justice (DoJ) in June 2013 filed charges against Sinovel Wind Group, a Chinese energy firm, alleging Sinovel stole intellectual property from Massachusetts-based company American Superconductor (AMSC).⁶⁰ Once Sinovel was allegedly able to reproduce AMSC's software after stealing its proprietary source code, the Chinese firm broke the partnership, cancelled existing orders, and devastated AMSC's revenue. AMSC has sought compensation from Sinovel through lawsuits in China, an effort which is ongoing and has resulted in legal fees for AMSC exceeding \$6 million.⁶¹ While these lawsuits continue to

move slowly through the Chinese legal system, adding to AMSC's legal fees, Sinovel is reaping the profits of stolen technology.⁶²

Detering Chinese Cyber Theft

It is clear that naming the perpetrators in China in an attempt to shame the Chinese government is not sufficient to deter Chinese entities from conducting cyber espionage against U.S. companies. Mitigating the problem will require a well-coordinated approach across the U.S. government and with industry. Many potential actions are being discussed by Congress, the Obama Administration, and outside experts. These actions include linking economic cyber espionage to trade restrictions, prohibiting Chinese firms using stolen U.S. intellectual property from accessing U.S. banks, and banning U.S. travel for Chinese organizations that are involved with cyber espionage. The Commission recommends Congress take the following actions:

- Adopt legislation clarifying the actions companies are permitted to take regarding tracking intellectual property stolen through cyber intrusions.
- Amend the Economic Espionage Act (18 U.S.C. § 1831-1839) to permit a private right of action when trade secrets are stolen.
- Support the Administration's efforts to achieve a high standard of protection of intellectual property rights in the Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership.
- Encourage the Administration to partner with other countries to establish an international list of individuals, groups, and organizations engaged in commercial cyber espionage. The Administration and partner governments should develop a process for the list's validation, adjudication, and shared access.
- Urge the Administration to continue to enhance its sharing of information about cyber threats with the private sector, particularly small- and medium-sized companies.

My personal view is that the President already has the authority to place sanctions on Chinese persons, government industries and companies through the International Emergency Economic Powers Act.⁶³ If the magnitude of the damage to the U.S. economy is as great as that cited by General Alexander, the President should exercise that authority.

Sustaining the U.S. Military's "Rebalance" to Asia

In closing, I would like to briefly talk about the U.S. rebalance to Asia. In January 2012, DoD's *Defense Strategic Guidance* declared the U.S. military will "of necessity rebalance toward the Asia Pacific" by emphasizing existing alliances, expanding its networks of cooperation with "emerging" partners, and investing in military capabilities to ensure access to and freedom to maneuver within the region.⁶⁴ U.S. Chief of Naval Operations Admiral Jonathan Greenert explained the U.S. Navy's role in the rebalance: "As directed by the 2012 *Defense Strategic Guidance* ... the [U.S.] Navy formulated and implemented a plan to rebalance our forces, their homeports, our capabilities, and our intellectual capital and partnerships toward the Asia Pacific."⁶⁵ Specifically, the U.S. Navy aims to increase its presence in the Asia Pacific from about 50 ships in 2013 to 60 ships by 2020 and "rebalance homeports to 60 percent" in the region by 2020.⁶⁶

However, the Commission's *2013 Report to Congress* notes that U.S. Defense Secretary Chuck Hagel in July 2013 said Washington would have to choose between a smaller, modern military and a larger, older one if sequester-level funding continues.⁶⁷ Admiral Greenert has warned constraints in the current budget environment could delay or prevent the U.S. Navy from achieving its objectives in the rebalance.⁶⁸ There is growing concern in the United States and among U.S. allies and partners that DoD will be unable to follow through on its commitment to the rebalance due to declining defense budgets and emerging crises elsewhere in the world. This could lead some regional countries to increasingly accommodate China or pursue military capabilities that could be used offensively or preemptively. Either scenario could undermine U.S. interests in the region.

I urge you to keep in mind that by 2020, China could have a navy and air force that outnumber and almost match the technical capability of our own forces in the Asia Pacific. If our military force shrinks because of our own budget problems, we may have sixty percent of our forces in the Asia Pacific region, but 60 percent of 200 ships is far less than sixty percent of a 300 ship navy. That may not be sufficient to deter China or to reassure our friends and allies in the region.

Thank you for the opportunity to appear today. I am happy to respond to any questions you may have.

- ¹ *Renmin Ribao* (People's Daily), "Chinese aircraft carrier returns to home port," September 22, 2013, <http://english.peopledaily.com.cn/90786/8407244.html>; Xinhua, "China's carrier-borne jet pilots receive certification," July 4, 2013, <http://english.peopledaily.com.cn/90786/8310416.html>; Xinhua, "China's first aircraft carrier leaves homeport for sea trials," June 11, 2013, http://news.xinhuanet.com/english/china/2013-06/11/c_132447284.htm; Xinhua, "China's aircraft carrier anchors in military port," February 27, 2013, http://www.china.org.cn/china/NPC_CPPCC_2013/2013-02/27/content_28071340.htm; and Xinhua, "China Now Capable to Deploy Jets on Aircraft Carrier: Navy," November 25, 2012, OSC ID: CPP20121125968098, <http://www.opensource.gov>.
- ² U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013* (Washington, DC: 2013), p. 31.
- ³ U.S. Office of Naval Intelligence, *The People's Liberation Army Navy: A Modern Navy with Chinese Characteristics* (Suitland, MD: 2009), p. 23.
- ⁴ U.S. Office of Naval Intelligence, *PLA Navy Orders of Battle 2000-2020*, written response to request for information provided to the U.S.-China Economic and Security Review Commission, Suitland, MD, June 24, 2013; U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013*, pp. 10, 31.
- ⁵ U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013*, pp. 6-7; J. Michael Cole, "China's Growing Long-Range Strike Capability," *Diplomat*, August 13, 2012, <http://thediplomat.com/flashpoints-blog/2012/08/13/chinas-growing-long-range-strike-capability/>.
- ⁶ Andrew Erickson and Gabe Collins, "China Carrier Demo Module Highlights Surging Navy," *National Interest*, August 6, 2013, <http://nationalinterest.org/commentary/china-carrier-demo-module-highlights-surging-navy-8842>; U.S. Office of Naval Intelligence, *PLA Navy Orders of Battle 2000-2020*, written response to request for information provided to the U.S.-China Economic and Security Review Commission, Suitland, MD, June 24, 2013; and U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013*, pp. 5-7.
- ⁷ International Institute of Strategic Studies, *The Military Balance 2013* (Routledge: London, March 2013), pp.289-290.
- ⁸ *Ibid.*
- ⁹ BBC News, "China 'Buys Fighter Jets and Submarines from Russia,'" March 25, 2013, <http://www.bbc.co.uk/news/world-asia-21930280>; Robert Foster, "Russia to Sell, Co-Produce Lada-class Submarines to China," *IHS Jane's Defence Industry*, December 20, 2012, <http://www.janes.com/article/19682/russia-to-sell-co-produce-lada-class-submarines-to-china>.
- ¹⁰ U.S. Office of Naval Intelligence, *PLA Navy Orders of Battle 2000-2020*; U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013*, pp. 5-7.
- ¹¹ Roger Cliff, "Chinese Military Aviation Capabilities, Doctrine, and Missions," in Andrew S. Erickson and Lyle J. Goldstein, eds., *Chinese Aerospace Power: Evolving Maritime Roles* (Annapolis, MD: Naval Institute Press, 2011), p. 252; Richard Fisher, "Deterring China's Fighter Buildup," *Defense News*, November 19, 2012, <http://www.defensenews.com/article/20121119/DEFEEAT05/311190005/>.
- ¹² U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013*, p. 8; Fisher, "Deterring China's Fighter Buildup," <http://www.defensenews.com/article/20121119/DEFEEAT05/311190005/>.
- ¹³ Open Source Center, *Summary: PRC Expert Says Yun-20 Transport Makes Strategic Air Force Possible* (Washington, DC: January 27, 2013), OSC ID: CPP20130128787028, <http://www.opensource.gov>.
- ¹⁴ Open Source Center, *Summary: Guangdong Journal Views Strategic Card of 'Yun-20' Jumbo Air Freighter* (Washington, DC: January 31, 2013), OSC ID: CPP20130214695013, <http://www.opensource.gov>; Andrew Erikson and Gabe Collins, "The Y-20: China Aviation Milestone Means New Power Projection," *Wall Street Journal: China Real time Report*, January 28, 2013, <http://blogs.wsj.com/chinarealtime/2013/01/28/the-y-20-china-aviation-milestone-means-new-power-projection/>.

