



**2013**

**REPORT TO CONGRESS**

*of the*

**U.S.-CHINA ECONOMIC AND  
SECURITY REVIEW COMMISSION**

**EXECUTIVE SUMMARY AND  
RECOMMENDATIONS**

**ONE HUNDRED THIRTEENTH CONGRESS  
FIRST SESSION**

**NOVEMBER 2013**

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U.S.-China Economic and Security Review Commission  
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The Commission’s full charter <http://www.uscc.gov/about/uscc-charter> and Statutory Mandate [http://www.uscc.gov/about/fact\\_sheet](http://www.uscc.gov/about/fact_sheet) are available via the World Wide Web.

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

NOVEMBER 13, 2013

The Honorable Patrick Leahy,

*President Pro Tempore of the U.S. Senate, Washington, DC 20510*

The Honorable John Boehner,

*Speaker of the U.S. House of Representatives, Washington, DC 20510*

DEAR SENATOR LEAHY AND SPEAKER BOEHNER:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to transmit the Commission's 2013 Annual Report to the Congress—the eleventh major Report presented to Congress by the Commission—pursuant to Public Law 106–398 (October 30, 2000), as amended by Public Law No. 109–108 (November 22, 2005). This report responds to the mandate for the Commission “to monitor, investigate, and report to Congress on the national security implications of the bilateral trade and economic relationship between the United States and the People’s Republic of China.” In this Report, the Commission reached a broad and bipartisan consensus, approving the Report by a vote of 11 ayes to 1 nay.

In accordance with our mandate, this Report, which is current as of November 13, includes detailed treatment of our investigations of the areas identified by Congress for our examination and recommendation. These areas are:

- **PROLIFERATION PRACTICES**—The role of the People’s Republic of China in the proliferation of weapons of mass destruction and other weapons (including dual-use technologies), including actions the United States might take to encourage the People’s Republic of China to cease such practices;
- **ECONOMIC TRANSFERS**—The qualitative and quantitative nature of the transfer of United States production activities to the People’s Republic of China, including the relocation of high technology, manufacturing, and research and development facilities, the impact of such transfers on United States national security, the adequacy of United States export control laws, and the effect of such transfers on United States economic security and employment;
- **ENERGY**—The effect of the large and growing economy of the People’s Republic of China on world energy supplies and the role the United States can play (including joint research and development efforts and technological assistance), in influencing the energy policy of the People’s Republic of China;
- **UNITED STATES CAPITAL MARKETS**—The extent of access to and use of United States capital markets by the People’s Republic of China, including whether or not existing disclosure and transparency rules are adequate to identify People’s Republic of China companies engaged in harmful activities;
- **REGIONAL ECONOMIC AND SECURITY IMPACTS**—The triangular economic and security relationship among the United States, [Taiwan] and the People’s Republic of China (including the military modernization and force deployments of the People’s Republic of China aimed at [Taiwan]), the national budget of the People’s Republic of China, and the fiscal strength of the People’s Republic of China in relation to internal instability in the People’s Republic of China and the likelihood of the externalization of problems arising from such internal instability;
- **UNITED STATES–CHINA BILATERAL PROGRAMS**—Science and technology programs, the degree of noncompliance by the People’s Republic of China with agreements between the United States and the People’s Republic of China on prison labor imports and intellectual property rights, and United States enforcement policies with respect to such agreements;

- **WORLD TRADE ORGANIZATION COMPLIANCE**—The compliance of the People’s Republic of China with its accession agreement to the World Trade Organization (WTO); and
- **FREEDOM OF EXPRESSION**—The implications of restrictions on speech and access to information in the People’s Republic of China for its relations with the United States in the areas of economic and security policy.

The Commission conducted its work through a comprehensive set of seven public hearings and one public roundtable, taking testimony from 57 witnesses from the executive branch, industry, academia, policy groups, and other experts. For each of its hearings, the Commission produced a transcript (posted on its Web site—*www.uscc.gov*). The Commission also received a number of briefings by officials of executive branch agencies, intelligence community agencies, and the armed services, including classified briefings on Chinese investment, China’s cyber operations, China’s foreign policy, and China’s navy. The Commission is preparing a classified report to Congress on these and other topics.

Commissioners also made an official delegation visit to Taiwan, Japan, China, and Hong Kong to hear and discuss perspectives on China and its global and regional activities. In these visits, the Commission delegations met with U.S. diplomats, host government officials, representatives of the U.S. and foreign business communities, and local experts.

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

The Report includes 41 recommendations for Congressional action. Our 10 most important recommendations are at the conclusion of the Executive Summary.

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

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

Yours truly,



William A. Reinsch  
*Chairman*



Dennis C. Shea  
*Vice Chairman*

# 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

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

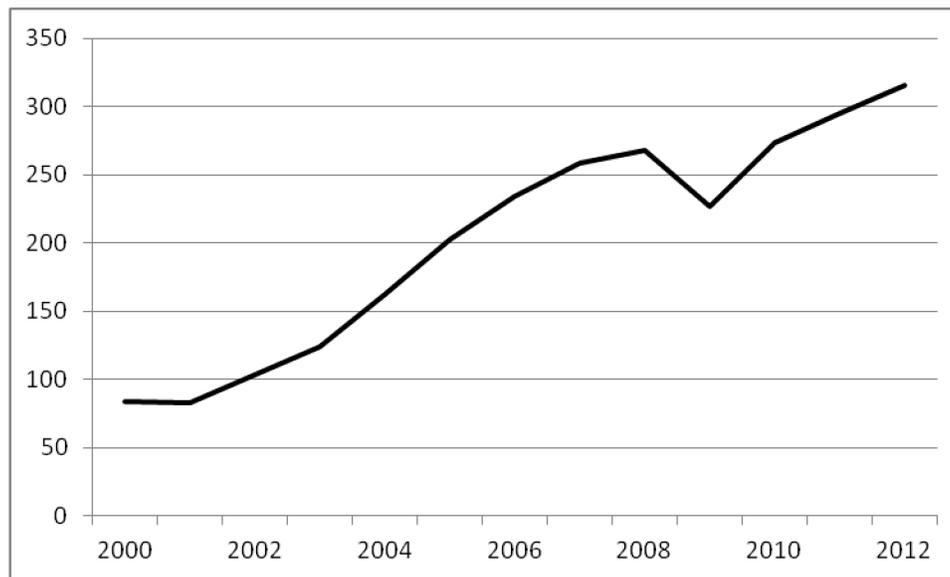
### *Trade and Economics Year in Review*

China's economy grew at a 7.6 percent annualized rate in the first half 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 a year. 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 automotive 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.

