

# 2016 Report to Congress of the

# U.S.-China Economic and Security Review Commission



## Executive Summary and Recommendations

One Hundred Fourteenth Congress  
Second Session  
November 2016

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



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The Commission was created on October 30, 2000, by the Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Pub. L. No. 106–398, (Oct. 30, 2000) (codified at 22 U.S.C. § 7002 (2001)); as amended by the Treasury and General Government Appropriations Act for 2002 § 645 (regarding employment status of staff) & § 648 (regarding changing annual report due date from March to June), Pub. L. No. 107–67, (Nov. 12, 2001); as amended by Division P of the “Consolidated Appropriations Resolution, 2003,” Pub. L. No. 108–7 (Feb. 20, 2003) (regarding Commission name change, terms of Commissioners, and responsibilities of Commission); as amended by the Science, State, Justice, Commerce, and related agencies Appropriations Act of 2006, Pub. L. No. 109–108 (Nov. 22, 2005) (regarding responsibilities of Commission and applicability of FACA); as amended by Pub. L. No. 110–161 (Dec. 26, 2007) (regarding changes in annual report due date, submission of financial reports, printing and binding of Congressional reports, employee compensation and performance reviews, and applicability of House rules for travel by members and staff); as amended by the Carl Levin and Howard P. “Buck” McKeon National Defense Authorization Act for Fiscal Year 2015 § 1259b, Pub. L. No. 113–291 (Dec. 19, 2014) (regarding changes to matters for discussion in the annual reports of the Commission).

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 16, 2016

The Honorable Orrin G. Hatch  
President Pro Tempore of the U.S. Senate, Washington, DC 20510

The Honorable Paul D. Ryan  
Speaker of the U.S. House of Representatives, Washington, DC 20510

Dear Senator Hatch and Speaker Ryan:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to transmit the Commission's 2016 Annual Report to the Congress—the fourteenth 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); as amended by Public Law No. 110–161 (December 26, 2007); as amended by Public Law No. 113–291 (December 19, 2014). This Report responds to the mandate for the Commission “to monitor, investigate, and report to Congress on the national security implications of the bilateral trade and economic relationship between the United States and the People’s Republic of China.” The Commission reached a broad and bipartisan consensus, approving the Report by a vote of 11 ayes to 1 nay.

In accordance with our mandate, this Report, which is current as of October 7, includes detailed treatment of our investigations of the areas identified by Congress for our examination and recommendation. These areas are:

- The role of the People’s Republic of China in the proliferation of weapons of mass destruction and other weapon systems (including systems and technologies of a dual use nature), including actions the United States might take to encourage the People’s Republic of China to cease such practices.
- The qualitative and quantitative nature of the transfer of United States production activities to the People’s Republic of China, including the relocation of manufacturing, advanced technology and intellectual property, and research and development facilities, the impact of such transfers on the national security of the United States (including the dependence of the national security industrial base of the United States on imports from China), the economic security of the United States, and employment in the United States, and the adequacy of United States export control laws in relation to the People’s Republic of China;
- The effects of the need for energy and natural resources in the People’s Republic of China on the foreign and military policies of the People’s Republic of China, the impact of the large and growing economy of the People’s Republic of China on world energy and natural resource supplies, prices, and the environment, and the role the United States can play (including through joint research and development efforts and technological assistance) in influencing the energy and natural resource policies of the People’s Republic of China;
- Foreign investment by the United States in the People’s Republic of China and by the People’s Republic of China in the United States, including an assessment of its economic and security implications, the challenges to market access confronting potential United States investment in the People’s Republic of China, and foreign activities by financial institutions in the People’s Republic of China;
- The military plans, strategy and doctrine of the People’s Republic of China, the structure and organization of the People’s Republic of China military, the decision-making process of the People’s Republic of China military, the interaction between the civilian and military leadership in the People’s Republic of China, the development and promotion process for leaders in the People’s Republic of China military, deployments of the People’s Republic of China military, resources available to the People’s Republic of China military (including the development and execution of budgets and the allocation of funds), force modernization objectives and trends for the People’s Republic of China military, and the implications of such objectives and trends for the national security of the United States;

- The strategic economic and security implications of the cyber capabilities and operations of the People's Republic of China;
- The national budget, fiscal policy, monetary policy, capital controls, and currency management practices of the People's Republic of China, their impact on internal stability in the People's Republic of China, and their implications for the United States;
- The drivers, nature, and implications of the growing economic, technological, political, cultural, people-to-people, and security relations of the People's Republic of China's with other countries, regions, and international and regional entities (including multilateral organizations), including the relationship among the United States, Taiwan, and the People's Republic of China;
- The compliance of the People's Republic of China with its commitments to the World Trade Organization, other multilateral commitments, bilateral agreements signed with the United States, commitments made to bilateral science and technology programs, and any other commitments and agreements strategic to the United States (including agreements on intellectual property rights and prison labor imports), and United States enforcement policies with respect to such agreements; and
- 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 economic and security policy, as well as any potential impact of media control by the People's Republic of China on United States economic interests.
- The safety of food, drug, and other products imported from China, the measures used by the People's Republic of China Government and the United States Government to monitor and enforce product safety, and the role the United States can play (including through technical assistance) to improve product safety in the People's Republic of China.

The Commission conducted six public hearings, taking testimony from 52 witnesses that included industry, academia, think tanks and research institutions, and other experts. For each of these hearings, the Commission produced a transcript (posted on its website at [www.uscc.gov](http://www.uscc.gov)). The Commission received a number of briefings by executive branch agencies and the Intelligence Community, including classified briefings on China's industrial espionage activities, military reforms, aviation industry, and cyber activities. The Commission is preparing a classified report to Congress on these and other topics. The Commission also received briefs by foreign diplomatic and military officials as well as U.S. and foreign nongovernmental experts.

Commissioners made official delegation visits to Taiwan, China, and India to hear and discuss perspectives on China and its global and regional activities. In these visits, the Commission delegation met with U.S. diplomats, host government officials, business representatives, academics, journalists, and other experts.

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

The Report includes 20 recommendations for Congressional action, which appear on page 26 at the conclusion of the Executive Summary.

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

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

Yours truly,



**Dennis C. Shea**  
Chairman



**Carolyn Bartholomew**  
Vice Chairman

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# Introduction

This year marks the 15th anniversary of China's World Trade Organization (WTO) accession. While China's transformation has accelerated over the past decade and a half, its economic liberalization has fallen far short of global expectations. The reality of the U.S.-China economic relationship, too, has turned out to be much different than many had hoped. In 2015, the U.S. trade deficit with China was \$365.7 billion, the highest on record; in the first eight months of 2016, the deficit was \$225 billion. The cumulative U.S. trade deficit with China since it joined the WTO is a staggering \$3.5 trillion. As it protects its domestic industry from foreign competition, China continues to dump its massive overcapacity in U.S. and other global markets, materially damaging U.S. industries, including steel.

Some Western observers were optimistic when China announced its latest economic reform agenda in November 2013, viewing it as an overdue but welcome sign of commitment by the Chinese government to market reform. In the intervening years, however, it has become increasingly apparent that under the leadership of Chinese President and General Secretary of the Chinese Communist Party (CCP) Xi Jinping, China's domestic reform agenda is aimed at strengthening the hand of the state and maintaining CCP control—not promoting economic liberalization.

China continues to violate the spirit and the letter of its international obligations by pursuing import substitution policies, imposing forced technology transfers, engaging in cyber-enabled theft of intellectual property, and obstructing the free flow of information and commerce. China is also becoming a less welcoming market for foreign investors, with a host of restrictions and anticompetitive laws that proscribe foreign participation in broad swathes of the economy and promote domestic companies. At the same time, the extensive subsidization of and policy support for favored companies and sectors puts international competitors wishing to export to China at a distinct disadvantage. It has become all too apparent that the CCP has no intention of opening up what it considers key sectors of its economy to significant U.S. or foreign competition and control.

China's economic slowdown adds another dimension to the CCP's complicated economic calculus. In 2015, China's officially reported gross domestic product (GDP) growth rate fell to 6.9 percent, the lowest in 25 years. Far from allowing the market to determine optimal outcomes and letting weak firms go out of business, the government has been employing its previously used growth-boosting methods, including excessive emphasis on credit growth, support for state-owned enterprises, and infrastructure spending. While these measures help achieve short-term growth targets, they risk worsening resource misallocation, exacerbating ballooning local government debt, and jeopardizing long-term growth. The harmful effects of the slowdown extend beyond China's economy: these trends also negatively impact countries along the Asian and global supply chains. Censorship and repression are on the rise in China, with adverse consequences for the Chinese people, foreign companies, and foreign and domestic nongovernmental organizations.

Similarly, hopes that China would stick to its path of "peaceful development" and become a global power that upholds and strengthens the rules-based liberal world order have not been met. China's leaders have taken advantage of the existing international order when convenient and sought to rewrite the rules when it benefits them. This was starkly illustrated this year by an international tribunal's ruling that many of China's activities in the South China Sea are unlawful—and by China's obstinate rejection of the proceedings. On North Korea, although China signed on to the UN Security Council's strictest sanctions on Pyongyang to date, there are already indications that China does not intend to enforce them in a way that might deter Kim Jong-un from his increasingly dangerous behavior, illustrated by two nuclear tests and a dozen ballistic missile tests in 2016 alone. Closer to home, China has been employing new levers of coercion in Taiwan and Hong Kong in ways that infringe upon longstanding practices and agreements, and which threaten to erode autonomy and democratic values in both places.

China's willingness to reshape the economic, geopolitical, and security order to accommodate its interests are of great concern as China's global influence grows. This influence has been manifesting most recently with China's "One Belt, One Road" initiative aimed at connecting China with great portions of the rest of the world via a wide range of investments and infrastructure projects. Last year, the Commission tracked the initiative's impact in Central Asia. This year, as part of our examination of China's rise and South Asia, we considered its impact on some of the countries in that region. China's emergence as a major player in South Asia is affecting the geopolitics of the region, and is causing the region's traditional major power, India, to grow increasingly concerned about the prospect of Chinese encirclement.

Meanwhile, China's military modernization—fueled by a growing defense budget—continues to emphasize capabilities that are designed to challenge the United States and intimidate China's neighbors. For example, China's ability to conduct conventional strikes against U.S. regional facilities recently reached an inflection point with the fielding of new ballistic missiles capable of reaching Guam. The Chinese military's pursuit of force projection and expeditionary capabilities, while enabling it to provide public goods in the form of antipiracy, peacekeeping, and humanitarian assistance and disaster relief operations, will also strengthen China's traditional warfighting capabilities against its weaker neighbors, many of whom are U.S. allies or partners. These developments are underpinned by advancements in China's naval, air force, cyber, and space capabilities. In response to conflicting claims in the East and South

China seas, China has increased its military deployments there. Moreover, China's expanding intelligence collection capabilities, including in the cyber realm, have enabled many infiltrations of U.S. national security entities. The information China has extracted could strengthen its hand in a conflict with the United States.

China's actions in the economic, foreign policy, and military realms suggest China's leaders have decided the time has come for China to leave behind its long-held strategy, espoused by Deng Xiaoping, of "hide your strength, bide your time." China is showing itself to the world now, and the outcome is not what many had hoped for 15 years ago when the country was welcomed into the WTO and the global economic system. Our Report and recommendations reflect the China that is, not the China for which some have hoped.

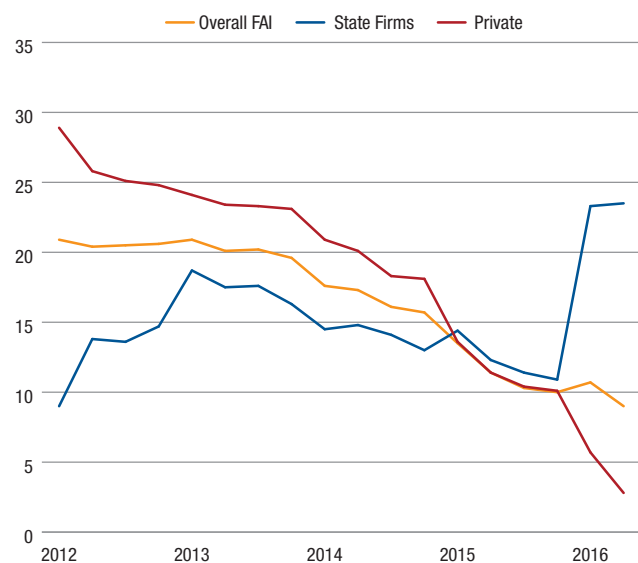
# Executive Summary

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

### SECTION 1: YEAR IN REVIEW: ECONOMICS AND TRADE

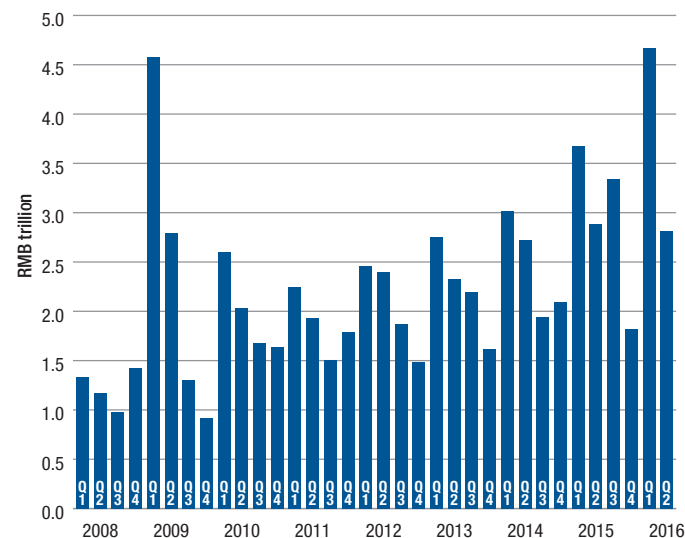
In the first half of 2016, China's gross domestic product (GDP) grew at 6.7 percent, according to official Chinese statistics. Facing a more pronounced slowdown in growth, Chinese policymakers leaned heavily on stimulus measures and infrastructure spending to boost the economy. In the first quarter of 2016, China's state-controlled banks released a record \$701 billion (renminbi [RMB] 4.7 trillion) of credit, rivaling the \$687 billion (RMB 4.6 trillion) released in 2009 during the global financial crisis. Government stimulus has largely accrued to the inefficient state sector while the private sector struggles to secure credit. In the first half of 2016, state sector investment grew by over 20 percent year-on-year, while private investment growth dropped to a record low of 2.8 percent. China's rapidly rising corporate debt—which stands at 169 percent of GDP—also raises questions about the sustainability of the country's economic growth. The International Monetary Fund warned in its annual review of China's economy that China's rising corporate debt was a “serious and growing problem that must be addressed immediately,” estimating the potential losses from bad corporate loans to be worth 7 percent of GDP.