- ¹⁵ Zachary Keck, "Can China's New Strategic Bomber Reach Hawaii?" *Diplomat*, August 13, 2013. http://thediplomat.com/flashpoints-blog/2013/08/13/can-chinas-new-strategic-bomber-reach-hawaii/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+the-diplomat+%28The+Diplomat+RSS%29; Noam Eshel, "Chinese Air Force Gets More H-6K Strategic Bombers," *Defense Update*, June 25, 2013. http://defense-update.com/20130625_h-6k-bombers-delivered-to-pla-air-force.html; and Chen Boyuan, "H-6K bombers delivered to PLA Air Force," *China.org.cn*, June 22, 2013. http://www.china.org.cn/china/2013-06/22/content_29197824.htm.
- ¹⁶ U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013*, pp. 33, 42, 81.
- ¹⁷ Ian Easton, *The Assassin Under the Radar: China's DF-10 Cruise Missile Program* (Arlington, VA: The Project 2049 Institute, October 2009), pp. 1-6. http://project2049.net/documents/assassin_under_radar_china_cruise_missile.pdf.
- ¹⁸ Keck, "Can China's New Strategic Bomber Reach Hawaii?"
- ¹⁹ Andrea Shalal-Esa, "RPT-China's space activities raising U.S. satellite security concerns," Reuters, January 14, 2013. <http://www.reuters.com/article/2013/01/14/china-usa-satellites-idUSL2N0AJ10620130114>; Central News Agency (Taipei), "Beijing to Trigger Arms Race by Testing Anti-satellite Missiles," January 13, 2013, OSC ID: CPP20130115968204. <http://www.opensource.gov>; Gregory Kulacki, "Is January Chinese ASAT Testing Month?" *All Things Nuclear, Insights on Science and Security*, January 4, 2013. <http://allthingsnuclear.org/is-january-chinese-asat-testing-month/>; U.S. Department of Defense, *China: PLA Activities Report 16-31 Oct 2012* (Washington, DC: October 31, 2012), OSC ID: CPP20121120440020. <http://www.opensource.gov>; Xinhua, "China Dismisses Report on Planned Test Launch of Anti-Satellite Missile," October 25, 2012, OSC ID: CPP20121025968325. <http://www.opensource.gov>; and Bill Gertz, "China to Shoot at High Frontier," *Washington Free Beacon*, October 16, 2012. <http://freebeacon.com/china-to-shoot-at-high-frontier/>.
- ²⁰ Gregory Kulacki, "'Kuaizhou' Challenges U.S. Perceptions of Chinese Military Space Strategy," *All Things Nuclear, Insights on Science and Security*, September 27, 2013. <http://allthingsnuclear.org/kuaizhou-challenges-u-s-perceptions-of-chinese-military-space-strategy/>.
- ²¹ U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013*, pp. 35-36.
- ²² Bingqi Zhishi (Ordnance Knowledge), "'Beidou,' China's Pride," August 1, 2012, OSC ID: CPP20121016680010. <http://www.opensource.gov>.
- ²³ Xinhua, "China Targeting Navigation System's Global Coverage by 2020," March 3, 2012. http://news.xinhuanet.com/english/sci/2013-03/03/c_132204892.htm.
- ²⁴ *Jiefangjun Bao* (PLA Daily), "Navy North Sea Fleet's New Smart Target Ship Emits Electromagnetic Jamming Against Missiles," August 04, 2013, OSC ID: CHO2013080530196614. <http://www.opensource.gov>; Yu Hu, "PLA Jinan MR Extends Military Use of the Beidou Satellite Navigation System," *Jinan Qianwei Bao* (Jinan Front News), January 17, 2012, OSC ID: CPP20130222667020. <http://www.opensource.gov>; and Sun Chao, Zhang Jun, and Wang Jun, "PLA Chengdu MR Sichuan Div Uses Satellite Navigation to Standardize Time," *Chengdu Zhanqi Bao* (Chengdu Battle Standard News), November 3, 2011, OSC ID: CPP20130223667002. <http://www.opensource.gov>.
- ²⁵ Bill Gertz, "China Conducts Another Mobile ICBM Test," *Washington Free Beacon*, August 14, 2013. <http://freebeacon.com/china-conducts-another-mobile-icbm-test/>.
- ²⁶ U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013*, 30; Bill Gertz, "Riding the Nuclear Rails," *Washington Free Beacon*, January 25, 2013. <http://freebeacon.com/riding-the-nuclear-rails/>.
- ²⁷ *Ibid.*, p. 36.
- ²⁸ Xinhua, "Facts Figures: China's 2013 Draft Budget Report," March 5, 2013, OSC ID: CPP20130305968101. <http://www.opensource.gov>; Bloomberg, "China Boosts Defense Spending as Military Modernizes Arsenal," March 5, 2013. <http://www.bloomberg.com/news/2013-03-05/china-boosts-defense-spending-as-military-modernizes-its-arsenal.html>.
- ²⁹ Luo Zheng, "Investment in Our National Defense Expenditure Mutually Conforms with National Security and Development Interests – Interview with Sun Huangtian, Deputy Director of PLA General Logistics Department, on 2013 National Defense Budget," *Jiefangjun Bao* (PLA Daily), March 6, 2013, OSC ID: CPP20130307088001. <http://www.opensource.gov>; Bloomberg, "China Boosts Defense Spending as Military Modernizes Arsenal," March 5, 2013. <http://www.bloomberg.com/news/2013-03-05/china-boosts-defense-spending-as-military-modernizes-its-arsenal.html>.
- ³⁰ Adam Liff and Andrew Erickson, "Demystifying China's Defence Spending: Less Mysterious in the Aggregate," *China Quarterly* (2013).
- ³¹ The Institute of International Strategic Studies, "China's defence spending: new questions," *Strategic Comments*, August 2, 2013. <http://www.iiss.org/en/publications/strategic%20comments/sections/2013-a8b5/china--39-s-defence-spending--new-questions-e625>.
- ³² U.S. Department of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2013*, p. 45.
- ³³ *Ibid.*, pp. 69-71.
- ³⁴ Shirley Kan, *U.S.-China Military Contacts: Issues for Congress* (Washington, DC: Congressional Research Service, July 25, 2013).
- ³⁵ Karen Parrish, "U.S.-China Military Ties Growing, Pacom Commander Says," U.S. Armed Forces Press Service, July 11, 2013. <http://www.defense.gov/news/newsarticle.aspx?id=120440>.