**Figure 1: U.S.-China Trade Deficit in Goods, 2000–2012**  
(US\$ billions)



Source: U.S. Bureau of Economic Analysis

China continues to intervene in the 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*

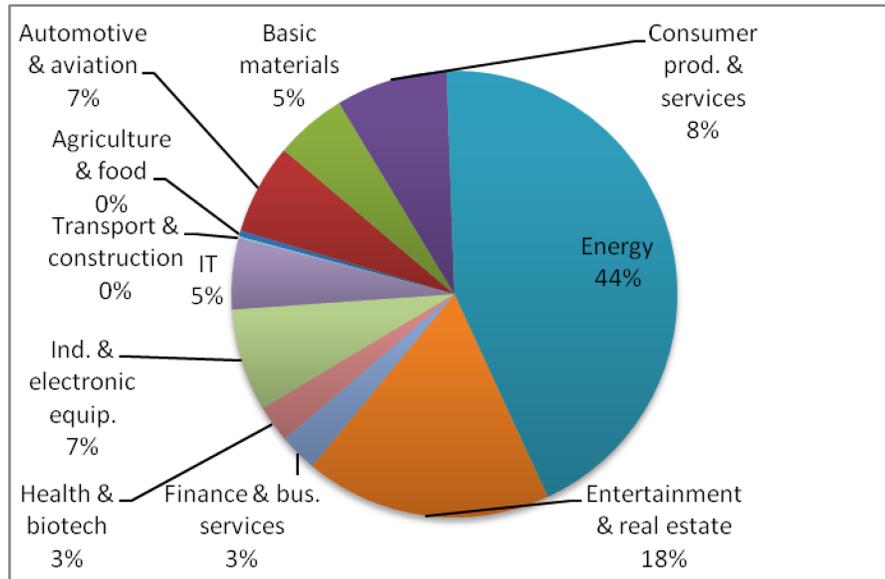
China has amassed the world's largest trove of dollar-denominated assets. Although the true composition of China's foreign exchange reserves, valued at \$3.66 trillion, is a state secret, outside observers estimate that about 70 percent is in dollars. In recent years, China has become less risk averse 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

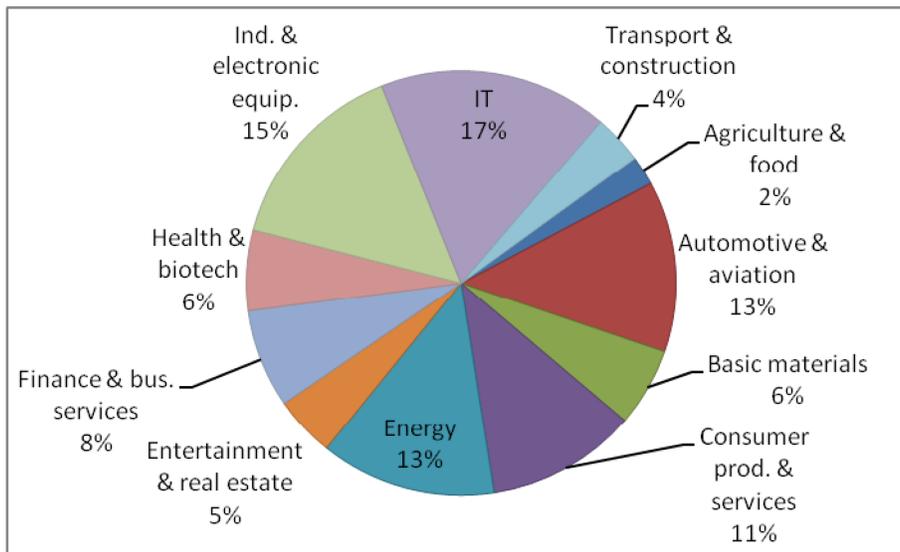
attracted \$174.7 billion of global FDI, of which only \$219 million came from China. Official estimates of Chinese FDI in the United States are too low, because they do not account for flows of FDI through Hong Kong and other offshore financial centers, among other things. Chinese FDI in the United States has emphasized services, energy, and technology and is notable for its focus on brand acquisition.

**Figure 2: Cumulative Chinese FDI in the United States, by Sector, 2000–2013Q2**  
(total deal value \$27.9 billion)



Source: Rhodium Group, *China Investment Monitor* (New York, NY: 2013)

**Figure 3: Cumulative Chinese FDI in the United States, by Sector, 2000–2013Q2**  
(670 deals total)



Source: Rhodium Group, *China Investment Monitor* (New York, NY: 2013)

State-owned enterprises (SOEs) have dominated Chinese FDI investment 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