**FIGURE 1: CHINA'S FIXED-ASSET INVESTMENT (% CHANGE YEAR-ON-YEAR, YEAR-TO-DATE)**



Source: China's National Bureau of Statistics via CEIC database.

**FIGURE 2: NEW LOANS ISSUED BY CHINESE BANKS, 2008–2016 Q2 (YEAR-ON-YEAR)**

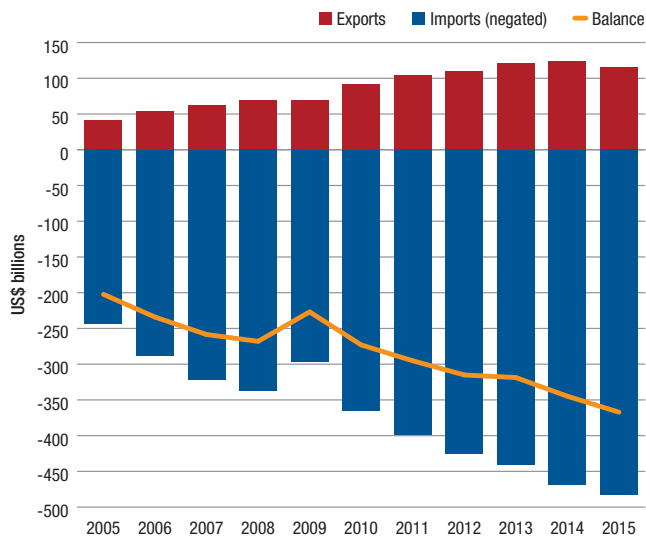


Source: The People's Bank of China via CEIC database.

Chinese leaders recognize these challenges, but have not yet taken steps to decisively address them. In 2016, Chinese President and General Secretary of the Chinese Communist Party (CCP) Xi Jinping made “supply-side structural reform” the dominant theme of economic policy. This concept includes cutting excess industrial capacity and housing inventories, deleveraging, and reducing business costs—reforms that increase economic efficiency, but leave the government firmly in charge. The central government has put the onus of implementing these broad policy planks on local governments.

Beijing's ongoing failure to uphold its World Trade Organization (WTO) commitments, ineffective efforts to cut industrial overcapacity, and unfair treatment of U.S. companies are straining the bilateral relationship. In 2015, the U.S. goods trade deficit with China increased by 6.5 percent year-on-year to \$367.2 billion, a new record; in the first eight months of 2016, the goods deficit was \$225 billion. U.S. companies are finding it increasingly difficult to operate in China, citing unclear laws and inconsistent regulatory enforcement, policies that favor domestic competitors, and industrial overcapacity. According to the American Chamber of Commerce in China's 2016 Business Climate Survey, more than three-fourths of surveyed U.S. companies reported they felt foreign businesses are less welcome in China than in years past. Meanwhile, Chinese investment in the United States is growing rapidly, driven by the Chinese government's “going out” strategy, a generally more open policy environment for outbound investment, and capital flight. The increased acquisition of U.S. assets by Chinese companies, which often receive state funding, has led to growing concern over the economic and national security implications of such acquisitions.

FIGURE 3: U.S.-CHINA GOODS TRADE, 2005–2015



Source: U.S. Census Bureau. <http://www.census.gov/foreign-trade/balance/c5700.html>.

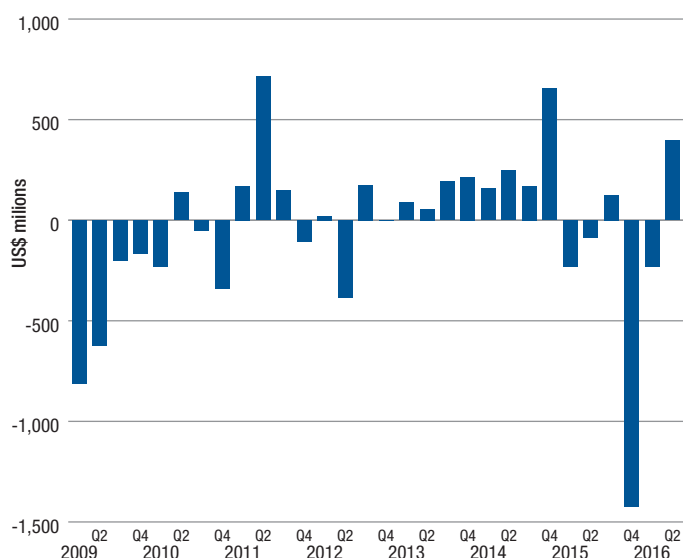
## Conclusions

- ▶ In 2015, the U.S. goods trade deficit with China increased by 6.5 percent year-on-year to \$367.2 billion, a new record. Over the same period, the U.S. deficit with China in advanced technology products reached \$120.7 billion, a decrease of \$3 billion from 2014. In the first eight months of 2016, the U.S. goods deficit with China fell 5.7 percent year-on-year to \$225.2 billion due to weaker imports. The United States has a substantial but much smaller trade surplus with China in services: in 2015, the U.S. trade surplus in services with China totaled \$29.5 billion. China continues to stall on liberalizing key sectors in which the United States is competitive globally, such as services.
- ▶ The Chinese government has made “supply-side structural reform” the dominant theme of economic policy. This concept includes cutting excess industrial capacity and housing inventories, deleveraging, and reducing business costs. Early signs suggest the central government’s supply-side focus has not yet translated into a serious change of course. Facing a slowdown in growth, Chinese policymakers have leaned on stimulus measures to boost growth. Government stimulus has largely accrued to the state sector while the private sector struggles to secure credit, endangering China’s rebalancing.
- ▶ China’s rapidly rising debt levels heighten risks to the stability of the country’s financial markets, which can quickly spill over into global markets. Beijing continues to increase the flexibility of its exchange rate, driven in part by its goal of internationalizing the renminbi (RMB). Despite this progress, the People’s Bank of China still carefully manages the value of the RMB, intervening in foreign exchange markets to keep the currency’s external value stable.
- ▶ China’s foreign investment climate continues to worsen for companies in strategic industries because of the Xi Administration’s focus on domestic industrial innovation goals. In addition, Beijing has forcefully argued that the country must reduce its dependence on foreign technology due to national security concerns, and introduced stricter information and communications technology requirements and stronger cybersecurity policies.
- ▶ While Chinese investment remains a small percentage of total inward foreign direct investment in the United States, it is rising rapidly and will continue to rise, driven by the Chinese government’s “going out” strategy, capital flight, and a generally more open policy environment for outbound investment. Chinese companies’ record acquisition of U.S. assets—in particular, their drive to acquire U.S. technology firms—has led to growing political concern. However, some major Chinese acquisition deals have fallen apart due to regulatory concerns or questions over Chinese buyers’ ability to pay. The Committee on Foreign Investment in the United States (CFIUS) reviews foreign investments in the United States for national security implications. In 2014, the latest year for which data are available, China led foreign countries in CFIUS reviews with 24 reviewed transactions out of more than 100 total acquisition deals. Although the number of Chinese transactions reviewed increased in absolute terms, it declined as a share of all Chinese acquisitions, and the vast majority of reviewed transactions proceed.
- ▶ China appears to be conducting a campaign of commercial espionage against U.S. companies involving a combination of cyber espionage and human infiltration to systematically penetrate the information systems of U.S. companies to steal their intellectual property, devalue them, and acquire them at dramatically reduced prices.
- ▶ The U.S. government’s efforts to address tensions in the U.S.-China relationship continue to yield only limited results. At the final round of the Strategic and Economic Dialogue talks under the Obama Administration, participants failed to achieve any major breakthroughs but left with some deliverables on financial sector cooperation. Industrial overcapacity topped the U.S. economic agenda, replacing currency as its primary concern, but China only made a vague pledge with regard to steel overcapacity. The unwelcoming investment climate for U.S. companies in China, along with China’s recently passed law restricting foreign nongovernmental organizations, also added friction to the talks.
- ▶ China’s adherence to the World Trade Organization (WTO) principles and its Protocol of Accession remains mixed, partly due to China’s opaque subsidy regime. Recently, the United States initiated WTO cases on China’s aircraft taxation, export restrictions on raw materials, and agricultural subsidies. The United States also requested consultations over China’s continued imposition of antidumping duties on U.S. broiler chicken products, in violation of an earlier WTO ruling.

## SECTION 2: STATE-OWNED ENTERPRISES, OVERCAPACITY, AND CHINA'S MARKET ECONOMY STATUS

Although Beijing has taken superficial steps toward meaningful state-owned enterprise (SOE) reform, including pursuing plans for mixed-ownership and SOE consolidation, it has effectively abandoned its boldest reform proposals. Rather than restructuring the state sector to reduce corporate debt and increase efficiency, the Chinese government continues to prop up nonviable companies with government subsidies, discounted production inputs, and favorable lending from state banks. As a result, SOEs remain the driving force behind key sectors of the Chinese economy despite incurring significant losses. Under President Xi, the Chinese government has not only expanded its control over SOEs, but also exerted its influence over private companies. By enhancing government oversight, centralizing bureaucratic coordination, and regulating market entry in economically and politically strategic sectors, Beijing is able to direct both private and public firms to promote state goals.

**FIGURE 4: U.S. STEEL INDUSTRY QUARTERLY NET INCOME, Q1 2009–Q2 2016**

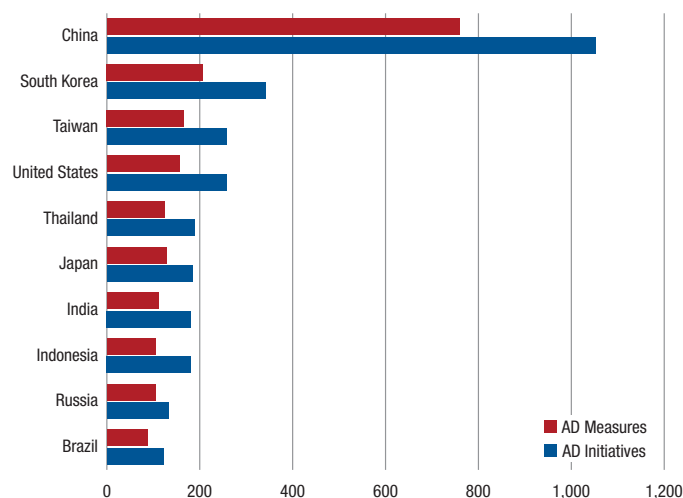


*Note:* Data include financials of AK Steel, Carpenter Technology, Commercial Metals Company, Nucor, Steel Dynamics, and U.S. Steel.

*Source:* U.S. Department of Commerce International Trade Administration, *Steel Industry Executive Summary: September 2016*, September 2016.  
<http://enforcement.trade.gov/steel/license/documents/execsumm.pdf>.

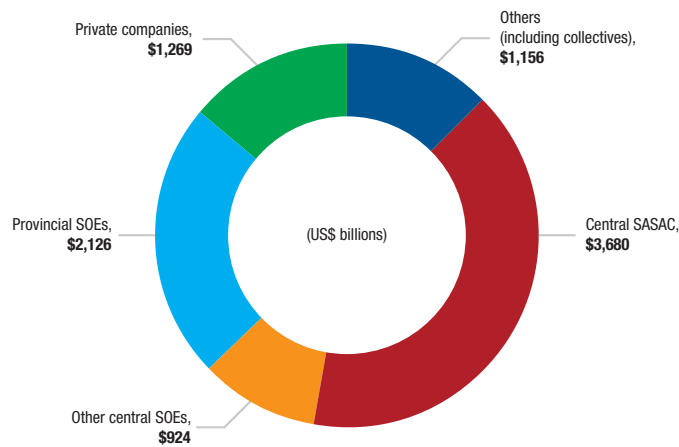
China's stalled economic reform agenda presents a particularly acute problem in the country's heavy industries, where years of government subsidies and preferential loans have created pervasive overcapacity and market distortions. Despite Chinese officials' repeated promises to cut production in industries like steel, aluminum, and coal, reforms have taken a backseat to policies aimed at maintaining employment and economic growth. Without production capacity reductions, utilization rates for a variety of products have declined below optimization levels, while a surge of Chinese exports has suppressed commodity prices and flooded global markets. The ramifications of China's overcapacity are particularly evident in the U.S. steel industry, where U.S. producers posted net losses of \$1.43 billion in the fourth quarter of 2015 and \$233 million in the first quarter of 2016. Although the U.S. International Trade Commission authorized imposition of new tariffs on Chinese steel dumping in 2016, many dominant U.S. steelmakers have still been forced to shutter capacity and lay off employees, with as many as 19,000 U.S. steel and iron workers facing layoffs as a result of Chinese overcapacity.