- ³⁶ Michelle Tan, "Army hosts China in first joint field exercise," *Army Times*, November 12, 2013. <http://www.armytimes.com/article/20131112/NEWS/311120006/Army-hosts-China-first-joint-field-exercise>.
- ³⁷ Caitlin Campbell and Craig Murray, *China Seeks a "New Type of Major-Country Relationship" with the United States* (Washington, DC: U.S.-China Economic and Security Review Commission, June 2013). http://origin.www.uscc.gov/sites/default/files/Research/China%20Seeks%20New%20Type%20of%20Major-Country%20Relationship%20with%20United%20States_Staff%20Research%20Backgroundder.pdf; Michael S. Chase, "China's Search for a 'New Type of Great Power Relationship,'" *Jamestown Foundation China Brief* 12:27 (September 7, 2012): 14. http://www.jamestown.org/uploads/media/cb_09_04.pdf.
- ³⁸ Larry M. Wortzel, *The Dragon Extends its Reach: Chinese Military Power Goes Global* (Washington, DC: Potomac Books, 2013), pp. 17, 41-41, 134, 145-148.
- ³⁹ Dan McWhorter, "APT1 Three Months Later – Significantly Impacted, Though Active & Rebuilding," M-union, May 21, 2013. <https://www.mandiant.com/blog/apt1-months-significantly-impacted-active-rebuilding/>; Richard Bejtlich (chief security officer at Mandiant), telephone interview with Commission staff, August 21, 2013.
- ⁴⁰ U.S. Department of Defense, *Directory of PRC Military Personalities* (Washington, DC: Defense Intelligence Agency, March 2013).
- ⁴¹ William C. Hannas, James Mulvenon, and Anna B. Puglisi, *Chinese Industrial Espionage: Technology Acquisition and Military Modernization*, (London and New York: Routledge, 2013), p. 226.
- ⁴² Ministry of Foreign Affairs (China), "2013 Nian 2 Yue 19 Ri Waijiaobu Fayanyen Honglei Zhuchi Lixing Jizhehui" (Ministry of Foreign Affairs Spokesperson Hong Lei Presides Over Regular Press Conference) (Beijing, China: February 19, 2013). http://www.fmprc.gov.cn/mfa_chn/yrbt_602243/t1014798.shtml.
- ⁴³ U.S.-China Economic and Security Review Commission, *2012 Report to Congress* (Washington, DC: U.S. Government Printing Office, November 2012), p. 166.
- ⁴⁴ Tom Simonite, "Chinese Hacking Team Caught Taking Over Decoy Water Plant," *MIT Technology Review*, August 2, 2013. <http://www.technologyreview.com/news/517786/chinese-hacking-team-caught-taking-over-decoy-water-plant/>.
- ⁴⁵ Wortzel, *The Dragon Extends its Reach: Chinese Military Power Goes Global*, p. 142.
- ⁴⁶ Ellen Nakashima, "Confidential Report Lists U.S. Weapons System Designs Compromised by Chinese Cyberspies," *Washington Post*, May 27, 2013. http://www.washingtonpost.com/world/national-security/confidential-report-lists-us-weapons-system-designs-compromised-by-chinese-cyberspies/2013/05/27/a42c3e1c-c2dd-11e2-8c3b-0b5e9247e8ca_story.html.
- ⁴⁷ *Ibid.*
- ⁴⁸ U.S. Congress, National Defense Authorization Act for Fiscal Year 2011 (Public Law 111-383), 111th Cong., 2nd sess., January 7, 2011. <http://www.gpo.gov/dsvs/pkg/PLAW-111/publ383/pdf/PLAW-111/publ383.pdf>
- ⁴⁹ Special Assistant to the DoD Chief Information Officer, Office of the Assistant Secretary of Defense for Legislative Affairs, e-mail interview with Commission staff, May 28, 2013.
- ⁵⁰ Leigh Ann Ragland et al., *Red Cloud Rising: Cloud Computing in China* (Vienna, VA: Defense Group Inc. for the U.S.-China Economic and Security Review Commission, September 2013), pp. 32-34. http://origin.www.uscc.gov/sites/default/files/Research/Red%20Cloud%20Rising_Cloud%20Computing%20in%20China.pdf.
- ⁵¹ *Ibid.*, p. 39.
- ⁵² *Ibid.*, p. 38.
- ⁵³ Josh Rogin, "NSA Chief: Cybercrime Constitutes the 'Greatest Transfer of Wealth in History'," *Foreign Policy*, July 9, 2012. http://thecable.foreignpolicy.com/posts/2012/07/09/nsa_chief_cybercrime_constitutes_the_greatest_transfer_of_wealth_in_history.
- ⁵⁴ Mike McConnell, Michael Chertoff, and William Lynn, "China's Cyber Thievery is a National Policy – And Must Be Challenged," *Wall Street Journal*, January 27, 2012. <http://online.wsj.com/article/SB10001424052970203718504577178832338032176.html>.
- ⁵⁵ The Commission on the Theft of Intellectual Property, *The IP Commission Report*, (Washington, DC: National Bureau of Asian Research, May 2013), 12. http://ipcommission.org/report/IP_Commission_Report_052213.pdf.
- ⁵⁶ U.S.-China Economic and Security Review Commission, *2012 Annual Report to Congress*, p. 156.
- ⁵⁷ The Commission on the Theft of American Intellectual Property, *The IP Commission Report*, p. 3, 18.
- ⁵⁸ Mandiant, *APT1: Exposing One of China's Cyber Espionage Units* (Alexandria, VA: February 2013), pp. 2, 3, 4, 9, 21-23. http://intelreport.mandiant.com/Mandiant_APT1_Report.pdf.
- ⁵⁹ Mandiant, *APT1: Exposing One of China's Cyber Espionage Units*, p. 9.
- ⁶⁰ U.S. Department of Justice, "Sinovel Corporation and Three Individuals Charged in Wisconsin with Theft of AMSC Trade Secrets" (Washington, DC: June 27, 2013). <http://www.justice.gov/opa/pr/2013/June/13-crm-730.html>.
- ⁶¹ Melanie Hart, "Criminal Charges Mark New Phase in Bellwether U.S.-China Intellectual Property Dispute" (Washington, DC: Center for American Progress, June 2013). <http://www.americanprogress.org/issues/china/news/2013/06/27/68339/criminal-charges-mark-new-phase-in-bellwether-u-s-china-intellectual-property-dispute/>.
- ⁶² *Ibid.*
- ⁶³ 50 U.S.C. § 1701: <http://uscode.house.gov/view.xhtml?path=/prelim@title50/chapter35&edition=prelim>.
- ⁶⁴ U.S. Department of Defense, *Sustaining U.S. Global Leadership: Priorities for 21st Century Leadership* (Washington, DC: January 2012). http://www.defense.gov/news/Defense_Strategic_Guidance.pdf.