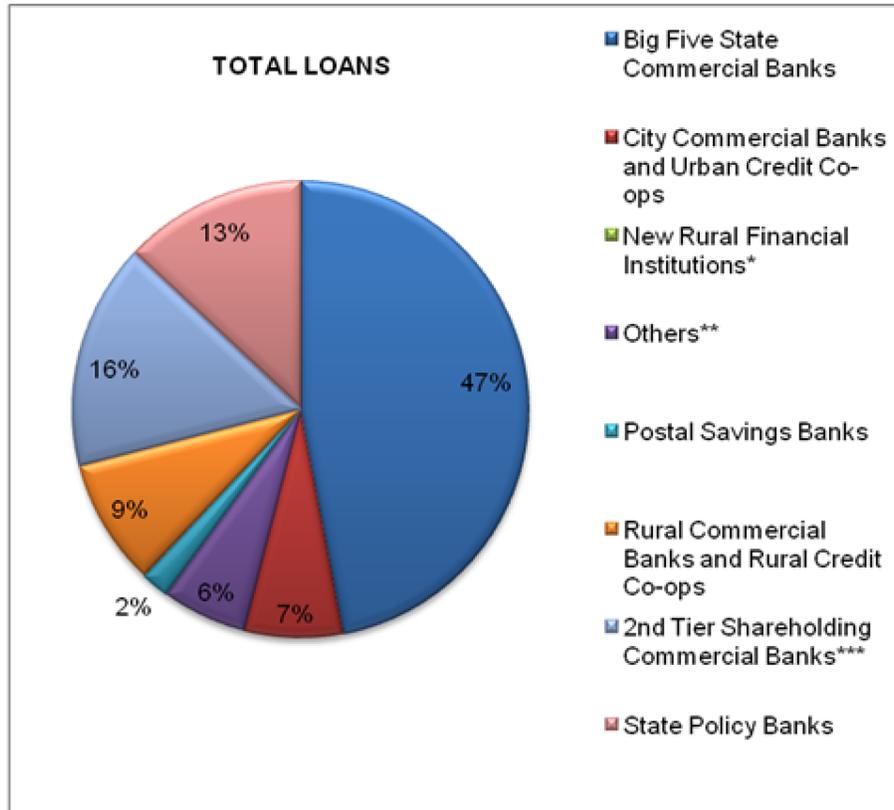
low cost of capital. Furthermore, SOEs investing in the United States may engage in particular predatory or anticompetitive behavior that U.S. trade remedies cannot address.

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.

**Figure 4: Chinese Financial Institutions by Size of Loans and Deposits, 2010**

\*New rural financial institutions include township and village banks, microcredit companies, and rural mutual aid funds (less than 0.5%).

\*\* Others consist of nonbank finance companies and overseas banks.

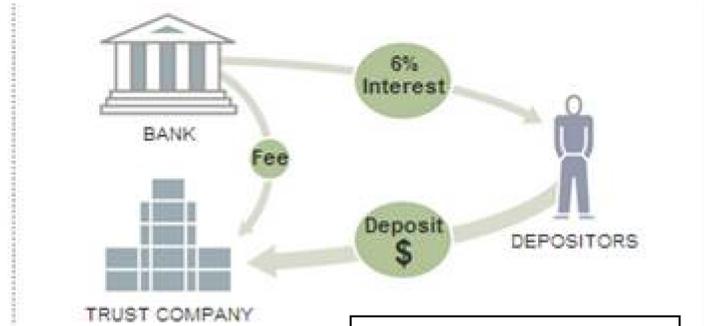
\*\*\* The government owns a majority of shares in most of the 2nd tier shareholding commercial banks.

Source: U.S.-China Economic and Security Review Commission, *Hearing on Corporate Accountability, Access to Credit, and Access to Markets in China's Financial System: Rules and their Ramifications for U.S. Investors*, written testimony of Lynette Ong, March 7, 2013.

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.

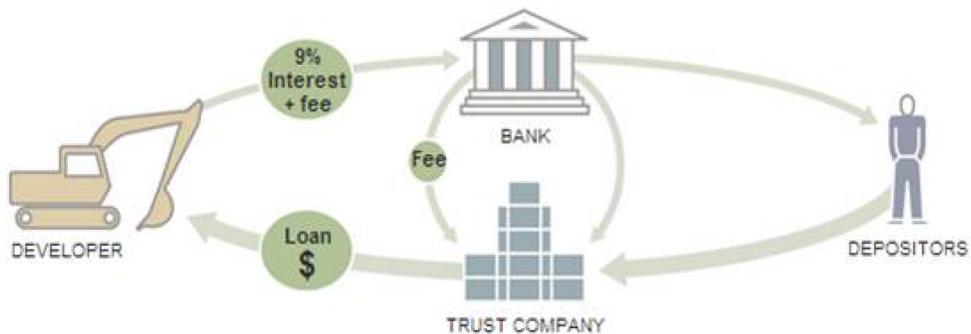
**Figure 5: Example of Off-Balance Sheet Lending By Chinese Banks**

**Step 1—**  
 Unsecured developer willing to pay high interest rate of 9% asks bank for loan.



**Step 3—**  
 Bank uses depositors' money to provide loan to developer via the trust company (off the books again). Developer pays 9% interest and large fee. Bank keeps fee and the 3% difference between the 9% interest paid by developer and 6% interest paid to depositors.

**Step 2—**  
 Bank seeks deposits to finance the loan by offering depositors a return of 6%, well above the 3.3% maximum officially permitted. To keep the transaction off of the bank's books, bank and trust company set up a wealth management product.



For a fee, both the deposits and the loan are held nominally on trust company's books.

Source: *The New York Times*, "Questionable Lending in China," July 1, 2013.

<http://www.nytimes.com/interactive/2013/07/02/business/Questionable-Lending-in-China.html>

As noted in the *The New York Times* article, this is but one example of how shadow banking might work.

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.