**FIGURE 5: TOP TEN COUNTRIES BY AD ACTIONS RECEIVED, 1995–JUNE 2014**



*Source:* Rui Fan, "China's Excess Capacity: Drivers and Implications," Stewart and Stewart, June 2015, 12.

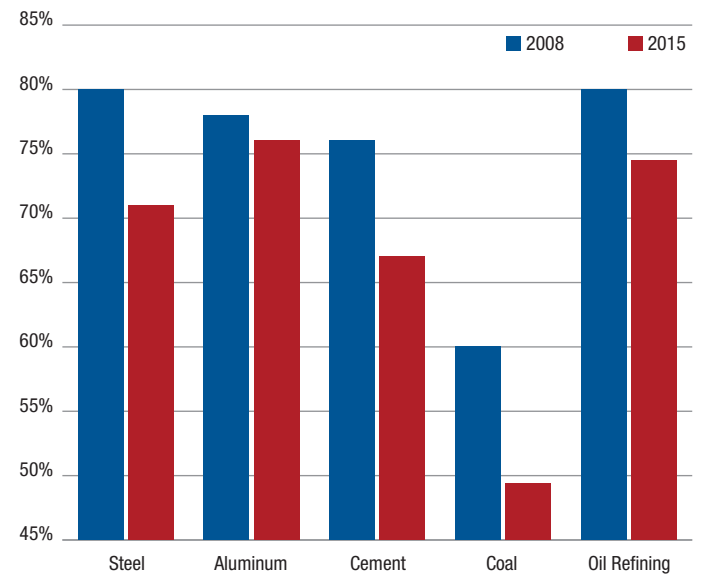
FIGURE 6: REVENUE OF CHINA'S TOP 500 FIRMS BY OWNERSHIP, 2013



Source: U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, written testimony of Paul Hubbard, February 24, 2016.

Over the last 20 years, antidumping (AD) and countervailing duty (CVD) cases have frequently been brought against China, with over 1,000 AD cases initiated against China globally since 1995. The United States has been a leading complainant, launching 28 AD and CVD investigations—out of a total 48 AD/CVD cases globally—against China in the first nine months of 2016. On December 11, 2016, a provision of China's WTO accession agreement will expire, ending a 15-year period during which trade partners were automatically authorized to treat China as a nonmarket economy for the purposes of AD and CVD enforcement. The U.S. government has clarified that the expiration of the accession protocol provision does not mandate automatic conferral of market economy status to China. The U.S. Department of Commerce is responsible for determining whether a country is a market economy for the purposes of AD investigations, and whether market economy status will apply to the whole country or on a sector-by-sector basis. If the Department of Commerce designates China as a market economy, the margins of U.S. dumping duties imposed on Beijing will be significantly reduced, allowing China's anticompetitive activities to further harm U.S. companies.

FIGURE 7: CHINA'S UTILIZATION RATES FOR SELECT INDUSTRIES, 2008 AND 2015



Source: European Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda," February 2016, 6; U.S. Energy Information Administration, China, May 14, 2016, 15; Christine Shearer et al., "Boom and Bust 2016," *Sierra Club*, March 27, 2016; Organisation for Economic Co-operation and Development, "Recent Market Developments in the Global Steel Industry," February 16, 2016, 12; Nathan Vanderklippe, "China's Huge Cement Industry Latest to Face Massive Cuts," *Globe and Mail*, May 30, 2016.

## Conclusions

- ▶ Despite repeated pledges to let the market play a "decisive role" in resource allocation, Beijing continues to use state-owned enterprises (SOEs) as a tool to pursue social, industrial, and foreign policy objectives, offering direct and indirect subsidies and other incentives to influence business decisions and achieve state goals. While proposed SOE reforms have made little progress incorporating market drivers into SOE activities or addressing the country's growing credit crisis, they have taken steps to strengthen state control—particularly in sectors involving the government's political or economic interests.
- ▶ For the foreseeable future, it is highly unlikely that the Chinese Communist Party (CCP) will subject SOEs to free market reforms. Such reform would diminish the CCP's control in strategic sectors, through which it directs the economy. In addition, real structural reforms would substantially increase unemployment in the short term and undermine entrenched interests within the CCP leadership.



- ▶ In China's state capitalist system, government ownership is not the sole measure of Beijing's economic influence. Beijing has fostered a unique ecosystem whereby the government is at the center of the economy, with state control extended through an array of measures, including financial support, political connections, and extralegal control to SOEs and private enterprises alike. As such, all Chinese companies' economic activity—not just the activity of state-owned firms—is conducted in support of the state's goals and policies. This is particularly true for Chinese firms operating in strategic sectors.
- ▶ The CCP continues to use SOEs as the primary economic tool for advancing and achieving its national security objectives. Consequently, there is an inherently high risk that whenever an SOE acquires or gains effective control of a U.S. company, it will use the technology, intelligence, and market power it gains in the service of the Chinese state to the detriment of U.S. national security.
- ▶ China's economic policies have fueled a commodity boom, which, coupled with the recent economic slowdown, has created a vast oversupply of industrial goods like steel, aluminum, and coal. Beijing has repeatedly stated its commitment to eliminating excess capacity, yet progress has been extremely slow—and in some cases nonexistent.
- ▶ Rather than closing industrial production facilities and laying off workers, Beijing is exporting its surplus production to the detriment of U.S. and other foreign competitors. As a result, U.S. industries are struggling, with steel and aluminum producers shedding capacity, cutting employment, and reducing capital expenditures.
- ▶ Amid an influx of unfairly priced steel imports from China, U.S. steel manufacturing jobs are being eliminated, dramatically reducing the United States' critically important defense industrial base. If the U.S. steel industry is hollowed out, U.S. manufacturers of military equipment and machinery will be forced to import components from China and elsewhere, raising the possibility that products of subpar or compromised quality could endanger U.S. military personnel and limit the country's ability to respond to a military threat.
- ▶ China argues it should be automatically granted market economy status (MES) after a provision in its World Trade Organization (WTO) accession protocol expires on December 11, 2016. A review of the U.S. statutory test for determining whether an economy can be classified as a market economy—including the extent to which the currency is convertible, the extent to which wage rates are determined by free bargaining between labor and management, the extent to which joint ventures or other investments by foreign firms are permitted, the extent of government ownership or control of the means of production, and the extent of government control over the allocation of resources—reveals that China is not currently a market economy and is not on the path to become one in the near future.
- ▶ To address global economic imbalances created by China's state-led economic model, the United States has relied on trade remedies consistent with its WTO obligations. However, if China is granted MES in December 2016, dumping margins for antidumping cases will be significantly reduced, removing an important tool U.S. businesses rely on to limit losses taken from price distortions in China's economy.

### SECTION 3: CHINA'S 13TH FIVE-YEAR PLAN

In March 2016, China's National People's Congress, China's legislature, ratified the 13th Five-Year Plan (FYP) (2016–2020), which sets targets to rebalance the economy toward higher-value-added manufacturing and domestic consumption, reform SOEs, increase urbanization, enhance indigenous innovation, and improve quality of life for its citizens through improvements to health, education, and social welfare. The Chinese government's ability to reach these targets is a political question, not an economic one, and relies on its willingness to relinquish a substantial degree of state control, overcome entrenched interests, and endure the short-term and medium-term economic pain that structural reform creates. In addition, the costs of the 13th FYP are high: just meeting the urbanization, healthcare, and clean energy and environmental objectives is expected to cost around \$8.1 trillion (RMB 54 trillion) over the next five years in public and private sector investment. It remains unclear how these objectives will be funded, especially as local governments are overburdened by debt taken on during the 12th FYP and incentives for private sector investment remain limited.

TABLE 1: CHINA'S MAJOR REFORM PRIORITIES

| Priorities                               | Major Reforms and Goals                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Boost domestic consumption               | <b>Urbanization</b> <ul style="list-style-type: none"> <li>► Raise urbanization levels to 60 percent and create more than 50 million urban jobs by 2020</li> <li>► Renovate 20 million housing units in urban low-income housing by 2020</li> <li>► More effectively coordinate regional government policies within existing megaregions around Beijing and Shanghai; integrate intercity regional air, car, rail, and sea transportation networks; and reconfigure regional industry layouts</li> <li>► Expand use of public-private partnerships</li> </ul> |
|                                          | <b>Hukou household registration system</b> <ul style="list-style-type: none"> <li>► Raise the share of the population registered as permanent urban residents from 39.9 percent in 2015 to 45 percent in 2020</li> </ul>                                                                                                                                                                                                                                                                                                                                      |
| Enhance quality of life                  | <b>Healthcare</b> <ul style="list-style-type: none"> <li>► Create a high-quality, affordable, and accessible healthcare system</li> <li>► Establish a national basic public service market to include services such as pension, healthcare, and compulsory education</li> </ul>                                                                                                                                                                                                                                                                               |
|                                          | <b>Energy conservation and environmental preservation</b> <ul style="list-style-type: none"> <li>► Set targets for energy consumption, reductions to carbon and pollutant emissions, and air and water quality levels</li> <li>► Decontaminate water and soil</li> <li>► Strictly enforce existing environmental standards</li> <li>► Promote green financing and public-private partnerships</li> </ul>                                                                                                                                                      |
| Strengthen Industrial Competitiveness    | <b>Indigenous innovation</b> <ul style="list-style-type: none"> <li>► Increase China's global innovation ranking from 18 to 15 by 2020*</li> <li>► Raise R&amp;D spending as a percent of GDP from 2.1 to 2.5 by 2020</li> <li>► Increase the number of patents filed per 10,000 people from 6.3 to 12 by 2020</li> </ul>                                                                                                                                                                                                                                     |
|                                          | <b>Higher-value-added manufacturing</b> <ul style="list-style-type: none"> <li>► Implement Made in China 2025 and Internet Plus initiatives</li> <li>► Develop globally competitive domestic firms in semiconductors, aviation, and automobiles and other designated sectors</li> <li>► Create government-controlled venture capital funds</li> </ul>                                                                                                                                                                                                         |
| Improve efficiency of capital allocation | <b>Fiscal system</b> <ul style="list-style-type: none"> <li>► Delineate central-local tax collection and expenditure responsibilities</li> <li>► Roll-out value-added tax</li> <li>► Expand debt-for-bonds swaps</li> </ul>                                                                                                                                                                                                                                                                                                                                   |
|                                          | <b>Financial sector</b> <ul style="list-style-type: none"> <li>► Liberalize deposit interest rates</li> <li>► Reopen securitization market</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                         |
|                                          | <b>Capital controls</b> <ul style="list-style-type: none"> <li>► Widen foreign access to interbank bond market</li> <li>► Loosen quotas and remittance restrictions for capital accounts</li> <li>► Promote the internationalization of the RMB</li> </ul>                                                                                                                                                                                                                                                                                                    |

Source: Compiled by Commission staff.

\* China's International Innovation Index 2015 ranked China as the 18th most innovative country; the United States was ranked first followed by Japan, Switzerland, South Korea, and Israel. By comparison, the 2016 Global Innovation Index published by Cornell University, French business school INSEAD, and the World Intellectual Property Organization ranked Switzerland first, followed by Sweden, the United Kingdom, and the United States at 4th. The report placed China 25th out of 128 countries. Ministry of Science and Technology of the People's Republic of China, "'Country Innovation Index Report 2015' Released," July 25, 2016. Staff translation. [http://www.most.gov.cn/kjbgz/201607/t20160725\\_126747.htm](http://www.most.gov.cn/kjbgz/201607/t20160725_126747.htm); Soumitra Dutta, Bruno Lanvin, and Sacha Wunsch-Vincent, ed., The Global Innovation Index 2016, 2016.



The Chinese government's efforts under the 13th FYP to expand the middle class, improve the quality of public services, reduce the country's environmental footprint, and open up the service sector could provide numerous opportunities for U.S. businesses and open avenues for U.S.-China bilateral cooperation. However, the Chinese government's sustained commitment to technonationalism is a growing challenge for U.S. and foreign firms seeking to enter China's market or compete with its state-supported firms abroad. To gain and then maintain market access in China, U.S. and other foreign firms often must transfer technology, move manufacturing and assembly facilities to China, and collaborate with their Chinese competitors, displacing U.S. workers and impacting U.S. firms' profitability, operations, and future competitiveness. Thus far, the Chinese government's efforts to establish national champions in high-tech sectors such as automotive, aviation, and semiconductors have resulted in the successful creation of lower-end producers and suppliers, but China's firms continue to lag behind U.S. competitors in terms of quality, reliability, and technological edge. Since 2015, the Chinese government has been attempting to address these gaps and develop globally competitive domestic firms by investing in foreign firms to meet industrial policy goals (U.S. semiconductor firms are a notable example), rolling out the "Made in China 2025" and "Internet Plus" initiatives, and creating government-controlled venture capital firms. The scale and volume of resources the Chinese government has directed toward expanding domestic production capacity and creating globally competitive domestic firms may undermine fair competition, erode U.S. commercial and military technological advantages, displace U.S. workers, and increase U.S. dependence on foreign production.

The Chinese government is also attempting to boost domestic consumption and provide a higher quality of life for its citizens by increasing urbanization, reforming the hukou household registration system, improving citizens' access to healthcare, and cleaning up severe environmental degradation. To finance this ambitious reform agenda, the Chinese government wants to attract greater domestic and foreign private sector investment and improve capital allocation efficiency through fiscal and financial reforms. These reforms would permit a greater role for the market while simultaneously maintaining state control. This year's fiscal reforms were successful at restructuring existing local government debt obligations through debt-for-bond swaps and clarifying central-local tax collection and expenditure responsibilities, but announced reforms are not creating new, sustainable sources of funding such as a property tax needed by local governments.