⁶⁵ Jonathan Greenert, "Foreword," in *U.S. Navy Program Guide 2013* (Washington, DC: 2013).

<http://www.navy.mil/navydata/policy/seapower/npg13/top-npg13.pdf>.

⁶⁶ U.S. Navy, *U.S. Navy Program Guide 2013* (Washington, DC: 2013).

<http://www.navy.mil/navydata/policy/seapower/npg13/top-npg13.pdf>.

⁶⁷ U.S. Department of Defense, *Statement on Strategic Choices and Management Review*, Pentagon press briefing remarks by Secretary of Defense Chuck Hagel (Washington, DC: July 31, 2013).

<http://www.defense.gov/speeches/speech.aspx?speechid=1978>.

⁶⁸ House Committee on Armed Services, *Hearing on Planning for Sequestration in FY 2014 and Perspectives of the Military Services on the Strategic Choices and Management Review*, 113th Cong., 1st sess., September 18, 2013.

Larry M. Wortzel, Ph.D.

Larry Wortzel was reappointed by Speaker of the House John Boehner for a seventh two-year term expiring on December 31, 2014. Dr. Wortzel has served on the Commission since November 2001, was the Commission's Chairman for the 2006 and 2008 Report cycles, and served as Vice Chairman for the 2009 Report cycle.

A leading authority on China, Asia, national security, and military strategy, Commissioner Wortzel had a distinguished career in the U.S. Armed Forces. Following three years in the Marine Corps, Commissioner Wortzel enlisted in the U.S. Army in 1970. His first assignment with the Army Security Agency took him to Thailand, where he focused on Chinese military communications in Vietnam and Laos. Within three years, he had graduated from the Infantry Officer Candidate School and the Airborne and Ranger schools. After four years as an infantry officer, Commissioner Wortzel shifted to military intelligence. Commissioner Wortzel traveled regularly throughout Asia while serving in the U.S. Pacific Command from 1978 to 1982. The following year, he attended the National University of Singapore, where he studied advanced Chinese and traveled in China and Southeast Asia. He next worked for the Under Secretary of Defense for Policy, developing counterintelligence programs to protect emerging defense technologies from foreign espionage. Also, the Commissioner managed programs to gather foreign intelligence for the Army Intelligence and Security Command.

From 1988 to 1990, Commissioner Wortzel was the Assistant Army Attaché at the U.S. Embassy in Beijing, where he witnessed and reported on the Tiananmen Massacre. After assignments as an army strategist and managing army intelligence officers, he returned to China in 1995 as the army attaché. In December 1997, Commissioner Wortzel became a faculty member of the U.S. Army War College, serving as the Director of the Strategic Studies Institute. He retired from the army as a colonel.

After his military retirement, Commissioner Wortzel served as the director of the Asian Studies Center and vice president for foreign policy at The Heritage Foundation from 1999 to 2006. Commissioner Wortzel's books include *Class in China: Stratification in a Classless Society*; *China's Military Modernization: International Implications*; *The Chinese Armed Forces in the 21st Century*; and *Dictionary of Contemporary Chinese Military History*. His newest book, *The Dragon Extends its Reach: Chinese Military Power Goes Global*, was published by Potomac Books, Inc., in 2013.

A graduate of the Armed Forces Staff College and the U.S. Army War College, Commissioner Wortzel earned his Bachelor of Arts from Columbus College and his Master of Arts and Ph.D. from the University of Hawaii. He and his wife live in Williamsburg, Virginia.

U.S.-China Economic and Security Review Commission**2013 Annual Report: China's Foreign Policy****Testimony of Carolyn Bartholomew****before the House of Representatives Armed Services Committee****November 20, 2013**

Chairman McKeon, Ranking Member Smith, members of the Committee, thank you for the opportunity to testify today. The Commission in 2013 continued its ongoing examination of China's foreign policy and its emergence as a global power. The Commission focused in particular on China's policies in the Middle East and North Africa; it also discussed China's evolving relationships with two of its neighbors, North Korea and India.⁸ Before I begin, I would like to remind the Committee that due to the dynamic nature of foreign affairs, some of the issues covered in the 2013 Annual Report have already seen developments that will not necessarily be captured in this testimony.

As China's global interests expand, Beijing is becoming increasingly assertive and active in its foreign affairs. This trend is apparent in the Middle East and North Africa, where China's ever-growing demand for energy imports has driven Beijing to pursue greater political and security involvement. Beijing's emergent influence in this part of the world has at times competed with or challenged U.S. strategic interests, particularly in Syria and Iran. As in other parts of the world, it remains to be seen whether China's stated interests in regional stability and peace will make a lasting, positive impact in the Middle East and North Africa. Given the United States' deep security interests in the region, China's developing role there presents geostrategic opportunities and challenges for U.S. diplomats, policymakers, and armed forces.

Similarly, China was newly assertive in its relations with India this year, which I discuss briefly below. And while China has recently taken steps to rein in North Korea after a series of provocative actions, it appears Beijing will continue to support the status quo on the Korean Peninsula. Given Pyongyang's aggressiveness toward the United States and its allies and its pursuit of weapons of mass destruction, this has significant implications for the United States.

China and the Middle East and North Africa (MENA)

In the past decade, China's trade and economic ties with MENA have grown substantially. Between 2003 and 2012, China-MENA annual trade increased more than twelvefold from \$20.8 billion to \$262.1 billion.¹ The region is an important export market for China, and in 2009, China overtook the United States to become the world's largest exporter to MENA.²

Energy security is the key driver of China's trade ties with MENA.³ In 2012 and the first eight months of 2013, the region accounted for about 54 percent of China's imported crude oil.⁴ Among the MENA producers, Saudi Arabia, Iran, Oman, and Iraq, respectively, exported the most oil to China in that period.⁵ Qatar and Yemen are China's third- and fifth-largest sources of liquefied natural gas (LNG), providing 18 percent and seven percent of China's LNG imports in 2011, respectively.⁶ China's reliance

⁸ For additional information, see the Commission's 2013 Annual Report to Congress, particularly "China and the Middle East and North Africa" (chapter 3, section 1), and "Military and Security Year in Review" (chapter 2, section 1).

on energy flows from the region likely will continue to grow significantly.⁷ By 2035, China's oil imports from the region are estimated to reach 6.7 million barrels per day, up from 2.9 million barrels per day in 2011.⁸ In addition to imports, China's national oil companies (the state-owned "national champions" of China's energy sector) have invested heavily in energy companies and projects throughout the region.