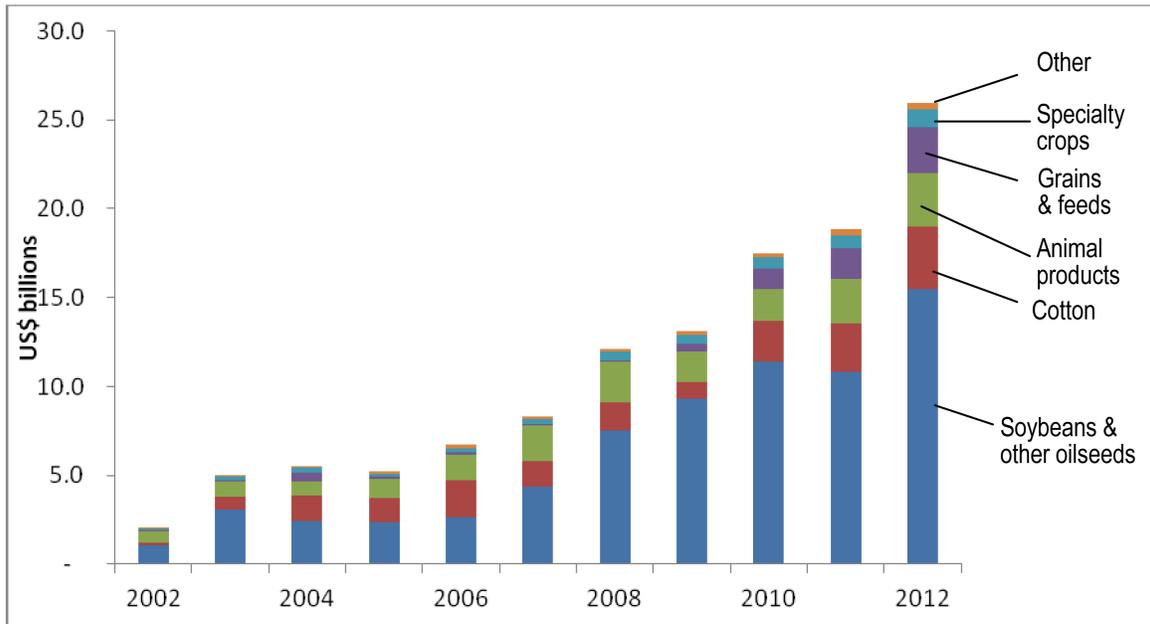
In May 2013, the United States and China announced a deal for limited information-sharing between their regulatory agencies when there are questions regarding audits of U.S.-listed Chinese companies. In July, Chinese regulators agreed to turn over certain requested documents of some listed Chinese companies 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.

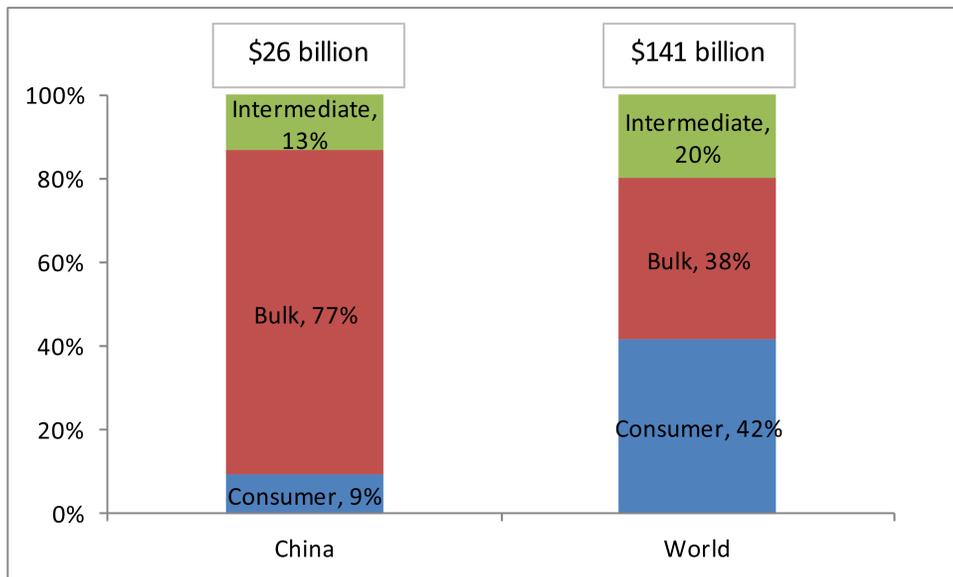
There remain serious problems within the U.S.-China bilateral agriculture trade relationship, however. Many in the U.S. agriculture industry lobbied Congress in 2000 to grant China permanent normal trade relations, because they expected China to become a major purchaser of U.S. food products once it 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 non-essential 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.

**Figure 6: Value and Composition of U.S. Agricultural Exports to China, 2002–2012**  
(US\$ billions)



Source: USDA (Washington, DC: Foreign Agricultural Service, 2013).

**Figure 7: Basic Composition of U.S. Agricultural Exports to China and to the World, 2012**  
Share (%)



Note: Under the USDA’s classification system, “bulk commodities” refer primarily to crops shipped in raw form, such as wheat, coarse grains, rice, soybeans, and cotton; “intermediate goods” refer to processed crops, such as flour, soybean meal, and feeds and fodders as well as products not directly for consumer use, such as live animals, planting seeds, hides and skins, and sweeteners; “consumer-oriented products” include, among others, meat and dairy products, fruits and vegetables, and snack foods.

Source: USDA (Washington, DC: Foreign Agricultural Service, 2013).

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. The deal, valued at \$7 billion, is the largest-ever acquisition of a U.S. company by a Chinese company. 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 Renminbi (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 six 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 Association of Southeast Asian Nations (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.

**Figure 8: Members of the 18th Central Military Commission**

<i>CMC Member</i>	<i>Position</i>
Xi Jinping	Chairman
General Fan Changlong *	Vice Chairman
General Xu Qiliang	Vice Chairman
General Chang Wanquan	Minister of National Defense
General Fang Fenghui*	General Staff Department Chief
General Zhang Yang*	General Political Department Director
General Zhao Keshi*	General Logistics Department Director
General Zhang Youxia*	General Armament Department Director
Admiral Wu Shengli	PLA Navy Commander
General Ma Xiaotian*	PLA Air Force Commander
General Wei Fenghe*	Second Artillery Corps Commander

CMC members are listed according to official protocol order. An asterisk indicates the officer is a new CMC member.