**TABLE 2: EXPECTED TOTAL COSTS OF SELECT INITIATIVES UNDER THE 13TH FYP**

| Initiatives                               | Estimated Public and Private Sector Costs (2020) |
|-------------------------------------------|--------------------------------------------------|
| Urbanization                              | \$6.3 trillion (RMB 42 trillion)                 |
| Healthcare                                | \$298.9 billion (RMB 2 trillion)                 |
| Green Energy and Environmental Priorities | \$1.5 trillion (RMB 10 trillion)                 |
| <b>TOTAL</b>                              | <b>\$8.1 trillion (RMB 54 trillion)</b>          |

*Note:* Urbanization cost estimates are from 2014 to 2020. Healthcare expenditures are based on a study by the World Bank, Chinese government agencies, and Chinese researchers that calculated a 9.4 percent annual increase in real healthcare costs from 2015 to 2020 under a business-as-usual scenario.

*Source:* Amy He, "The World's Biggest Uprooting," *China Daily*, April 11, 2014; World Bank Group, et al., "Deepening Health Reform in China: Building High-Quality and Value-Based Service Delivery," July 22, 2016, 14–15; and People's Bank of China and U.N. Environment Program, *Establishing China's Green Financial System: Report of the Green Finance Task Force*, April 2015, 5.

In the financial sector, the People's Bank of China liberalized deposit rates, reopened its securitization market, widened foreign access to interbank bond market, loosened quotas and remittance restrictions for capital accounts, and promoted green finance and the internationalization of the RMB. But reforms necessary to increase the liquidity of financial markets and attract foreign investors—strengthening auditing and accounting standards, regulatory frameworks, and corporate governance—have proceeded more slowly. The Chinese government's gradual steps toward loosening capital controls and promoting the internationalization of the RMB are increasing China's presence in the international financial system as more global investors are able to invest in China's stock and bond markets, and more Chinese investors are able to invest internationally. While China's continued use of capital controls and slow progress on strengthening financial institutions and governance have ensured U.S. exposure to China's financial system remains limited, the impact of China's slowing growth and economic reforms on international trade, commodities demand, and investor confidence is affecting global markets.

**TABLE 3: CHINESE ATTEMPTED AND COMPLETED ACQUISITIONS AND INVESTMENTS IN U.S. SEMICONDUCTOR COMPANIES, 2015-2016**

| U.S. Target                                                      | Specialty                                                                                                                                                 | Chinese Investor                                                                                                                                    | Value (US\$ millions) | Status                                                                                                                                                                                                                                                                                     |
|------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| FlipChip International                                           | Designer of wafer chip assembly and packaging                                                                                                             | Tianshui Huatian Technology                                                                                                                         | \$40.2                | Acquisition completed, April 2015                                                                                                                                                                                                                                                          |
| WiSpry                                                           | Designer of chips for wireless communication products                                                                                                     | AAC Technologies Holdings                                                                                                                           | \$16.6                | Acquisition completed, May 2015                                                                                                                                                                                                                                                            |
| OmniVision Technologies                                          | Designer of chips for advanced digital imaging solutions for consumer and commercial applications                                                         | CITIC Capital Holdings, Goldstone Investment, Hua Capital Management                                                                                | \$1,900               | Merger completed, July 2015                                                                                                                                                                                                                                                                |
| Bridgelux                                                        | Designer of chips for light-emitting diode (LED) commercial and industrial lighting                                                                       | China Electronics Corporation, Chongqing Linkong Development Investment                                                                             | \$130                 | Acquisition completed, July 2015                                                                                                                                                                                                                                                           |
| Atmel                                                            | Designer and manufacturer of microcontrollers and touch technology for the automotive, industrial, and consumer markets                                   | China Electronics Corporation                                                                                                                       | \$3,400               | Withdrawn after higher bid from competitor, U.S. firm Dialog Semiconductor, who was later outbid by U.S. firm Micron Technologies, September 2015                                                                                                                                          |
| Pericom Semiconductor Corp.                                      | Designer of integrated connectivity, advanced timing, and signal integrity for the computing, communications, and consumer market                         | Montage Technology Group (subsidiary of China Electronics Corporation)                                                                              | \$400                 | Pericom rejected bid, citing a lack of committed financing and potential regulatory hurdles in China, Taiwan, and the United States, November 2015; U.S. firm Diodes acquired Pericom for \$413 million that same month                                                                    |
| Xcerra Corporation (semiconductor test interface board business) | Designer of semiconductor and electronics manufacturing testing equipment                                                                                 | Fastprint Hong Kong Co. (subsidiary of Shenzhen Fastprint Circuit Tech Co.)                                                                         | \$2.3                 | Acquisition of its semiconductor test interface business completed, December 2015                                                                                                                                                                                                          |
| Integrated Silicon Solutions (ISSI)                              | Designer of chips for automotive and other industries                                                                                                     | Uphill Investment (consortium including Hua Capital Management, SummitView Capital, E-Town MenteK)                                                  | \$640                 | Acquisition completed, December 2015                                                                                                                                                                                                                                                       |
| Initio                                                           | Designer of chips for storage devices                                                                                                                     | Sage Microelectronics                                                                                                                               | Not disclosed         | Acquisition completed, January 2016                                                                                                                                                                                                                                                        |
| Vivante                                                          | Designer of chips for mobile, consumer, and automobile products                                                                                           | VeriSilicon Holdings                                                                                                                                | Not disclosed         | Acquisition completed, January 2016                                                                                                                                                                                                                                                        |
| Integrated Memory Logic Limited (subsidiary of Exar Corporation) | Designer of chips for power management and color calibration for flat-panel display and LED lighting                                                      | Beijing E-town Chipone Technology Co. (consortium including Chipone Technology Co. and Beijing E-Town International Investment and Development Co.) | \$136                 | Acquisition announced, June 2016                                                                                                                                                                                                                                                           |
| Fairchild Semiconductor                                          | Designer and manufacturer of chips for power management and mobile applications                                                                           | China Resources, Hua Capital Management                                                                                                             | \$2,600               | Fairchild rejected bid, citing concerns over Committee on Foreign Investment in the United States (CFIUS) <sup>†</sup> approval, February 2016; U.S. firm ON Semiconductors received approval from the U.S. Federal Trade Commission to acquire Fairchild for \$2.4 billion in August 2016 |
| Micron Technology                                                | Designer and manufacturer of memory chips; only U.S.-based dynamic random access memory (DRAM) manufacturer                                               | Tsinghua Holdings                                                                                                                                   | \$23,000              | Micron rejected bid, citing concerns over CFIUS approval, February 2016                                                                                                                                                                                                                    |
| Multi-Fineline Electronix                                        | Manufacturer of flexible circuits and assemblies                                                                                                          | Suzhou Dongshan Precision Manufacturing                                                                                                             | \$610                 | Acquisition completed, February 2016                                                                                                                                                                                                                                                       |
| Western Digital (15% stake)                                      | Designer and manufacturer of computer hard drives                                                                                                         | Tsinghua Unisplendour                                                                                                                               | \$3,780               | Withdrawn due to CFIUS concerns, March 2016                                                                                                                                                                                                                                                |
| GigOptix (3.8% stake)                                            | Designer of chips for cloud connectivity, data centers, and high-speed optical and wireless networks                                                      | Shanghai Pudong Science and Technology Investment                                                                                                   | \$5                   | Purchase of minority stake completed, March 2016                                                                                                                                                                                                                                           |
| Lattice Semiconductor Corporation (8.65% stake)                  | Designer of low-power, programmable chips for high-tech data centers and telecommunication networks with dual-use applications                            | Tsinghua Unigroup                                                                                                                                   | \$41.5                | Purchase of 6% share completed, April 2016; share increased to 8.65% in May 2016                                                                                                                                                                                                           |
| Mattson Technology                                               | Manufacturer and supplier of semiconductor manufacturing equipment                                                                                        | Beijing E-Town Dragon Semiconductor Industry Investment Center                                                                                      | \$300                 | Acquisition completed, May 2016                                                                                                                                                                                                                                                            |
| Marvell Technology (~2% stake)                                   | Designer of storage, cloud infrastructure, Internet of Things, connectivity and multimedia semiconductor chips                                            | Tsinghua Holdings                                                                                                                                   | \$78.2                | Purchase of minority stake completed, May 2016                                                                                                                                                                                                                                             |
| Global Communications Semiconductors                             | Designer and manufacturer of radio frequency, wireless, power electronic, and optoelectronic chips                                                        | SAIC Acquisition (subsidiary of Xiamen Sanan Integrated Circuits)                                                                                   | \$226                 | Withdrawn after CFIUS rejected the merger, August 2016                                                                                                                                                                                                                                     |
| Analogix Semiconductor                                           | Designer of high-speed, mixed-signal chips for use in high-performance displays such as mobile devices, virtual and augmented reality, and other products | Beijing Shanhai Capital Management, National IC Industry Investment Fund                                                                            | \$500                 | Announced merger, September 2016                                                                                                                                                                                                                                                           |

Sources: Company press releases and news articles. See full Annual Report for complete list of sources.

<sup>†</sup> CFIUS is an interagency committee that reviews transactions that shift control of a U.S. business to a foreign person or business and the potential national security implications for the United States. U.S. Department of the Treasury, "The Committee on Foreign Investment in the United States," December 20, 2012.

## Conclusions

- ▶ The 13th Five-Year Plan (FYP) (2016–2020) seeks to address China's “unbalanced, uncoordinated, and unsustainable growth” and create a “moderately prosperous society in all respects” through innovative, open, green, coordinated, and inclusive growth. This agenda strengthens the Chinese Communist Party's and Chinese government's roles in managing the economy while allowing a greater role for markets to determine the allocation of resources in some sectors of the economy.
- ▶ The success of the 13th FYP agenda hinges on the Chinese government's willingness to make politically difficult trade-offs between contradictory policy objectives, overcome entrenched interests, and allow for greater volatility. While senior leadership has repeatedly reiterated its commitment to enacting reforms, it remains averse to the market volatility and social instability that reforms create.
- ▶ The Chinese government is increasing urbanization, expanding public services such as healthcare and education, and pursuing limited reforms to its household registration system to alleviate poverty, boost domestic consumption, improve quality of life, and create new drivers of economic growth. This transition is fueling enormous demand in urban infrastructure and services, but strict market entry criteria, opaque regulations, compulsory joint ventures, and China-specific technical regulations limit the market opportunities for U.S. and other foreign firms in China.
- ▶ The Chinese government is building on its success under the 12th FYP to reduce greenhouse gas and air pollution and address the more technically difficult soil and water contamination under the 13th FYP. In 2016, the Ministry of Environmental Protection stepped up enforcement of its environmental standards—a key weakness of environmental reform efforts under the 12th FYP—through its new authority to conduct random inspections of provincial and municipal governments and its expansion of national, real-time monitoring systems.
- ▶ China's renewed focus on indigenous innovation and creation of globally competitive firms in key emerging industries, such as integrated circuits, biomedicines, cloud computing, and e-commerce, targets sectors in which the United States is a global leader. Continued preferential government treatment and financial support of state-owned enterprises and designated industries have lowered these firms' cost of capital and production, creating a competitive advantage over U.S. and other private firms both within China and abroad.
- ▶ The 13th FYP's requires an estimated \$8.1 trillion (RMB 54 trillion) of public and private capital just to fund portions of its agenda focused on urbanization, healthcare, and clean energy and environmental remediation. To attract sufficient investment, the Chinese government is pursuing fiscal reform, encouraging public-private partnerships, increasing its government debt, and loosening capital controls. Despite repeated pledges to allow the market to play a bigger role, the Chinese government continues to reinforce the state's central role in the economy. In addition, fiscal and financial reforms have yet to impose discipline and hard budget constraints on borrowers.

## Chapter 2: U.S.-China Security Relations

### SECTION 1: YEAR IN REVIEW: SECURITY AND FOREIGN AFFAIRS

China's aggressive pursuit of control in the South China Sea was the dominant feature of China's security and foreign affairs in 2016. The most high-profile development was the July ruling by an arbitral tribunal at the Permanent Court of Arbitration in The Hague for a case filed by the Philippines in 2013. In a blow to China's credibility, the tribunal ruled that several of China's actions and claims in the South China Sea were unlawful. Predictably, Beijing immediately rejected and sought to discredit the ruling. Meanwhile, China continued building military and civilian infrastructure on the 3,200 acres of artificial islands it has created since 2013, completing runways and building reinforced aircraft hangars on three outposts. This and other infrastructure will serve to improve China's ability to detect and track foreign maritime forces and fishing boats. As in 2015, China's dispute with Japan and Taiwan in the East China Sea received less official and media attention, though China continued to patrol contested East China Sea waters with its increasingly capable coast guard; on one occasion, six Chinese coast guard ships and 230 Chinese fishing boats sailed out to waters near the disputed Senkaku Islands.

FIGURE 8: MAP OF THE SOUTH CHINA SEA



Source: Chun Han Wong, "U.S., China Trade Familiar Accusations over South China Sea," *Wall Street Journal*, February 18, 2016. <http://www.wsj.com/articles/u-s-china-trade-familiar-accusations-over-south-china-seas-1455806108>.

Another major development in 2016 was the initiation of the People's Liberation Army's (PLA) most sweeping reform and reorganization since the 1950s, aimed at enhancing the CCP's control over the military and improving the force's capability to fight regional conflicts at greater distances from China through integrated joint operations. The reforms will restructure China's leading military authority, the Central Military Commission; reorganize the military services into the PLA Army, Navy, Air Force, Rocket Force, and Strategic Support Force; transition from a military region to a joint theater command structure; and eventually reduce the force size by 300,000 troops.

Supported by a still-growing military budget (announced to be \$146.67 billion for 2016), the PLA is rolling out several new weapons systems for force projection in air, sea, and amphibious missions. Among these are: China's first squadron of J-20 multirole stealth jet fighters (expected delivery in late 2016); China's second aircraft carrier (officially confirmed in December 2015 and apparently nearly complete as of August 2016); additional frigates, destroyers, and tank landing ships commissioned or entering service; and China's first operational Y-20 heavy transport aircraft (inducted into service in 2016). China also signed a contract for 24 Su-35 multirole jet fighters from Russia, which could enter service in 2018. Additionally, China tested new space launch vehicles and launched more intelligence, surveillance, and reconnaissance and navigation satellites in 2016, in an effort to further augment the capabilities of its military forces.