China's burgeoning energy ties with Iraq are illustrative of the robust China-MENA energy nexus. Between 2008 and 2012, the value of Iraqi crude oil exports to China increased by almost 870 percent.⁹ Moreover, China is the largest foreign investor in Iraqi oilfields.¹⁰ China National Petroleum Corporation (CNPC), a Chinese national oil company, and British Petroleum are jointly developing Iraq's Rumaila field, which accounted for one-third of Iraqi oil production in 2012.¹¹ That year, Rumaila was CNPC's most productive overseas project and accounted for nearly half of the company's net overseas oil and gas production. CNPC is invested in two other Iraqi oilfields,¹² and its listed subsidiary PetroChina is in talks to become an investor in a \$50 billion Exxon Mobil-operated project to develop one of Iraq's largest oilfields, West Qurna-1.¹³

As China almost certainly will become more dependent on energy flows from MENA, the Commission expects Beijing will increasingly augment its economic ties in the region with stronger political and security engagement in an effort to protect and enhance its energy security interests. The Commission also found that China, in an effort to protect its interests, may be more willing to challenge U.S. influence and policy objectives in MENA. Historically, China has avoided directly opposing U.S. power in the region, content to "free ride" on the U.S. security presence there. In recent years, however, Beijing appears increasingly willing to take positions on important regional issues that directly oppose or undermine U.S. interests and objectives.

This is clearly the case with Syria. Despite its emphasis on neutrality and peaceful resolution in public statements, China's position has protected the Assad regime and prevented necessary international measures to promote the peaceful resolution of the conflict. China repeatedly has used its veto power to prevent the UN Security Council (and other UN bodies) from singling out, blaming, or imposing sanctions on the Syrian government.¹⁴ * China, along with Russia, also has opposed any military action, even in support of humanitarian efforts, in Syria.¹⁵

Likely in response to widespread criticism of its Syria policy,[†] Beijing has in recent weeks and months sought to be perceived as less supportive of Assad and more helpful in bringing about a solution to the conflict. China has made occasional efforts to reach out to the Syrian opposition,¹⁶ has called for talks between the regime and the opposition in Geneva,¹⁷ and has supported efforts to eliminate chemical

* China has vetoed three UN Security Council resolutions to take action against President Assad and exercised three "no" votes to punish President Assad in the UN General Assembly and UN Human Rights Council. I-wei Jennifer Chang, "China's Evolving Stance on Syria," *Middle East Institute*, February 18, 2013. <http://www.themiddleeastinstitute.org/content/chinas-evolving-stance-syria>; United Nations General Assembly, "General Assembly Adopts Text Condemning Violence in Syria, Demanding that all Sides End Hostilities," (New York, NY: May 15, 2013). <http://www.un.org/News/Press/docs/2013/ga1372.doc.htm>.

† Then U.S. Ambassador to the UN Susan Rice in February 2012 said the United States was "disgusted" by China's (and Russia's) vetoes of otherwise unanimous UN Security Council resolutions on Syria and remarked that the UN's mission was being "held hostage" by China and Russia. Even the MENA countries, which generally hold favorable views of China, have issued harsh criticisms of Beijing's position. Luis Martinez, "US 'Disgusted' by China, Russia Veto of UN Resolution to End Violence in Syria," *ABC News*, February 4, 2012. <http://abcnews.go.com/blogs/politics/2012/02/us-disgusted-by-russia-china-veto-of-un-resolution-to-end-violence-in-syria/>; U.S.-China Economic and Security Review Commission, *Hearing on China and the Middle East*, written testimony of Dawn Murphy, June 6, 2013.

weapons from the country, contributing experts to the Organization for the Prohibition of Chemical Weapons to help verify and destroy chemical weapons.¹⁸

These recent efforts notwithstanding, China's fundamental position on the conflict has not changed. Despite the worsening humanitarian situation in Syria, China appears to judge that the benefits of continuing to shield and enable the Assad regime outweigh the potential costs of supporting international action to undermine the regime.

Another problematic element of China's MENA engagement is Beijing's continued ties with and support for Iran.¹⁹ The multiple facets of this relationship - including energy ties, arms and dual-use technology sales, and diplomatic support - have enabled Tehran's destabilizing policies and damaged U.S.-China relations and China's international reputation. However, Beijing appears to judge these consequences are worth the energy security benefits gained from continued cooperation with Iran.

Energy interests are a primary driver of the Sino-Iranian relationship. China is Iran's top crude oil customer, and about eight percent of China's oil imports (by volume) were from Iran in the period from January 2012 to August 2013.¹⁹ Iran was China's third-largest supplier of crude oil globally for much of the 2000s, but in 2012 and in the first eight months of 2013 Iranian exports to China dropped, likely due to U.S. sanctions on Iran's energy sector and a pricing dispute between Chinese oil trader Unipet and the National Iranian Oil Company in 2012.²⁰

Although China has calibrated its trade to levels it judges will keep Iran from becoming a flashpoint in U.S.-China relations, China has not halted its energy trade with Iran despite U.S. sanctions, probably because Beijing views steady access to oil as essential to its continued economic growth. Instead, Beijing maximizes its economic leverage over Tehran to secure advantageous oil trade deals, then seeks exemptions from or exploits loopholes in the sanctions to ensure steady access to energy.⁷ For example, China in 2013 apparently began to exploit a loophole in U.S. sanctions by dramatically increasing its fuel oil imports from Iran, which are not technically covered by U.S. sanctions. According to the *Wall Street Journal*, China in the first seven months of 2013 imported \$495 million worth of Iranian fuel oil, compared to \$1 million in 2012. While fuel oil is less valuable and more difficult to refine than crude oil,

¹⁸ Commission publications on China and Iran from 2011 to 2013 include Marybeth Davis et al., *China-Iran: A Limited Partnership* (Washington, DC: CENTRA Technology, Inc. for the U.S.-China Economic and Security Review Commission, April 2013). <http://origin.www.uscc.gov/sites/default/files/Research/China-Iran--A%20Limited%20Partnership.pdf>; U.S.-China Economic and Security Review Commission, *2012 Annual Report to Congress* (Washington, DC: U.S. Government Printing Office, 2012), pp. 334-336; and U.S.-China Economic and Security Review Commission, *2011 Annual Report to Congress* (Washington, DC: U.S. Government Printing Office, 2011), pp. 252-260.

¹⁹ Since January 2012, the U.S. Department of State has consistently exempted China on a biannual basis from sanctions on foreign countries importing crude oil from Iran because, although China had continued to import crude oil from Iran, the State Department judged China had "significantly reduced" those imports. The Department of State is scheduled to announce the next round of exemptions in December 2013. U.S.-China Economic and Security Review Commission, *2012 Annual Report to Congress* (Washington, DC: U.S. Government Printing Office, 2012), pp. 335-336; U.S.-China Economic and Security Review Commission, *Hearing on China and the Middle East*, written testimony of Erica Downs, June 6, 2013; Keith Johnson, "Beijing Gets a Pass on Iran Sanctions," *Wall Street Journal*, June 5, 2013; Gabe Collins, "Chinese Oil Traders Will be Big Winners From EU Oil Embargo Against Iran," *China Oil Trader* 5 (June 2012). <http://www.chinaoiltrader.com/?p=112>; and Marybeth Davis et al., *China-Iran: A Limited Partnership* (Washington, DC: CENTRA Technology, Inc. for the U.S.-China Economic and Security Review Commission, April 2013). <http://origin.www.uscc.gov/sites/default/files/Research/China-Iran--A%20Limited%20Partnership.pdf>.