Source: Open Source Center, *OSC Graphic: Organizational Chart of China's Military Leadership 2013* (Washington, DC: May 22, 2013). OSC ID: CPF20130521017002. <http://www.opensource.gov>.

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", 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.

**Figure 9: PLA Navy Submarine Orders-of-Battle 1990–2020**

Type	1990	1995	2000	2005	2010	2015	2020
<b>Diesel Attack</b>	88	43	60	51	54	57-62	59-64
<b>Nuclear Attack</b>	4	5	5	6	6	6-8	6-9
<b>Nuclear Ballistic</b>	1	1	1	2	3	3-5	4-5
<b>Total</b>	<b>93</b>	<b>49</b>	<b>66</b>	<b>59</b>	<b>63</b>	<b>66-75</b>	<b>69-78</b>

*Sources:* Numbers from 1990 to 1995 are based on information from various editions of the International Institute for Strategic Studies’ *The Military Balance* series, reprinted in Anthony H. Cordesman et al., *Chinese Military Modernization and Force Development: A Western Perspective* (Washington, DC: Center for Strategic and International Studies, 2013), pp. 157–163. Numbers from 2000 to 2010 and projections for 2015 and 2020 were provided by the U.S. Office of Naval Intelligence. 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.

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.

**Figure 10: PLA Navy Surface Orders-of-Battle 1990–2020\***

Type	1990	1995	2000	2005	2010	2015	2020
<b>Aircraft Carriers</b>	0	0	0	0	0	1	1-2
<b>Destroyers</b>	19	18	21	21	25	28-32	30-34
<b>Frigates</b>	37	37	37	43	49	52-56	54-58
<b>Corvettes</b>	0	0	0	0	0	20-25	24-30
<b>Amphibious Ships</b>	58	50	60	43	55	53-55	50-55
<b>Coastal Patrol (Missile)</b>	215	217	100	51	85	85	85
<b>Total</b>	<b>329</b>	<b>322</b>	<b>218</b>	<b>158</b>	<b>214</b>	<b>239-254</b>	<b>244-264</b>

\*Totals do not include all types and sizes of surface ships, such as mine warfare and auxiliary ships.

*Sources:* Numbers from 1990 to 1995 are based on information from various editions of the International Institute for Strategic Studies' *The Military Balance* series, reprinted in Anthony H. Cordesman et al., *Chinese Military Modernization and Force Development: A Western Perspective* (Washington, D.C: Center for Strategic and International Studies, 2013), pp. 157–163. Numbers from 2000 to 2010 and projections for 2015 and 2020 were provided by the U.S. Office of Naval Intelligence. 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.

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

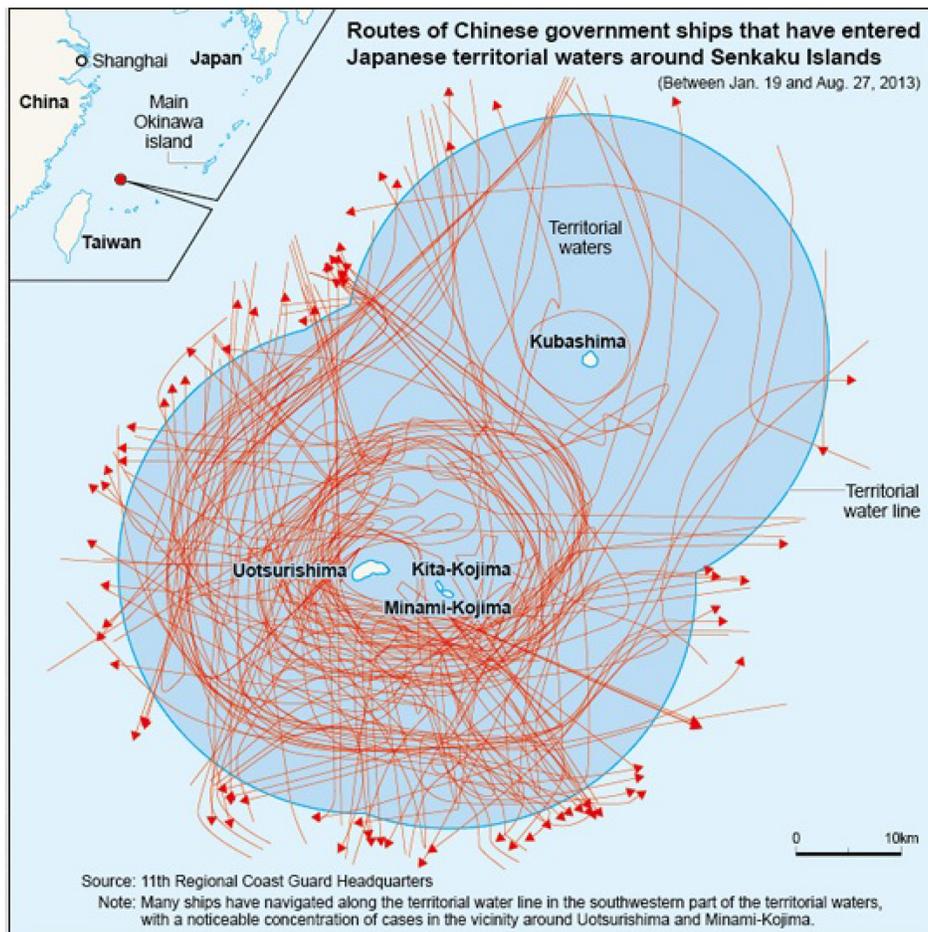
animosity between China and Japan and the strong nationalist sentiment on both sides regarding the sovereignty of the islands, the Senkaku Islands dispute is especially intense. The Japanese government's September 2012 purchase of three of the islands from a private Japanese owner angered China, sparking an escalation in tensions between China and Japan. PLA Navy and Chinese maritime law enforcement activity near the Senkaku Islands, previously 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.