The PLA continues to be active overseas. In 2016, China launched its 24th antipiracy deployment to the Gulf of Aden, announced it would increase its contributions to UN peacekeeping operations, and conducted humanitarian assistance and disaster relief operations in Nepal and in search of Malaysia Airlines flight MH370. China also began construction on its first overseas military facility in Djibouti. In addition to its own increasingly sophisticated training and exercises at home, China has increased the number and type of military exercises it conducts with other countries. Since late 2015, China has participated in 11 major bilateral or multilateral exercises with countries around the world. Military sales are another growing component of China's global security engagement: China was the world's third-largest arms exporter between 2011 and 2015 (behind the United States and Russia).

FIGURE 9: HANGARS UNDER CONSTRUCTION ON CHINA'S SOUTH CHINA SEA OUTPOSTS AT FIERY CROSS REEF (LEFT) AND SUBI REEF (MIDDLE, RIGHT) IN THE SPRATLY ISLANDS



Source: Center for Strategic and International Studies, Asia Maritime Transparency Initiative, "Build It and They Will Come," August 9, 2016. <https://amti.csis.org/build-it-and-they-will-come/>.

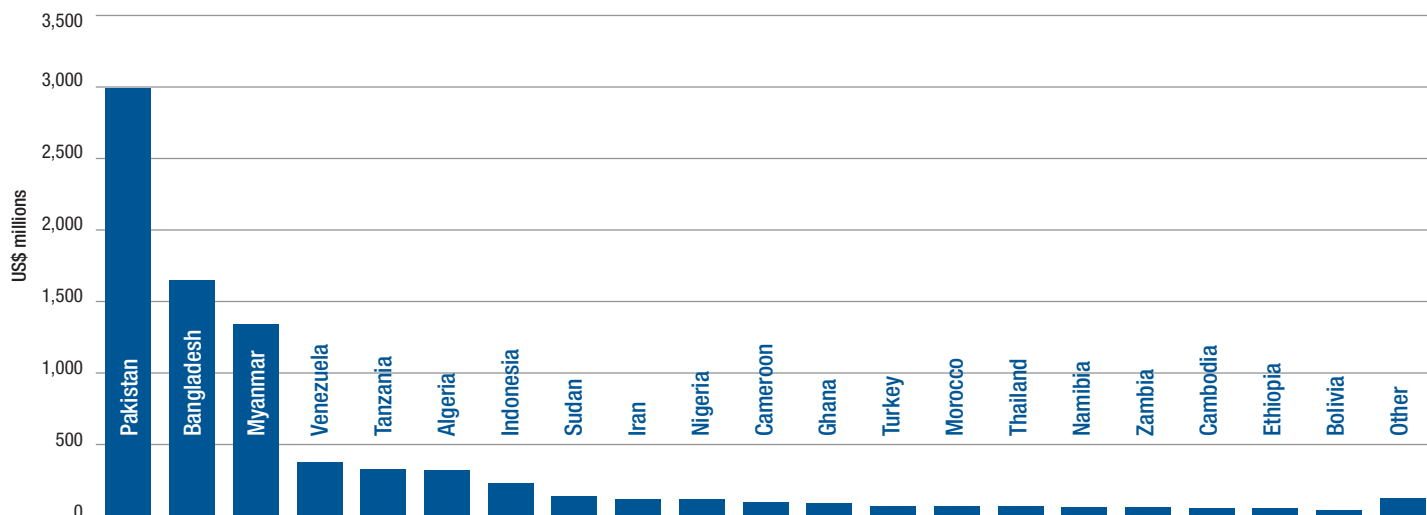
U.S.-China security relations benefited from meaningful cooperation



in 2016, though tensions over several issues continued to plague the relationship. In July, China joined the United States and other countries in signing the Joint Comprehensive Plan of Action to remove UN sanctions on Iran in exchange for the imposition of restrictions on Tehran's nuclear program. China's involvement in this effort was crucial. The two countries also took steps to enhance nuclear safety and security during the March 2016 Nuclear Security Summit. U.S.-China military-to-military ties continued to benefit from

regular exchanges, high-level visits, port calls, and other activities. Unfortunately, China's continued assertiveness in the South China Sea, and its resentment of the U.S. military presence there, fueled mistrust, as did ongoing Chinese cyber espionage against U.S. entities, the December 2015 announcement of a U.S. arms sale to Taiwan, and the decision by the United States and South Korea to deploy a Terminal High Altitude Area Defense ballistic missile defense system in South Korea.

**FIGURE 10: CHINA'S ARMS SALES BY RECIPIENT, 2011-2015 (CONSTANT 1990 DOLLARS)**



Source: Stockholm International Peace Research Institute, SIPRI Arms Transfers Database. <https://www.sipri.org/databases/armstransfers>.

## Conclusions

- ▶ In 2016, an international tribunal ruled overwhelmingly in the Philippines' favor in its case regarding China's South China Sea claims and activities; Beijing expectedly rejected the ruling. One of the most significant findings of the ruling was that China's claims to historic rights and resources within the "nine-dash line" have no legal basis. The strength of the ruling will be in its support from and enforcement by the international community, as the ruling itself has no enforcement mechanism. Aside from the arbitration ruling, tensions remained high in the South China Sea, as China landed several aircraft in the Spratly Islands and conducted military deployments to the Paracel Islands, both of which are disputed territories.
- ▶ The risk of escalation in tensions between China and Japan in the East China Sea and miscalculation or an accidental collision between Chinese and Japanese ships and aircraft has grown with the first instances of the Chinese navy sailing within 24 nautical miles of the disputed Senkaku Islands, the increased size of Chinese coast guard ships patrolling there, and the growing frequency of scrambles of Japanese fighter aircraft against Chinese aircraft.
- ▶ The ongoing People's Liberation Army (PLA) reorganization, the most sweeping structural reorganization of the PLA since the 1950s, seeks to address operational and developmental challenges Beijing believes have prevented the PLA from meeting the needs of modern warfare. Operational challenges addressed by flattening command and control between Beijing and the theaters could improve the PLA's capability to conduct joint integrated operations against a range of perceived threats along China's periphery and within western China. Though China seeks to complete reforms by 2020, it will likely take longer. However, once reforms are fully realized the PLA will be better positioned to execute the contingency operations assigned to each theater.
- ▶ China's reported 2016 military budget grew relative to the previous year at the lowest rate in six years, with slowing economic growth likely playing a role. Future defense spending increases should be sustainable in the near term, however. China is acquiring a growing number of increasingly advanced multi-mission ships, fighter aircraft, heavy transport aircraft, and space assets, which will increase its ability to project power both near and far from its shores. The PLA's improving force projection capabilities will strengthen its hand in regional military conflicts and support its imperative to protect its overseas interests.

- ▶ China's increasing overseas military presence reflects its interest and willingness to use military force to defend its growing overseas assets. China's global security activities likely will continue to increase as the population of Chinese nationals overseas grows along with Chinese overseas economic activity and national interests.
- ▶ China's military exercises will continue to expand in complexity and scale as the PLA works to overcome its lack of combat experience. As exercises increase in complexity they will reveal insights into specific missions or contingency operations the PLA may be preparing to conduct along China's periphery or beyond. China has also increased the number and type of military exercises it holds with other countries; many of these exercises focused on nontraditional security challenges, including counterterrorism, antipiracy, and humanitarian assistance/disaster relief, helping the PLA improve its capacity to conduct such operations and ease other countries' anxieties about China's military modernization.
- ▶ Despite cooperation on several areas of mutual interest and the continued expansion of security ties, U.S.-China relations over the past year continued to be strained. Points of tension included China's activities in the South China Sea, the planned deployment of a U.S. Terminal High Altitude Area Defense (THAAD) missile defense system to South Korea, the U.S. arms sale to Taiwan, Chinese cyber espionage activities, and the U.S. Rebalance to Asia strategy.

## SECTION 2: DEVELOPMENTS IN CHINA'S MILITARY EXPEDITIONARY AND FORCE PROJECTION CAPABILITIES

Chinese defense and national security writings highlight multiple military missions that would require the PLA to conduct operations beyond the territorial boundaries of—and at greater distances from—the People's Republic of China. These missions, aimed at safeguarding and securing China's overseas interests, include antipiracy, noncombatant evacuation, and humanitarian assistance and disaster relief operations. This nascent capability to conduct what China refers to as “non-war” missions will also improve the PLA's ability to conduct some warfighting missions. Enablers of China's growing expeditionary capability include its overall military modernization program, lessons learned from joint training, and experience gained from operational deployments.

In terms of military modernization, China continues to construct large amphibious ships, such as the YUZHAO-class amphibious transport dock, suitable for carrying equipment and forces in support of long-distance operations. The PLA Navy is integrating its *Liaoning* aircraft carrier into the fleet, and China is nearing completion of its first indigenously produced aircraft carrier. The PLA will likely use its carriers to defend ships conducting expeditionary operations. China also continues to build multi-mission-capable ships, such as the LUYANG III-class guided missile destroyer, which is able to conduct anti-air, antisurface, and antisubmarine warfare. Moreover, China is producing large transport aircraft, such as the Y-20, to bolster its strategic airlift capacity.

Regarding exercises and training, to date the PLA has focused exercises on China's most important conflict scenarios: contingencies involving Taiwan or along China's periphery. However, the long-range mobility training occurring during exercises such as Stride, Mission Action, and Joint Action provide the PLA some experience that would apply to conducting expeditionary operations.

The PLA has also gained valuable experience from its own operational deployments around the region and the world, such as antipiracy operations in the Gulf of Aden, sending aircraft to participate in search and rescue operations for missing Malaysia Airlines Flight 370, peacekeeping operations in South Sudan, and a noncombatant evacuation operation in Yemen. These types of deployments provide opportunities for the PLA to improve coordination, planning, and logistics associated with expeditionary operations. The PLA Navy's underway replenishment capability, which will improve its ability to sustain long-distance operations, will be augmented by China's first overseas military support facility in Djibouti.

China's growing expeditionary capability presents the United States and its regional allies and partners with a conundrum: the same expeditionary capabilities that could allow China to contribute to regional security could enable the PLA to pose a military threat and spur military competition. For example, training for visit, board, search, and seizure operations in conjunction with at-sea intercept training could be applied to a blockade operation against Taiwan. Additionally, these capabilities will provide Beijing a wider range of options for using force to resolve territorial disputes in the East and South China seas. The prospect of an expanded PLA expeditionary presence could also result in U.S. and Chinese forces conducting missions within the same operational space, putting their military forces in closer proximity and raising the risk of miscalculation or escalation should an incident occur.

## Conclusions

- ▶ The military capabilities China is developing will expand or improve the ability of the People's Liberation Army to conduct a range of externally focused operations, to include combat insertion, island landing operations, humanitarian assistance/disaster relief operations, noncombatant evacuation operations, and peacekeeping missions. Improvements in these areas can also strengthen China's traditional warfighting capabilities against weaker neighbors. Given its enhanced strategic lift capability, strengthened employment of special operations forces, increasing capabilities of surface vessels and aircraft, and more frequent and sophisticated experience operating abroad, China may also be more inclined to use force to protect its interests.
- ▶ China's pursuit of expeditionary capabilities, coupled with the aggressive trends that have been displayed in both the East and South China seas, are compounding existing concerns about China's rise among U.S. allies and partners in the greater Asia. This also is driving additional increases in defense acquisitions throughout the region.

- ▶ The People's Liberation Army will continue to modernize in the area of logistics, with implications for expeditionary operations. The air force will continue to see additional strategic airlift aircraft incorporated into the air order of battle, particularly once the Y-20 heavy lift aircraft enters serial production. Furthermore, China is likely to continue to seek opportunities to secure military facilities abroad, such as the one it has begun constructing in Djibouti, to facilitate a range of operations.
- ▶ Regardless of China's interest in developing a more robust expeditionary capability, regional contingencies, such as a conflict with Taiwan or concerning maritime disputes in the East or South China seas, will remain the focus of Chinese war planning.

### SECTION 3: CHINESE INTELLIGENCE SERVICES AND ESPIONAGE THREATS TO THE UNITED STATES

Chinese intelligence collection operations against the United States pose a large and increasing threat to U.S. national security. Reports of these operations have increased sharply over the past 15 years. China has targeted a wide range of U.S. national security organizations, including military forces, defense industrial entities, national security decision makers and government organizations, and critical infrastructure entities. Given rising U.S.-China competition and China's increasing military might, China's extraction of U.S. national security information through these operations has significant implications for U.S. military superiority in the Western Pacific and the security of U.S. plans and decision-making processes related to potential conflicts with China.

The two most prominent organizations in China's intelligence community are the Ministry of State Security (MSS) and intelligence units within the PLA. Both organizations conduct a range of intelligence collection operations against the United States, including cyber and human intelligence collection operations. In many reported cases in recent years, espionage operations by both the MSS and PLA have targeted national security organizations in the United States and in U.S. ally and partner countries. Chinese intelligence services seek to collect a wide range of information, from second-hand and unclassified information to classified information extracted directly from operatives within leading U.S. national security organizations. Through the use of financial incentives and coercion, MSS and PLA intelligence units build networks of agents within and outside of China working as diplomats, defense attachés, and academics, among other roles. These organizations are pursuing more aggressive human intelligence operations and—in a significant departure from their past approach to human intelligence operations—increasingly are recruiting agents outside of mainland China.