Chinese oil companies appear to have imported large amounts at discounted rates from Iran, enabling China to partially compensate for its reduction in crude oil imports.^{21*}

Concerns persist about the role of China in proliferation of weapons to Iran. In the past, China sold tactical ballistic and antiship cruise missiles to Iran. More recently, open source reporting indicates China continues to provide support to Iran's advanced conventional weapons programs. A 2011 report by the U.S. Director of National Intelligence notes that "Chinese entities – including private and state-owned firms – continue to engage in weapons of mass destruction related proliferation activities ... Chinese entities continue to supply a variety of missile-related items to multiple customers, including Iran, Syria, and Pakistan."²² Since 2009, the United States has sanctioned six Chinese entities for missile or weapons proliferation to Iran.²³

China also assisted Iran in the development of its civilian – and perhaps military - nuclear program. Much of this assistance, including uranium enrichment, has military applications. While Beijing insists it has not provided assistance to Iran's nuclear program since 1997, open source reporting suggests that Chinese assistance continued to augment Iran's nuclear programs well into the 2000s.²⁴ As recently as this February, an Iranian company reportedly sought to transit 100,000 magnets through China to Iran for use in uranium enrichment centrifuges.²⁵

When Chinese companies have sold or attempted to sell arms or dual-use technologies to Iran, it is unclear whether the Chinese government directs, condones, is merely aware of, or is ignorant of continuing proliferation efforts. In any case, the Chinese government's enforcement of export controls appears insufficient.

On a related note, Beijing does not appear to judge Iran's nuclear program as a serious threat to Chinese economic or security interests or to security in MENA.²⁶ Joel Wuthnow, researcher at CNA China Studies, testified to the Commission, "Although some Chinese analysts accept the premise that an Iranian nuclear weapon might spark a regional arms race, few have publicly discussed whether and how such an outcome may damage Chinese interests."²⁷ However, as China's presence and influence in the region grows, Dr. Wuthnow suggested Middle Eastern countries and the United States may find opportunities to persuade China that Iran's behavior poses a risk to "regional security, and thus to China's own interests in Iran and the region."²⁸

In addition to its involvement in the Iranian energy and weapons manufacturing industries, China also likely supports Tehran in an effort to ensure the United States does not enjoy unchecked power and influence in the Middle East.²⁹ According to a report by CENTRA Technology, Inc. prepared for the Commission this year on Sino-Iranian relations, "China has used its relations with Iran to balance against U.S. interests and what it sees as hegemonic policies in the Middle East."³⁰

China's growing interest in MENA manifests in several other ways. First, China has participated in counterpiracy and peacekeeping operations in the region. Second, China has taken a heightened interest in the Middle East peace process, which Beijing views as central to stability and security in the region. Earlier this year, Chinese President Xi Jinping articulated a Chinese proposal for peace between the Israelis and Palestinians, demonstrating that China's top leaders have an interest in the resolution of the conflict. Beijing has yet to take on an active mediation role, however. Third, this year, the U.S.

* In July 2013, the U.S. House of Representatives passed H.R. 850 ("Nuclear Iran Prevention Act of 2013"), a bill that would, among other things, require countries to reduce their fuel oil as well as crude oil imports in order to qualify for the State Department's exemption from sanctions. Wayne Ma and Tennille Tracy, "Sanctions Gap Allows China to Import Iranian Oil," *Wall Street Journal*, August 21, 2013. <http://online.wsj.com/article/SB1000142412788732461950457902633611696094.html>.

departments of State and Defense and the Chinese Ministry of Foreign Affairs convened the first Middle East Dialogue as part of the annual U.S.-China Strategic and Economic Dialogue. Ideally, this new Dialogue will enable U.S. and Chinese policymakers find common interests in the region and facilitate cooperation in areas of mutual concern.

The Commission's research and hearing on China and MENA informs the following recommendations:

- Congress work with the departments of State, Commerce, and the Treasury to utilize the full range of incentives and disincentives to encourage China to reduce its ties with Iran, including exploring conditioning Chinese energy companies' future investments in the United States on limiting commercial ties with Iran.
- Congress urge the Department of State to elevate the U.S.-China Middle East Dialogue to include an annual meeting at the Cabinet level and to increase meetings at the undersecretary level from once to twice per year.
- Congress direct the Administration to provide a report to Congress on China's enforcement of its export controls, to include an assessment of the level of scrutiny the Chinese government applies to end users in transfers that are of proliferation concern.
- Congress consider the merits of including fuel oil purchases in the current sanctions regime prohibiting countries from purchasing crude oil from Iran.
- Congress support efforts by the Department of Defense to strengthen cooperation with China on counterpiracy in the Gulf of Aden and elsewhere.

China and North Korea

As the Commission discussed in its previous reports, China for decades has provided North Korea with economic and political support and shielded Pyongyang from harsh punishment by the international community for its destabilizing rhetoric and activities.³¹ While Beijing appeared increasingly dissatisfied with Pyongyang after a series of North Korean provocations in the past year (including its December 2012 long-range rocket launch and February 2013 nuclear test), the Commission assesses Beijing is not likely to significantly alter its North Korea strategy and will continue to offer economic and political incentives for Pyongyang to refrain from major provocations and engage in multilateral diplomacy.³²

The most notable development in China's North Korea policy this year was the Chinese government's September release of a new 236-page list of technologies and materials to be banned from export to North Korea.³² The list focuses on dual-use items that could be used to produce weapons of mass destruction or ballistic missiles. However, according to the Nautilus Institute, "nothing indicates that by issuing tighter controls, China is fundamentally changing its policy toward North Korea, let alone abandoning it ... The degree to which China enforces the prohibition of trade in items on this list will mostly determine the success of the program."³³

³¹ Other analysts, however, suggest China's policy toward North Korea might be undergoing a subtle shift. These analysts cite Beijing's stronger and higher-level public signals of its frustration with Pyongyang. Chinese President Xi Jinping himself appeared to indirectly criticize North Korea in an April speech when he said, "No one should be allowed to throw a region and even the whole world into chaos for selfish gains." William Wan, "Chinese President Xi Jinping expresses concern over North Korea's rhetoric," *Washington Post*, April 7, 2013. http://articles.washingtonpost.com/2013-04-07/world/38354043_1_south-china-sea-schumer-united-nations:

China and India

Sino-Indian tensions flared in early 2013, underlining the simmering mutual distrust that continues to plague the relationship, particularly regarding the contested border. In April, New Delhi claimed a contingent of 30 to 50 People's Liberation Army (PLA) soldiers crossed the China-India border about 12 miles beyond the Line of Actual Control[†] and stayed there for three weeks.[‡] Beijing denied Chinese troops had crossed into Indian territory.