**Figure 11: The East China Sea**



Source: Mark Manyin, *Senkaku (Diaoyu/Diaoyutai) Islands Dispute: U.S. Treaty Obligations* (Washington, DC: Congressional Research Service, January 2013).

**Figure 12: Routes of Chinese government ships near Senkaku Islands from January 19, 2013 to August 27, 2013**

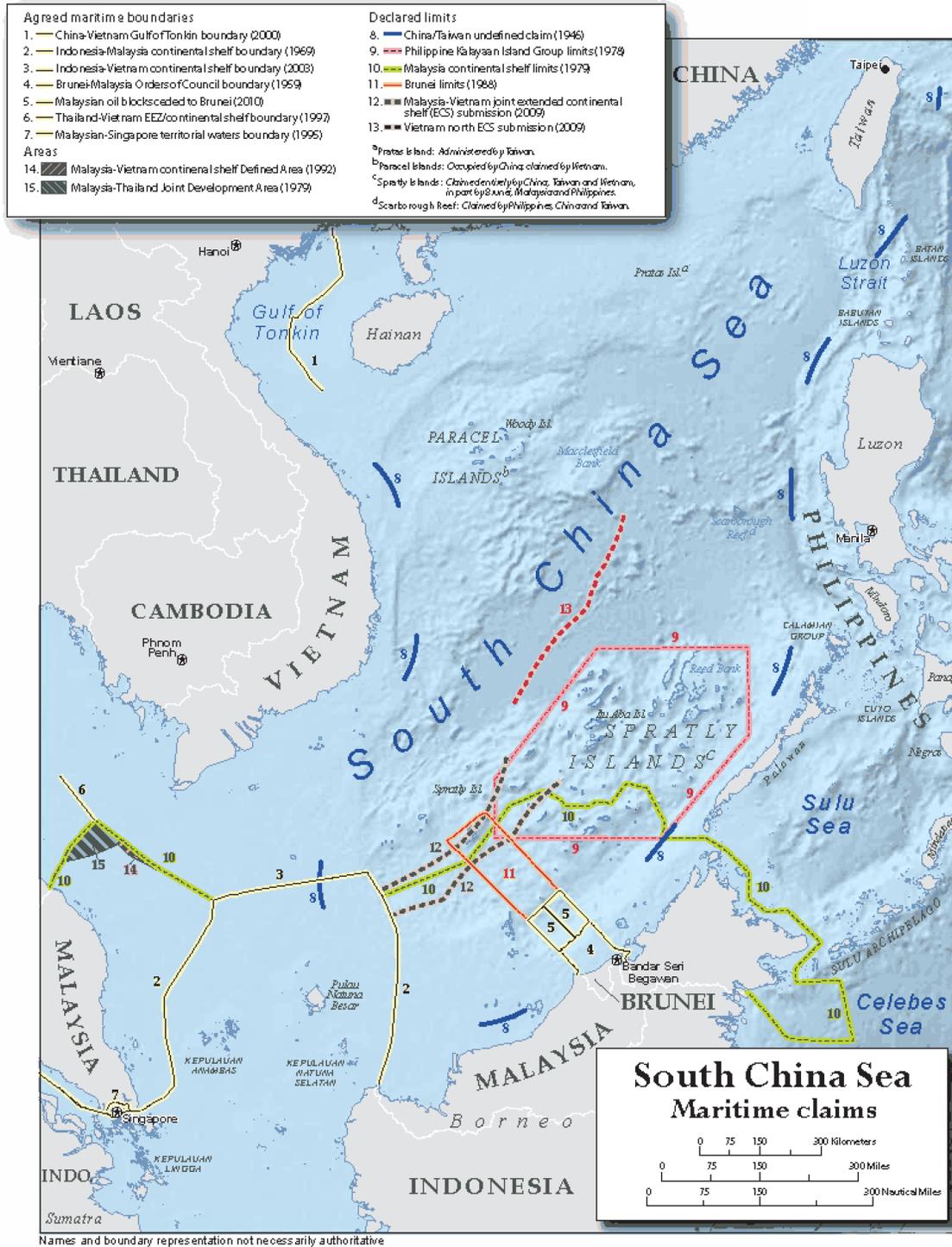


Source: *Asahi Shimbun* (Tokyo), "INSIGHT: Japan, China still far apart in mending ties 1 year after purchase of Senkakus," September 11, 2013. [http://ajw.asahi.com/article/behind\\_news/AJ201309110069](http://ajw.asahi.com/article/behind_news/AJ201309110069).

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.

**Figure 13: The South China Sea**



Source: U.S. State Department. From U.S. Energy Information Administration, *South China Sea* (Washington, DC: February 2013). <http://www.eia.gov/countries/regions-topics.cfm?fips=SCS>.