China's military technical intelligence collection capabilities are growing as well. China operates an increasingly sophisticated and extensive array of intelligence, surveillance, and reconnaissance assets capable of monitoring U.S. forces deployed to the Western Pacific. To coordinate and synthesize the use of these assets, the PLA appears to be moving toward greater jointness between intelligence units in different branches of the PLA. Moreover, as part of the broader reform of the PLA, China has reorganized many elements of PLA intelligence and created the Strategic Support Force, a new branch of the PLA that most likely will take on and centralize components of the PLA's intelligence mission.

The U.S. government response to the threat from Chinese intelligence collection has suffered from the lack of an integrated, coordinated effort within the U.S. Intelligence Community. The U.S. government's efforts to counter Chinese intelligence collection operations have manifested largely as a series of espionage prosecutions rather than a strategic, whole-of-government response. The Obama Administration has taken steps to improve cybersecurity among U.S. government agencies and defense contractors, but these measures could mitigate, not eliminate, the significant cyber espionage threats to these organizations.

### Conclusions

- ▶ Chinese intelligence has repeatedly infiltrated U.S. national security organizations and extracted information with serious consequences for U.S. national security, including information on the plans and operations of U.S. military forces and the designs of U.S. weapons and weapons systems. This information could erode U.S. military superiority by aiding China's military modernization and giving China insight into the operation of U.S. platforms and the operational approaches of U.S. forces to potential contingencies in the region.
- ▶ China's growing technical intelligence collection capabilities could strengthen China's hand in a contingency. Its extensive network of intelligence, surveillance, and reconnaissance (ISR) assets and continued development and deployment of increasingly advanced ISR platforms will increase the People's Liberation Army's (PLA) ability to monitor U.S. forces. Moreover, the enhanced jointness of PLA intelligence at the theater level will facilitate the integration of data collected by these platforms to form a more comprehensive, real-time battlefield picture.
- ▶ Chinese intelligence reportedly has repeatedly targeted and succeeded in infiltrating the personal e-mail accounts of leading U.S. government officials. These infiltrations could give China insight into highly sensitive U.S. national security decision making processes.
- ▶ China's infiltration of the national security establishments of U.S. allies and partners could allow China to indirectly access sensitive U.S. national security information. Moreover, these breaches could undermine the strength and stability of U.S. alliances by causing the United States to hesitate to share sensitive information with its partners.



## Chapter 3: China and the World

### SECTION 1: CHINA AND SOUTH ASIA

China is actively engaged in cultivating influence in South Asian countries (Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka). China has not publicly articulated a formal South Asia “strategy,” although Beijing’s key objectives and interests in the region can be observed in its activities in and diplomacy toward these countries. The key interests, concerns, and objectives of China’s South Asia strategy fall into four broad categories: (1) checking India’s rise, primarily by exploiting the India-Pakistan rivalry, (2) expanding economic activity and influence in the region, (3) enhancing access to the Indian Ocean, and (4) countering terrorism and religious extremism (often at the expense of religious freedom and other human rights). These objectives enable China to compete with potential rivals and increase China’s overall influence in the region, as well as diminish the influence of the United States.

FIGURE 11: MAP OF SOUTH ASIA



Source: U.S.-China Economic and Security Review Commission, 2016.

The overall balance of power between China and India currently is in China’s favor, and Beijing intends to keep it that way. China’s primary mechanism in this regard is its support for Pakistan. Beijing has long exploited the longstanding rivalry between India and Pakistan, aiming to keep India so preoccupied with its western neighbor that it will not have the ability to mount a serious challenge to China’s power and influence in Asia. To this end, Beijing has supported Pakistan’s military modernization for decades. It helped Pakistan build its first nuclear bomb, was instrumental in enabling its indigenous ballistic missile capability, and currently exports more arms to Pakistan than to any other country in the world. According to some observers, China’s support for Pakistan—coupled with Chinese military superiority along the disputed China-India land border and the growing Chinese naval presence in the Indian Ocean—is indicative of a Chinese strategy to encircle or contain India.

Until recently, China has lagged far behind India in terms of economic engagement with South Asia, forging a relationship with Pakistan but otherwise remaining a minor player. However, over the past decade China’s economic engagement (including trade, loans, and investment) with countries in the region has expanded dramatically, challenging India’s position. China has been a particularly prolific exporter of manufactured goods, an area where India cannot keep up due to its lagging manufacturing capacity (in fact, India’s persistent trade deficit with China contributes to bilateral frictions). China’s efforts to expand its global influence, embodied by infrastructure investment under the “One Belt, One Road” (OBOR) initiative, are gaining traction in South Asia, which is one of the least economically integrated regions in the world. To the extent that Chinese-driven transportation and other connectivity infrastructure projects can help alleviate these regional divisions, OBOR would make a positive contribution to the region. On the other hand, China’s activities in the region may exacerbate tensions and revive long-simmering conflicts. For example, India’s government is particularly troubled by the China-Pakistan Economic Corridor, a \$46 billion infrastructure investment plan under OBOR, because it would pass through the territory India claims in the disputed Kashmir region.

FIGURE 12: CHINA'S ONE BELT, ONE ROAD

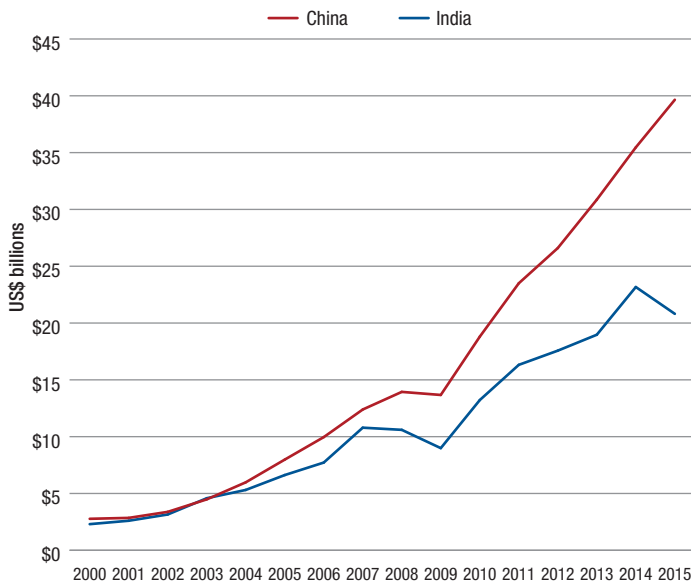


Source: Galina Petrovskaya, "'Silk Road' in EU: Trans-Caspian Transit Bypassing Russia," *Deutsche Welle*, September 3, 2016. Staff translation.

Though India has long been the dominant military power in the Indian Ocean, China has been seeking a greater presence and more influence there, primarily to protect the sea lines of communication upon which its economy depends. In recent years, this trend has been illustrated by PLA antipiracy patrols in the Gulf of Aden, submarine deployments and a combat readiness patrol in the Indian Ocean, and the announcement that China will establish its first overseas military logistics facility in Djibouti. China has also been investing in port facilities in strategic locations in the India Ocean (including Chittagong in Bangladesh, Gwadar in Pakistan, Colombo and Hambantota in Sri Lanka, Marao in the Maldives, and Kyaukpyu in Burma [Myanmar]), which is viewed by many in India as a geopolitical "string of pearls" to contain India. As both countries grow their maritime presence and capabilities, the Indian Ocean is likely to become an area of increasing competition between them.

As the threat of extremism and terrorism facing China grows, counterterrorism has become an increasingly important facet of Beijing's engagement with South Asia. Chinese leaders have for decades been concerned about Islamic extremism and terrorism in Xinjiang, China's westernmost region and home to a large Muslim minority, as well as links between terrorist activities in China and groups based in Pakistan and—to a lesser extent—Afghanistan and Central Asia. In recent years, Beijing has been more willing to increase pressure on Islamabad to take steps to eliminate any Pakistan-based activities that could potentially be directed at China or Chinese citizens abroad. China has also been enhancing bilateral and multilateral security engagement with Afghanistan, recognizing that it must shoulder greater responsibility in shaping the country's future. This is driven by the following factors: desire to ensure Afghanistan does not provide safe haven for extremists targeting China; fear that the departure of U.S. and coalition forces could leave Afghanistan in turmoil; and hope that Afghanistan can provide opportunities for Chinese companies, whose engagement in the country could encourage greater stability and security.

FIGURE 13: CHINA'S AND INDIA'S TRADE WITH SOUTH ASIA, 2000-2015



Note: Data for China's trade with South Asia exclude India.

Source: International Monetary Fund, "Direction of Trade Statistics."

## Conclusions

- ▶ China's key interests, concerns, and objectives in South Asia fall into four broad categories: (1) checking India's rise by exploiting the India-Pakistan rivalry, (2) expanding economic activity and influence in the region, (3) enhancing access to the Indian Ocean, and (4) countering terrorism and religious extremism. China's engagement in South Asia serves to expand its influence in the region and on the global stage.
- ▶ By virtue of its size, location, and historical and cultural influence, India has been the traditional regional power in South Asia. China, on the other hand, has forged a strong relationship with Pakistan since the 1960s, but otherwise has been a minor player in the region. Over the past decade, however, China's economic engagement (including trade, loans, and investment) with South Asia has expanded dramatically, challenging India's position. China has also been investing in infrastructure in the region, particularly ports in the Indian Ocean littoral states. South Asian countries take advantage of the Sino-Indian competition for influence in the region by playing the two countries against one another.
- ▶ Although China and India have begun to cooperate on issues of mutual interest, including Afghanistan and global economic integration, mutual suspicions undermine deeper engagement. Tensions in the relationship are driven by China's close relations with Pakistan, China's growing regional presence, the border dispute, and Tibet. To a lesser extent, tensions are aggravated by competition in the Indian Ocean and economic imbalances. Many of these trends have led Indians to perceive China is pursuing a strategy to encircle or contain India.
- ▶ In response to China's expanding activities in South Asia, India appears to have moved away from its traditional strategy of nonalignment toward more proactive engagement with its neighbors and countries in broader Asia, as well as the United States. Indian Prime Minister Narendra Modi's "Act East" and "Neighborhood First" policy initiatives, which include diplomatic, security, and economic components, are part of this effort.
- ▶ China's security concerns in South Asia historically have centered on its desire to enable Pakistan to thwart India's rise as a challenger to China's dominance in broader Asia. While this remains the most important determinant of Chinese security support to Pakistan, the rise of terrorism as a major perceived threat to China's security may be prompting a shift in this calculus as Beijing grows more concerned about Pakistan's complicated relationship with terrorist groups.
- ▶ Although China's relationship with Pakistan continues to be primarily based on shared security concerns, it has recently expanded to encompass economic and diplomatic components. China's economic commitment to Pakistan got a boost with the launch of the China-Pakistan Economic Corridor (CPEC), a \$46 billion infrastructure investment plan under the One Belt, One Road umbrella. For China, the goals of CPEC are threefold: (1) to create an alternative trade route through Pakistan and gain access to ports on the Arabian Sea; (2) to contain Islamic terrorism and insurgency in Xinjiang, and in Pakistan and Afghanistan through economic development; and (3) to stabilize Pakistan's economic and security environment. For Pakistan, CPEC presents an opportunity to address major infrastructure shortfalls, particularly energy shortages.
- ▶ Recent U.S.-China tensions in the Asia Pacific and Sino-Indian rivalry in South Asia have nurtured a much closer relationship between the United States and India. In 2015, the United States and India issued a "Joint Strategic Vision for the Asia-Pacific and Indian Ocean Region," emphasizing cooperation in economics and security. The relationship was further enhanced during Prime Minister Modi's visit to Washington, DC, in 2016, which culminated in extensive agreements to enhance defense technology sharing, begin a Maritime Security Dialogue, deepen cooperation on cybersecurity and outer space, and strengthen economic and trade ties. This, in turn, has led China to perceive that the United States and India are seeking to counter China's influence in the region.
- ▶ Despite these agreements, U.S.-India cooperation in the economic, diplomatic and security realms is expected to develop slowly due to India's adherence to the principle of "strategic autonomy," or the idea that India should not rely on other countries.

## SECTION 2: CHINA AND TAIWAN

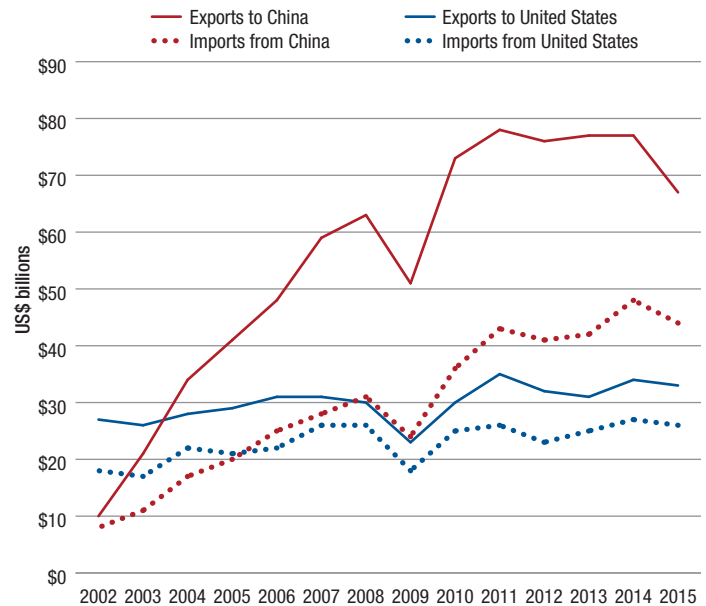
In January 2016, Taiwan citizens elected Tsai Ing-wen of the Democratic Progressive Party to the presidency, reflecting dissatisfaction with the previous eight years under the leadership of the Chinese Nationalist Party (the Kuomintang, or KMT) and concerns about the potential negative impact of growing ties with China on Taiwan's economy and political autonomy. Despite President Tsai's pragmatic cross-Straits policy of "maintaining the status quo" since taking office in May, Beijing has been displeased with her unwillingness to endorse the "one China" framework for cross-Straits relations (a framework Taipei and Beijing endorsed during the previous administration in Taiwan that acknowledges there is "one China," but that each side may maintain its own interpretation of the meaning of "one China").