Beijing and New Delhi resolved the border impasse in May after a series of talks and agreed to develop a formal mechanism to build trust and confidence between the border troops. The agreement was signed during the Indian prime minister's trip to China in October 2013.³⁴

Nevertheless, the potential for periodic low-level confrontations between border patrols to escalate likely will persist. Indian media have reported several additional albeit briefer incursions by Chinese troops since the April standoff. Furthermore, both China and India continue to boost their militaries' capabilities on the border, adding to mutual suspicion. This has left both sides sensitive to each other's border activities and disposed toward worst-case perceptions of the other sides' intentions and activities. Ely Ratner and Alexander Sullivan of the Center for a New American Security warn: "More intense strategic competition between India and China would reverberate throughout the continent, exacerbating tensions in Central Asia, the Indian Ocean, and Southeast Asia. Disruptions to the Asian engine of economic growth caused by these tensions could debilitate the global economy."³⁵

Conclusion

In its ongoing examination of China's foreign policy, the Commission assesses that China increasingly is asserting itself on the global stage to protect more actively Beijing's interests. This trend is reflected in recent statements by China's top leaders. In late October, President Xi Jinping insisted that China "be more active in blueprinting diplomatic strategy and undertaking diplomatic work."³⁶ Chinese State Councilor Yang Jiechi, China's senior foreign policy official, in early November delivered a speech on China's foreign policy in which he remarked, "China's future and destiny are closely connected with those of the world ... Developments and changes at home and abroad have put forward new, higher requirements for China's diplomacy which now stands at a new historic starting point."³⁷

The impact of China gradually taking on a more assertive global role will be significant. In particular, Beijing may become more willing to use its increasing political and economic clout to more openly impose a higher cost on countries whose actions and policies challenge China's interests. This trend has significant implications for the United States, particularly if China's foreign policies undermine or challenge America's.

Thank you for the opportunity to testify. I look forward to your questions.

[†] The Line of Actual Control is the effective border between China and India. The 2,400 mile-long Line of Actual Control traverses the Aksai Chin, the northern part of the Sikkim State, and crosses the McMahon Line in Arunachal Pradesh State.

[‡] According to New Delhi, PLA soldiers frequently conduct border incursions (more than 600 times over the last three years) but do not usually cross more than a few miles over the Line of Actual Control nor stay there longer than several hours. *Economist*, "India and China: Parsnips Unbattered," May 25, 2013. <http://www.economist.com/news/asia/21578412-flowery-rhetoric-fails-hide-difficulties-bilateral-relationship-parasnips-unbattered>; Open Source Center, *Summary: India Protests PRC Troop 'Intrusion'* (Washington, DC: April 23, 2013). OSC ID: FEA20130423030877. <http://www.opensource.gov>.

- ¹ China National Bureau of Statistics, via CEIC Database. <http://www.ceicdata.com/en>.
- ² Al-Masrah Capital Limited, *China and India's Growing Influence in the MENA Region: Their Legacy and Future Footprint* (Dubai, United Arab Emirates: April 2011), p. 4.
http://ae.zawya.com/researchreports/p_2010_07_22_09_20_27/20101219_p_2010_07_22_09_20_27_092416.pdf.
- ³ MergerMarket, *The New Silk Road: Investing in and venturing with Middle Eastern companies* (Hong Kong: Latham & Watkins, 2012), p. 8; Jon B. Alterman, *China's Balancing Act in the Gulf* (Washington, DC: Center for Strategic and International Studies, August 2013), pp. 1, 3, 4.
https://csis.org/files/publication/130821_Alterman_ChinaGulf_Web.pdf; Abdulaziz Sager, "GCC-China Relations: Looking Beyond Oil – Risks and Rewards," in *China's Growing Role in the Middle East* (Washington, DC: Nixon Center, 2010), p. 2; Zhao Hongtu, "China's Energy Interest and Security in the Middle East," in *China's Growing Role in the Middle East* (Washington, DC: Nixon Center, 2010), p. 58; and Dawn Murphy, *Rising Revisionist? China's Relations with the Middle East and Sub-Saharan Africa in the post-Cold War Era* (Washington, DC: George Washington University, 2012), pp. 103-108.
- ⁴ China National Bureau of Statistics, via CEIC Database. <http://www.ceicdata.com/en>.
- ⁵ China National Bureau of Statistics, via CEIC Database. <http://www.ceicdata.com/en>.
- ⁶ U.S. Energy Information Administration, "Analysis: China," April 22, 2013.
<http://www.eia.gov/countries/cab.cfm?fips=CH>.
- ⁷ International Energy Agency, "World Energy Outlook 2012: Presentation to the Press" (London, United Kingdom: November 12, 2012), slide 6. <http://www.slideshare.net/internationalenergyagency/world-energy-outlook-2012-presentation-to-press>; Christopher Johnson, "China oil imports to take over U.S. by 2017: WoodMac," Reuters, August 20, 2013. <http://www.reuters.com/article/2013/08/20/us-china-oil-idUSBRE97J0BB20130820>.
- ⁸ U.S.-China Economic and Security Review Commission, *Hearing on China and the Middle East*, written testimony of Erica Downs, June 6, 2013.
- ⁹ China National Bureau of Statistics, via CEIC Database. <http://www.ceicdata.com/en>.
- ¹⁰ Charlie Zhu and Peg Mackey, "UPDATE 1 – China, Indonesia to join Exxon at giant Iraq oilfield," Reuters, August 22, 2013. <http://www.reuters.com/article/2013/08/22/petrochina-iraq-idUSL4N0GN29G20130822>.
- ¹¹ U.S.-China Economic and Security Review Commission, *Hearing on China and the Middle East*, written testimony of Erica Downs, June 6, 2013.
- ¹² U.S.-China Economic and Security Review Commission, *Hearing on China and the Middle East*, written testimony of Erica Downs, June 6, 2013.
- ¹³ Charlie Zhu and Peg Mackey, "UPDATE 1 – China, Indonesia to join Exxon at giant Iraq oilfield," Reuters, August 22, 2013. <http://www.reuters.com/article/2013/08/22/petrochina-iraq-idUSL4N0GN29G20130822>.
- ¹⁴ Michael Swaine, "Chinese Views of the Syrian Conflict," *China Leadership Monitor* 39 (Fall 2012): 3.
http://carnegieendowment.org/files/Swaine_CLM_39_091312_2.pdf.
- ¹⁵ Michael Swaine, "Chinese Views of the Syrian Conflict," *China Leadership Monitor* 39 (Fall 2012): 2.
http://carnegieendowment.org/files/Swaine_CLM_39_091312_2.pdf.
- ¹⁶ Joel Wuthnow, "China as a Swing State on Syria," *US-China Focus*, October 8, 2013.
<http://www.chinafocus.com/peace-security/china-as-a-swing-state-on-syria/>.
- ¹⁷ Xinhua, "China calls for early peace conference on Syria," November 5, 2013.
http://www.china.org.cn/world/syria_situation/2013-11/05/content_30499472.htm.
- ¹⁸ Xinhua, "Chinese experts to join Syria weapons mission," November 4, 2013.
<http://english.people.com.cn/90786/8445516.html>.
- ¹⁹ China National Bureau of Statistics, via CEIC Database. <http://www.ceicdata.com/en>.
- ²⁰ Florence Tan, "Update 4—China Buys Russia, Vietnam oil as Iran supply cut," Reuters, January 3, 2012.
<http://www.reuters.com/article/2012/01/03/russia-crude-china-idUSL3E8C31W120120103>; Erica Downs, "China-Gulf Energy Relations," in Bryce Wakefield and Susan L. Levenstein, eds., *China and the Persian Gulf: Implications for the United States* (Washington, DC: Woodrow Wilson International Center for Scholars, 2011), p. 68.
http://www.wilsoncenter.org/sites/default/files/ASIA%20Program_China%20and%20the%20PG.pdf.
- ²¹ Wayne Ma and Tennille Tracy, "Sanctions Gap Allows China to Import Iranian Oil," *Wall Street Journal*, August 21, 2013. <http://online.wsj.com/article/SB1000142412788732461950457902633611696094.html>.
- ²² James R. Clapper, *Unclassified Statement for the Record on the Worldwide Threat Assessment of the U.S. Intelligence Community for the Senate Select Committee on Intelligence*, January 31, 2012.
<http://www.intelligence.senate.gov/120131/clapper.pdf>.