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 platform 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 policy-making 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**

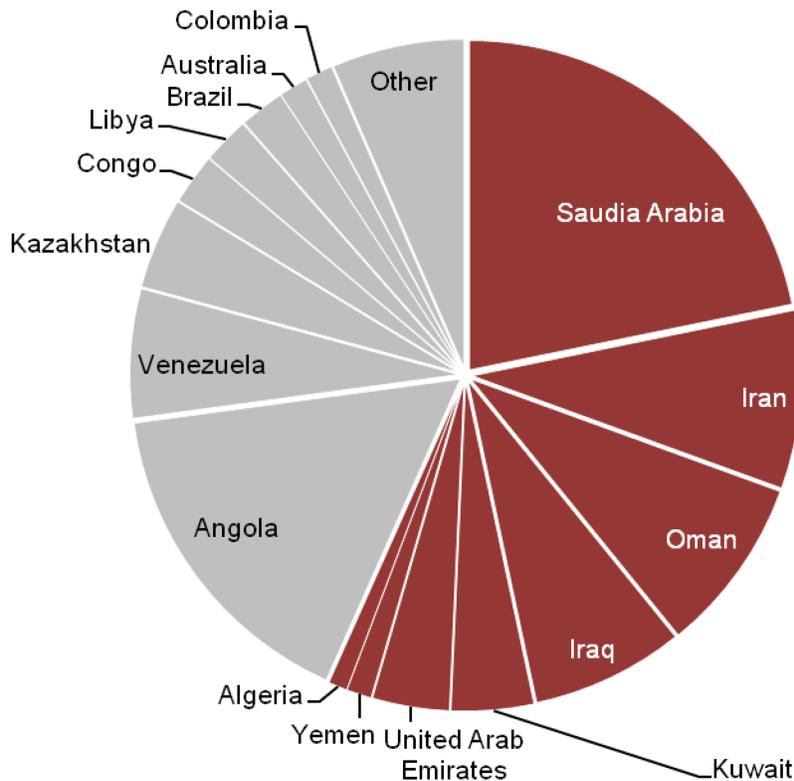
### *China and the Middle East and North Africa*

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 the region's largest oil producers, particularly Saudi Arabia and Iran, but also Iraq, Oman, and others.

**Figure 14: China's Crude Oil Imports by Volume, January 2012 to August 2013**  
(imports from MENA in red)



Source: China National Bureau of Statistics, via CEIC Database. <http://www.ceicdata.com/en>.

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.

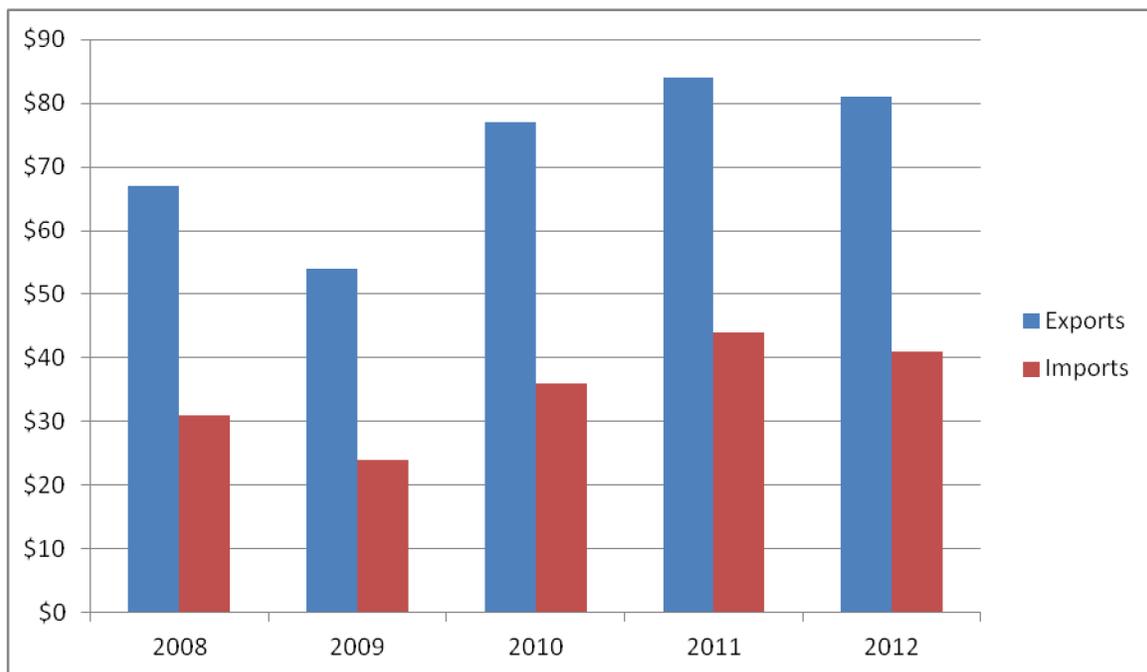
In addition, China has taken steps to promote stability within MENA. Offers of support for the Israeli-Palestinian peace process, counterpiracy operations in the Gulf of Aden, and participation in UN peacekeeping operations in MENA are among China's contributions to regional security and stability. However, 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.

**Figure 15: Taiwan's Trade with China, 2008–2012**  
(U.S. \$ billions)



Source: Bureau of Foreign Trade (Taiwan), "Trade Statistics." <http://cus93.trade.gov.tw/ENGLISH/FSCE/>.

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.

**Figure 16: Value of U.S. Arms Sales Notifications to Taiwan**

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
<b>Value of Arms Sales Notification (billion USD)</b>	1.082	1.521	0.775	1.776	0.280	-	3.717	6.463	-	6.392	5.852

Source: U.S.-Taiwan Business Council and Project 2049 Institute, *Chinese Reactions to Taiwan Arms Sales* (Arlington, VA: March, 2012), p. 38. [http://project2049.net/documents/2012\\_chinese\\_reactions\\_to\\_taiwan\\_arms\\_sales.pdf](http://project2049.net/documents/2012_chinese_reactions_to_taiwan_arms_sales.pdf).