As a result, Beijing is using several levers to pressure President Tsai, including suspending official communication with Taipei and, according to one Taiwan official, reducing the number of Chinese tourists going to Taiwan. In addition, since President Tsai's election, Beijing has increased its pressure on Taiwan in the international arena. For example, the UN's International Civil Aviation Organization (ICAO) did not invite Taiwan to participate in the 2016 ICAO Council Assembly, unlike the previous assembly held in 2013 when Taiwan was allowed to attend as a guest of the council's president. Beijing also is no longer cooperating with Taipei to bring Taiwan citizens who were suspected of committing crimes in countries with which Taiwan does not have official diplomatic relations back to Taiwan. Between April and September, around 200 Taiwan citizens living in Armenia, Cambodia, Kenya, and Malaysia who were accused of committing telecommunications fraud against people in China were deported to China, rather than to Taiwan, in a break from a pattern of cross-Straits cooperation that began in 2011.

Despite this pressure, Taiwan continues to pursue greater participation in the international community through its official diplomatic relations with 22 countries, efforts to expand its participation in international organizations, such as the International Criminal Police Organization (INTERPOL), and initiatives to strengthen economic and unofficial diplomatic partnerships with countries other than China. For example, one of the Tsai Administration's main initiatives to expand Taiwan's international participation is its "New Southbound Policy" of enhanced engagement with Southeast Asia, South Asia, and Oceania.

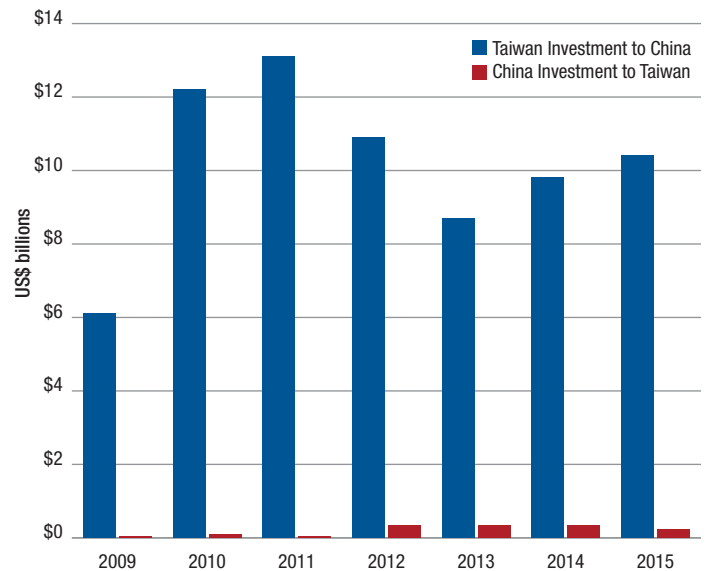
Taiwan's economic dependence on China—its largest trading partner—makes it vulnerable to fluctuations in China's economy. As of August 2016, China remains Taiwan's biggest export market and top source of imports. However, compared to 2014, total cross-Straits trade in 2015 decreased by about 11 percent, with Taiwan's exports to China shrinking by 13.2 percent, and its trade surplus with China decreasing by 21.5 percent. Taiwan's exports were hurt by China's economic slowdown and increased competition from Chinese high-tech suppliers, which undercut them on cost.

**FIGURE 14: TAIWAN'S TRADE WITH CHINA AND THE UNITED STATES, 2002-2015**



Source: Taiwan's Bureau of Foreign Trade, "Trade Statistics."  
<http://cus93.trade.gov.tw/english/fsc3/fsc3050f.aspx>.

**FIGURE 15: CROSS-STRAIT INVESTMENT, 2009-2015**



Source: Taiwan's Ministry of Economic Affairs, Investment Commission, *Monthly Report*, December 2015.  
[http://www.moeaic.gov.tw/system\\_external/ctrl?PRO=PublicationLoad&lang=1&id=245](http://www.moeaic.gov.tw/system_external/ctrl?PRO=PublicationLoad&lang=1&id=245).



The Tsai Administration also faces the challenge of a Chinese military modernization program that has increased dramatically despite eight years of enhanced cross-Strait economic, people-to-people, and government ties. Broadly, the cross-Strait military balance has shifted toward China. To meet this challenge, Taiwan has sought to enhance its military capabilities in part by indigenously developing platforms and weapons systems. Advanced antiship cruise missiles, air defense missiles, and fast attack and stealthy catamaran-style patrol ships are among the newest platforms and weapons systems Taiwan has produced. Taiwan also seeks to enhance its military capabilities through procurement of military equipment from the United States. In December 2015, the U.S. Department of State notified Congress of its approval of the potential sale of \$1.83 billion in arms to Taiwan, including two OLIVER HAZARD PERRY-class guided missile frigates, AAV-7 amphibious assault vehicles, and antitank missiles, among other platforms and weapons systems. Meanwhile, Taiwan and the United States continue to move forward with the upgrade of Taiwan's F-16 A/B fighter aircraft.

**TABLE 4: 2015 U.S. ARMS PACKAGE AND ITS UTILITY IN A CROSS-STRAIT CONFLICT**

| Platforms, Weapons, and Systems                                                                                                                          | Utility in a Cross-Strait Conflict                                                                                                                                                                                               |
|----------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Two PERRY-class guided missile frigates (refurbished)                                                                                                    | These general-purpose escort ships, which will be equipped for antisubmarine, surface-to-surface, and surface-to-air operations, would help Taiwan protect other ships against PLA submarines, surface combatants, and aircraft. |
| 36 AAV-7 Amphibious Assault Vehicles                                                                                                                     | The AAV-7s will strengthen the expeditionary capability and mobility of the Taiwan Marine Corps and would help Taiwan deploy troops along Taiwan's coastline in the event of an invasion.                                        |
| 208 Javelin antitank missiles                                                                                                                            | These portable missiles would help Taiwan defend against PLA tanks, mechanized infantry, and helicopters.                                                                                                                        |
| 769 BGM-71F tube-launched, optically-tracked, wireless-guided 2B-Aero antitank missiles                                                                  | With a range of 4.5 kilometers (3 miles), these missiles would help Taiwan engage PLA tanks and mechanized infantry at a distance.                                                                                               |
| 250 Stinger surface-to-air missiles                                                                                                                      | These missiles, with a range of five miles, would help Taiwan engage PLA aircraft approaching or over Taiwan.                                                                                                                    |
| 13 MK-15 Phalanx CIWS guns                                                                                                                               | The Phalanx close-in weapons systems (CIWS) is a close-range point-defense system and would help to defend Taiwan's surface combatants against PLA missiles and aircraft.                                                        |
| Support for Multifunctional Information Distribution System Low Volume Terminals (MIDS/LVT-1) and Joint Tactical Information Distribution System (JTIDS) | MIDS—a command, control, communications, computers, and intelligence system—and JTIDS—a radio communications system—would enhance communication and coordination across the Taiwan military during a cross-Strait conflict.      |
| Taiwan Advanced Tactical Data Link System (TATDLS) and Link-11 Integration                                                                               | TATDLS is a beyond line-of-sight datalink system that would enhance communication, data sharing, and integration between Taiwan's surface ships.                                                                                 |

Source: Various. See full Annual Report for complete list of sources.

Beyond security ties, the U.S.-Taiwan economic relationship remains strong. In 2015, bilateral trade totaled \$66.6 billion, and Taiwan became the United States' ninth-largest trading partner, surpassing India, Italy, and Brazil. U.S.-Taiwan cooperation spans many other areas as well, including environmental protection, public health, and cybersecurity. Taiwan's robust democracy, civil society, and technology sector, and its vast expertise and experience in areas such as humanitarian assistance and disaster relief make it a strong partner for the United States in facing global challenges.

## Conclusions

- ▶ In 2016, Taiwan held historic elections, in which Tsai Ing-wen of the Democratic Progressive Party (DPP), was elected Taiwan's first female president and the DPP gained an absolute legislative majority for the first time. Despite President Tsai's pragmatic cross-Strait policy focused on maintaining the status quo, Beijing appears to remain skeptical of President Tsai and has applied pressure on her administration with various statements and actions.
- ▶ China remains Taiwan's largest trading partner, biggest export market, and top source of imports. However, cross-Strait trade has slowed, in large part due to the negative impact of China's economic slowdown and the emergence of Chinese competitors on Taiwan's information technology exports to China, which underscores the vulnerability of Taiwan's export-dependent economy to developments in China.
- ▶ Taiwan's ability to participate in the international community is not only crucial to the wellbeing of its people but is also key to Taiwan's ability to contribute to international safety, security, and prosperity. Beijing restricts Taiwan's participation in international organizations and has placed additional limitations on Taiwan's international activities since President Tsai was elected. Should Beijing seek to further increase pressure on Taipei, it may take additional steps to restrict Taiwan's international space, including by enticing some countries with which Taiwan has diplomatic relations to cut ties and establish diplomatic relations with China.
- ▶ China's military modernization remains focused on preparing for a range of Taiwan contingencies, and the advancement in the capabilities of the People's Liberation Army (PLA) presents a significant challenge to Taiwan's ability to defend itself and the U.S. military's ability to effectively intervene in a cross-Strait conflict. Taiwan is engaged in a robust program to enhance its defensive capabilities through its domestic defense industrial production, the procurement of U.S. weapons systems, and its transition to an all-volunteer force, efforts which the Tsai Administration seeks to refine and build upon. However, the cross-Strait military balance has shifted toward China, and the PLA possesses both a quantitative and a qualitative military advantage over the Taiwan military.

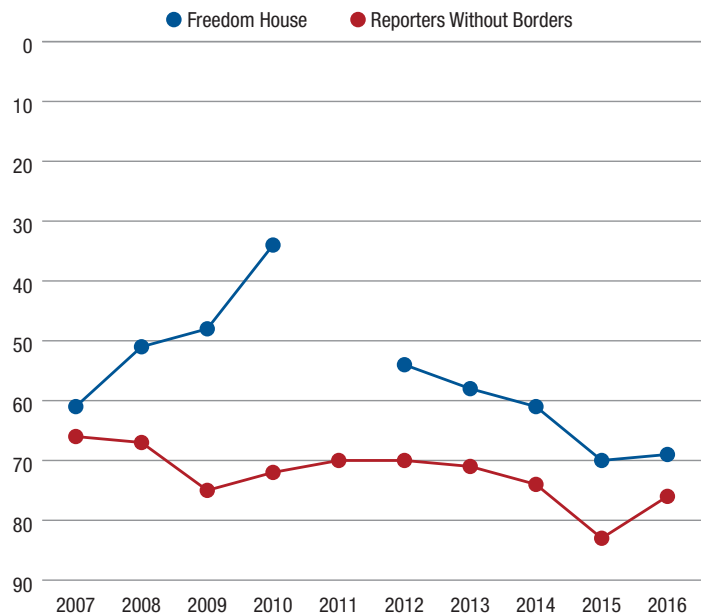
- U.S.-Taiwan relations have transitioned smoothly from the Ma Administration to the Tsai Administration and continue to strengthen and expand in scope. Security cooperation remains a robust area of the U.S.-Taiwan relationship.

### SECTION 3: CHINA AND HONG KONG

In a trend that has worsened since last year, mainland China has sought to exercise greater control over Hong Kong despite Hong Kong citizens' desire for more autonomy and democratic governance. Beijing's insistence on an electoral system that ensures the continuity of a pro-Beijing Hong Kong government and legislature has contributed to mounting feelings of frustration and disillusionment among prodemocracy advocates—particularly among young people. In the run-up to Hong Kong's September 2016 legislative election, the Hong Kong government, with Beijing's backing, banned six pro-independence candidates from running in the elections. Mainland China's heavy-handed efforts to limit support for the prodemocracy camp backfired, however: a record 58 percent voter turnout saw prodemocracy candidates capture 30 of 70 total seats, earning a net gain of three seats.

Hong Kong continues to face a steady erosion of the freedoms guaranteed under Hong Kong's mini constitution, the Basic Law. Many incidents have contributed to this trend, but perhaps none has had as significant a chilling effect as the mainland authorities' apparent abduction and detention of five Hong Kong sellers of political gossip books banned in mainland China. The disappearance of the booksellers, whose whereabouts were unknown for six months, raised concerns about Hong Kong's autonomy and rule of law among Hong Kong citizens, including those not previously worried about such issues, and demonstrated the deterioration of the "one country, two systems" framework. (The "one country, two systems" framework grants Hong Kong and Macau the right to self-govern their economy and political system to a certain extent, excluding foreign affairs and defense.) While the long-term effects of the incident are unclear, immediate impacts have already been felt throughout the book publishing industry, including self-censorship and bookstore closures. In addition to the booksellers incident, Hong Kong continues to face pressure on press and academic freedoms. Mainland e-commerce giant Alibaba's December 2015 acquisition of Hong Kong-based English-language newspaper *South China Morning Post* demonstrated Beijing's growing influence in Hong Kong media. In schools, Beijing and the Hong Kong government are applying pressure on prodemocracy activism and attempting to restrict the discussion of pro-independence ideas.

**FIGURE 16: HONG KONG'S GLOBAL PRESS FREEDOM RANKING, 2007-2016**



*Note:* Reporters Without Borders did not publish a report in 2011 and instead published a 2012 report reflecting events between December 1, 2010, and November 30, 2011. In the Reporters Without Borders ranking, 180 represents the country or territory with the lowest press freedom. In the Freedom House ranking, 199 represents the country or territory with the lowest press freedom.

*Source:* Reporters Without Borders, "Hong Kong," April 2016; Freedom House, "Freedom of the Press," April 2016, 23.