- ²³ Shirley A. Kan, *China and Proliferation of Weapons of Mass Destruction and Missiles: Issues for Congress* (Washington, DC: Congressional Research Service, March 2013), pp. 18-19, 69-70.
<http://www.fas.org/spp/crs/nuke/RL313555.pdf>.
- ²⁴ Shirley A. Kan, *China and Proliferation of Weapons of Mass Destruction and Missiles: Issues for Congress* (Washington, DC: Congressional Research Service, March 2013), p. 7.
<http://www.fas.org/spp/crs/nuke/RL313555.pdf>.
- ²⁵ Agence France-Presse, "Iran Using China to Smuggle Nuclear Material? David Albright's ISIS Report Raises Concerns," February 14, 2013. http://www.huffingtonpost.com/2013/02/14/iran-china-nuclear-smuggling_n_2689266.html?utm_hp_ref=world.
- ²⁶ U.S.-China Economic and Security Review Commission, *Hearing on China and the Middle East*, written testimony of Joel Wuthnow, June 6, 2013.
- ²⁷ U.S.-China Economic and Security Review Commission, *Hearing on China and the Middle East*, written testimony of Joel Wuthnow, June 6, 2013.
- ²⁸ U.S.-China Economic and Security Review Commission, *Hearing on China and the Middle East*, written testimony of Joel Wuthnow, June 6, 2013.
- ²⁹ Scott Harold and Alireza Nader, *China and Iran: Economic, Political, and Military Relations* (Santa Monica, CA: RAND Corporation, 2012), p. 2.
http://www.rand.org/content/dam/rand/pubs/occasional_papers/2012/RAND_OP351.pdf; Marybeth Davis et al., *China-Iran: A Limited Partnership* (Washington, DC: CENTRA Technology, Inc. for the U.S.-China Economic and Security Review Commission, April 2013), pp. 7, 33. <http://origin.www.uscc.gov/sites/default/files/Research/China-Iran--A%20Limited%20Partnership.pdf>.
- ³⁰ Marybeth Davis et al., *China-Iran: A Limited Partnership* (Washington, DC: CENTRA Technology, Inc. for the U.S.-China Economic and Security Review Commission, April 2013), p. 7.
<http://origin.www.uscc.gov/sites/default/files/Research/China-Iran--A%20Limited%20Partnership.pdf>.
- ³¹ U.S.-China Economic and Security Review Commission, *2012 Annual Report to Congress* (Washington, DC: U.S. Government Printing Office, November 2012), p. 11.
- ³² Jane Perlez, "China Bans Items for Export to North Korea, Fearing Their Use in Weapons," *New York Times*, September 24, 2013. <http://www.nytimes.com/2013/09/25/world/asia/china-bans-certain-north-korean-exports-for-fear-of-weapons-use.html>.
- ³³ Roger Cavazos, Peter Hayes, and David von Hippel, "Technical Bulletin #59 on Prohibition of Dual Use Exports to North Korea," Nautilus Institute for Security and Sustainability, September 26, 2013.
<http://nautilus.org/napsnet/napsnet-special-reports/technical-bulletin-59-on-prohibition-of-dual-use-exports-to-north-korea/#axzz2h4TEY8ZL>.
- ³⁴ Vivek Raghuvanshi, "India Sends Draft Border Cooperation Agreement to China," *Defense News*, August 20, 2013. <http://www.defensenews.com/article/20130820/DEFREG03/308200026/India-Sends-Draft-Border-Cooperation-Agreement-China>.
- ³⁵ Ely Ratner and Alexander Sullivan, "The Most Dangerous Border in the World: Why is China picking a fight with India?" *Foreign Policy*, May 4, 2013.
http://www.foreignpolicy.com/articles/2013/05/03/china_india_most_dangerous_border?page=0.0.
- ³⁶ Xinhua, "Xi Jinping: China to further relations with neighboring countries," October 26, 2013.
http://news.xinhuanet.com/english/china/2013-10/26/c_125601680.htm?utm_source=The+Sinocism+China+Newsletter&utm_campaign=abc8d0f38e-Sinocism10_28_13&utm_medium=email&utm_term=0_171f237867-abc8d0f38e-24564729.
- ³⁷ Yang Jiechi, "China's Diplomacy at a New Historic Starting Point," 21st Century Council Beijing Conference, Beijing, China, November 2, 2013. <http://np.china-embassy.org/eng/zgwjt1095554.htm>.

Carolyn Bartholomew

Carolyn Bartholomew was reappointed to the Commission by House Democratic Leader Nancy Pelosi for a sixth two-year term expiring on December 31, 2013. She previously served as the Commission's Chairman for the 2007 and 2009 Report cycles and served as Vice Chairman for the 2010, 2008, and 2006 Report cycles.

Commissioner Bartholomew has worked at senior levels in the U.S. Congress, serving as counsel, legislative director, and chief of staff to now House Democratic Leader Nancy Pelosi. She was a professional staff member on the House Permanent Select Committee on Intelligence and also served as a legislative assistant to then U.S. Representative Bill Richardson.

In these positions, Commissioner Bartholomew was integrally involved in developing U.S. policies on international affairs and security matters. She has particular expertise in U.S.-China relations, including issues related to trade, human rights, and the proliferation of weapons of mass destruction. Ms. Bartholomew led efforts in the establishment and funding of global AIDS programs and the promotion of human rights and democratization in countries around the world. She was a member of the first Presidential Delegation to Africa to Investigate the Impact of HIV/AIDS on Children and a member of the Council on Foreign Relations' Congressional Staff Roundtable on Asian Political and Security Issues.

In addition to U.S.-China relations, her areas of expertise include terrorism, trade, proliferation of weapons of mass destruction, human rights, U.S. foreign assistance programs, and international environmental issues. She is the Vice President for Development and Corporate Initiatives for the BlueGreen Alliance and also serves on the board of directors of the Kaiser Aluminum Corporation and the nonprofit organization Asia Catalyst. Commissioner Bartholomew received a Bachelor of Arts degree from the University of Minnesota, a Master of Arts in Anthropology from Duke University, and a Juris Doctorate from Georgetown University Law Center. She is a member of the State Bar of California