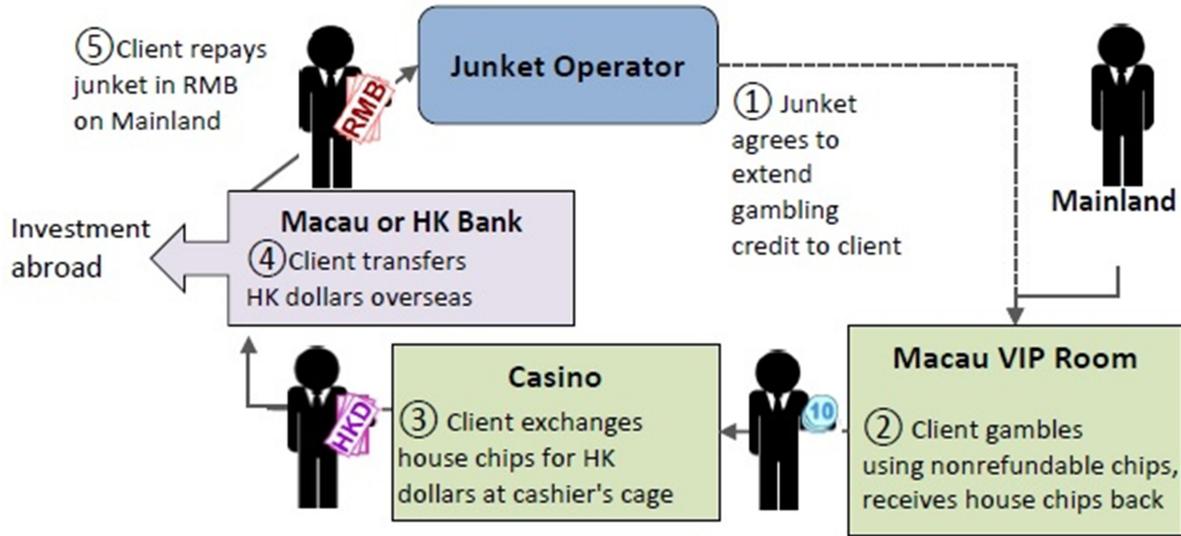
Despite warming cross-Strait ties, China continues to engage in aggressive espionage activities against Taiwan. Since September 2012, Taiwan has arrested at least six former or active Taiwan military officers, including one flag officer, for espionage. In one case, a former Taiwan Navy officer may have 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.

**Figure 17: Simplified Money Laundering Technique Using Junket/Casino System**

Source: U.S.-China Economic and Security Review Commission (Washington, DC).

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.

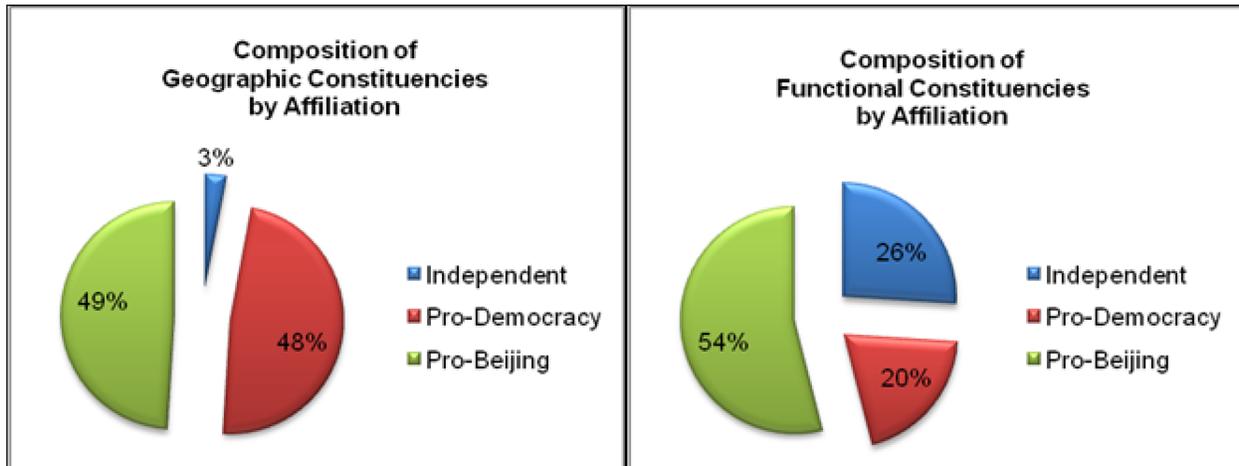
The PRC's capital controls have caused more money to cycle through Macau due to Macau's thriving VIP gaming industry, which relies on junket operators and their affiliates to facilitate cross-border money transfers for clients via underground banks. However, Beijing is beginning to take some measures 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.

**Figure 18: Pan-Democrat vs. Pro-Beijing Representatives in Legislative Council, 2012-2016**



Source: Chung-Kai Sin, “Political Elections, Parties and Reforms since 1984,” June 8, 2013.

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 accessing 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, 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 re-

quired 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.

## **ADDITIONAL RECOMMENDATIONS BY THE COMMISSION**

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

#### ***Section 3: Governance and Accountability in China’s Financial System***

##### **The Commission recommends:**

- 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.
- 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.
- Congress direct the Administration to assist the 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.

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

##### **The Commission recommends:**

- 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.
- 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.
- 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.
- 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.
- 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.

- 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 and Safety 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.
- 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.
- 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:**

- Congress adopt legislation clarifying the actions companies are permitted to take regarding tracking intellectual property stolen through cyber intrusions.
- Congress amend the Economic Espionage Act (18 U.S.C. §1831–1839) to permit a private right of action when trade secrets are stolen.
- 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.
- 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.
- 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.

### ***Section 3: China's Maritime Disputes***

#### **The Commission recommends:**

- 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.
- 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:**

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

### ***Section 2: Taiwan***

#### **The Commission recommends:**

- 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.
- Congress encourage the Administration to continue discussions between the United States and Taiwan concerning a bilateral investment agreement.
- 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:**

- Congress urge the State Department to negotiate with 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.
- Congress reconvene a congressional caucus on Hong Kong to ensure continuous attention to the region's democracy and civil rights issue.
- 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.
- Congress reaffirm its support for human rights and the rule of law in Hong Kong.
- Congress renew the biennial reporting requirements of the U.S.-Hong Kong Policy Act of 1992.