Regarding economic issues, Beijing is seeking to leverage Hong Kong's status as a leading global financial hub to facilitate the Mainland's economic priorities. Hong Kong continues to play a key part in Beijing's push to internationalize the RMB. Mainland and Hong Kong stock markets are also growing more integrated. Although the Shanghai-Hong Kong Stock Connect has not lived up to expectations (with money flowing to Hong Kong far outpacing flows to the Mainland), the opening of the Shenzhen-Hong Kong Stock Connect, planned for November 2016, is expected to attract more global investors since Shenzhen is the center for the Mainland's high-tech companies.

As Hong Kong's sole provider of defense under the Basic Law, the PLA over time has gradually expanded its presence but has maintained a relatively low profile compared to its activities and operations in and around mainland China. The PLA has worked to expand its outreach efforts to Hong Kong citizens and has conducted increasingly complex exercises. Many of these exercises have occurred during particularly sensitive periods, leading prodemocracy advocates and other observers to argue the CCP is using the PLA as a coercive tool to pressure Hong Kong citizens.



U.S. policy toward Hong Kong is based on the U.S.-Hong Kong Policy Act of 1992, which outlines U.S. support for Hong Kong's democratization, human rights, and autonomy under the "one country, two systems" framework. Hong Kong's 2016 legislative election serves as a vivid example of Hong Kong's democratic progress, particularly in resisting interference from Beijing. However, the recent downward trends in Hong Kong with regard to electoral reform, press freedom, and academic freedom run counter to U.S. interests and values. The case of Hong Kong—particularly as it relates to the booksellers incident and encroachment on press and academic freedoms—reflects a broader pattern of behavior in which Beijing disregards norms, agreements, or laws (either in spirit or in letter) in pursuit of its objectives. Moreover, Hong Kong's traditional standing as a global financial hub has economic implications for the United States, as U.S. trade and investment ties with Hong Kong are substantial. Many in the Hong Kong business community, including U.S.-based and global firms, are beginning to question Hong Kong's future as a global financial center due to the apparent threat to rule of law and the deterioration of the "one country, two systems" model, particularly in the aftermath of the booksellers incident over the past year.

## Conclusions

- ▶ In the highest voter turnout to date for the 2016 Legislative Council elections, Hong Kong citizens rejected Beijing's heavy-handed efforts to limit support for prodemocracy candidates, resulting in the pan-democrats winning 30 out of 70 total seats (a net gain of three) and maintaining its ability to block pro-Beijing legislation. The election of five candidates from political parties founded in the aftermath of the 2014 Occupy protests demonstrated progress in Hong Kong's democratic development, particularly the increasing involvement and influence of young people in the political process.
- ▶ The case of the five Hong Kong sellers of political gossip books banned in mainland China who appeared to have been abducted and detained by Chinese authorities led many, including those not previously concerned, to call into question the state of Hong Kong's ability to maintain its independent legal system; Hong Kong's autonomy under the "one country, two systems" model; and the city's standing as a global financial center. Although long-term impacts are unclear at this time, the incident has already caused a chill throughout the book publishing industry, leading to bookstore closures and increased self-censorship.
- ▶ Beijing's refusal in 2014 to allow democratic reforms to the chief executive nomination process along with increased pressure on Hong Kong's political discourse over the past year, have led to greater disillusionment and pessimism among Hong Kong prodemocracy advocates regarding China's commitment to the "one country, two systems" framework.

- ▶ Hong Kong continues to face pressure on press and academic freedoms guaranteed under its mini constitution, the Basic Law. Schools in Hong Kong are facing increasing pressure, limiting open debate about democratic ideas and independence. Chinese e-commerce giant Alibaba's acquisition of the Hong Kong-based English-language newspaper *South China Morning Post* demonstrated Beijing's increasing reach into Hong Kong. Hong Kong citizens and international press freedom watchdogs have expressed their concern regarding these developments.
- ▶ In 2016, Hong Kong played an increasing role in Beijing's push to internationalize the renminbi. Although the existing Shanghai-Hong Kong Stock Connect has not lived up to expectations thus far due in part to regulatory deficiencies, as it matures over the coming years the platform could help facilitate greater investment into mainland stock markets. In November, Beijing plans to establish a second stock connect between Shenzhen and Hong Kong, which is expected to have greater appeal to global investors as Shenzhen is a base for the Mainland's emerging industries and its most active stock exchange.
- ▶ As Hong Kong's sole provider of defense under the Basic Law, the People's Liberation Army (PLA) has retained a relatively low-key presence, but has gradually expanded its outreach efforts to Hong Kong citizens. The PLA has also conducted increasingly sophisticated exercises in recent years, particularly during sensitive periods in Hong Kong, leading some to accuse Beijing of using the exercises to pressure Hong Kong citizens.
- ▶ China's efforts to exert influence over Hong Kong in ways that undermine Hong Kong's autonomy under the Basic Law reflect a broader pattern of reliance on tools of pressure and coercion—rather than norms, laws, and agreements—to advance its interests vis-à-vis its neighbors. This pattern is also evident in China's relations with Taiwan and its recent behavior in the South China Sea.
- ▶ Hong Kong's standing as a global financial hub has significant economic implications for the United States, as U.S. trade and investment ties with Hong Kong are substantial. Nonetheless, some observers in Hong Kong are beginning to question its future as a global financial center due to the deterioration of the "one country, two systems" framework resulting in large part from the booksellers incident over the past year.

## SECTION 4: CHINA AND NORTH KOREA

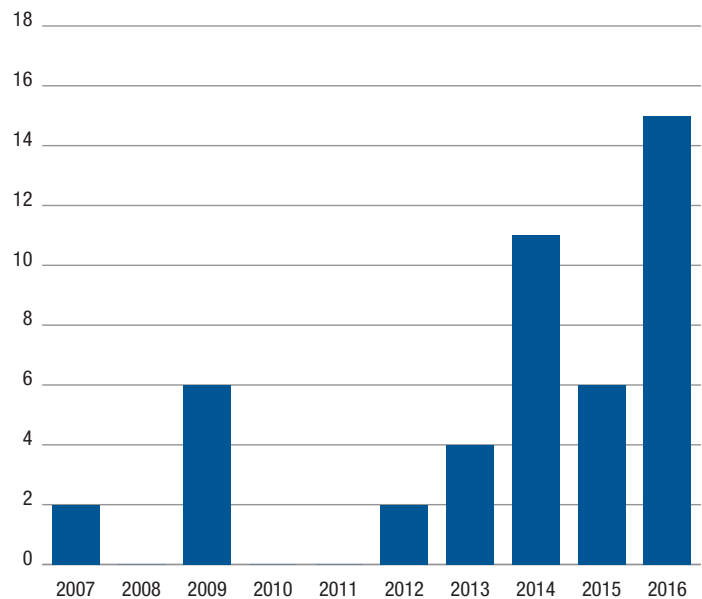
Following North Korea's fourth nuclear test in January 2016, Beijing agreed to UN Security Council Resolution (UNSCR) 2270, the most stringent set of sanctions on North Korea to date. The sanctions notably restricted, among other things, coal and other mineral imports from North Korea, which are a significant source of hard currency for Pyongyang and one of the major areas of China-North Korea trade (North Korean revenue from coal exports exceeds \$1 billion per year). Although it is too early to judge China's complete enforcement of UNSCR 2270, evidence suggests Beijing has not stopped the trade of all banned items with North Korea and has not fully maintained its commitments under the resolution. This behavior follows China's historical pattern of strictly enforcing sanctions in the months immediately following new rounds of sanctions and then loosening enforcement. For example, in the aftermath of the resolution the Chinese government issued new restrictions on certain trade with North Korea, banned North Korean remittances in Dandong (a Chinese border city through which an estimated 70 percent of China-North Korea trade passes), and took other actions in compliance with UNSCR 2270. However, in May and June some banned vessels listed in UNSCR 2270 were seen entering and leaving Chinese ports, while others have been observed operating close to Chinese ports and then disappearing from radar, raising questions about whether these vessels were conducting banned trade with China. Moreover, in August, China imported a record amount of coal in a single month, amounting to a 74 percent jump compared to the same month in 2015. In the wake of North Korea's fifth nuclear test in September, its second in 2016 and most powerful to date, China pledged to work with the United States and other UN Security Council members to further tighten North Korea sanctions. As this Report went to print, it was unclear how this cooperation would unfold.

Whether UNSCR 2270 and the forthcoming round of sanctions are effective will depend in large part on how China manages its economic relationship with North Korea going forward. China now accounts for over 90 percent of North Korea's legitimate foreign trade and approximately 95 percent of foreign direct investment in North Korea. Chinese firms also import North Korean labor to circumvent investment restrictions. As of August 2016, at least 70,000 North Koreans were estimated to have been working in China, providing several hundred million dollars annually to the Kim regime. Another critical area of support for North Korea is Chinese energy assistance, including an estimated 500,000 tons of oil per year. Chinese entities play a central role in illicit North Korean economic activity as well. The international community hopes that China will use this immense economic influence over North Korea to pressure Pyongyang to cease its provocations and eventually pursue denuclearization.

Such an outcome is unlikely, however. Even as Beijing's frustrations with Pyongyang have grown in recent years, Beijing continues to emphasize stability above denuclearization as its guiding strategy regarding North Korea policy. Given its fear of instability in North Korea making its way into China and of losing its strategic buffer with U.S.-allied South Korea, Beijing will almost certainly not cut off trade of critical resources with Pyongyang, including coal and oil, and other sources of hard currency for North Korea.

The July decision by South Korea and the United States to deploy the United States' Terminal High Altitude Area Defense (THAAD) ballistic missile system in South Korea by late 2017 appears to be reinforcing Beijing's long-held suspicion of U.S. intentions on the Korean Peninsula. Despite U.S. assurances that THAAD is not directed at China, Beijing sees the planned THAAD deployment complicating its security environment by expanding U.S.-allied radar into mainland China and facilitating broader strategic cooperation between the United States, South Korea, and Japan, including closer intelligence sharing.

**FIGURE 17: NORTH KOREA MISSILE TESTS VIOLATING UN RESOLUTIONS, 2007-SEPTEMBER 2016**

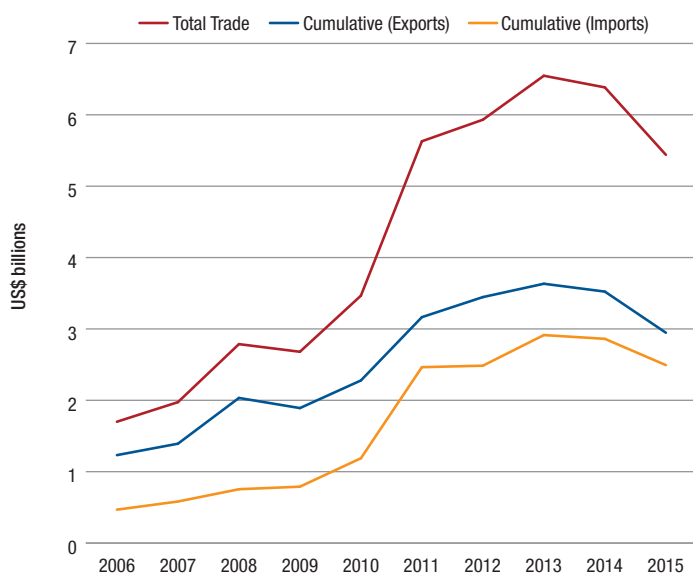


*Note:* Missile tests in this figure are defined as including all launches using ballistic missile technology in a single day. Tests in 2016 are current as of October 20, 2016.

*Source:* Ju-min Park and Eric Walsh, "Another North Korea Missile Test Fails after Launch, Says U.S. and South," Reuters, October 20, 2016; Associated Press, "US, S. Korea Say Latest N. Korea Missile Launch Fails," October 15, 2016; Victor Cha, "North Korean Provocations & US-ROK Military Exercises Dataset," *CSIS Beyond Parallel Original Datasets*, September 2016. <http://beyondparallel.csis.org/database/>; and for 2016 missile tests through September, see Japan's Ministry of Defense, *North Korea's Missile Launches in 2016*, September 9, 2016. Staff translation. [http://www.mod.go.jp/j/approach/surround/pdf/dprk\\_bm\\_20160909.pdf](http://www.mod.go.jp/j/approach/surround/pdf/dprk_bm_20160909.pdf).

As the North Korean threat to U.S. security interests grows, U.S. engagement with China on North Korea is of increased importance. However, China's views of the U.S. role in the region pose obstacles to the productive engagement necessary to achieve the goal of denuclearization of the Korean Peninsula. Moreover, Beijing's unwillingness to apply the full force of its economic influence on Pyongyang necessarily leaves the United States and the international community hamstrung in encouraging change in North Korea. Beijing's public statements prioritizing denuclearization in addressing the North Korea problem are unsupported by its actions.

**FIGURE 18: CHINA-NORTH KOREA TRADE, 2006-2015**



Source: China General Administration of Customs via CEIC database.

## Conclusions

▶ Following a series of missile and weapons systems tests demonstrating alarming advances in capabilities, in September 2016 North Korea conducted its fifth nuclear test, which was the most powerful to date. Beijing's diplomatic response to the test was its strongest yet, condemning the test and emphasizing that Pyongyang abide by UN resolutions. As of the publication of this Report, Beijing has said it will cooperate in a forthcoming UN resolution tightening sanctions on North Korea, but given its track record China can be expected to unevenly enforce sanctions in a way that will not seriously destabilize the Kim regime.

▶ Since 2012, when President Xi Jinping took office and Kim Jong-un became leader of North Korea, persistent North Korean belligerence has contributed to a noticeable downturn in China's relations with North Korea. This trend continued in 2016 when, after North Korea's fourth nuclear test, China supported the most stringent UN Security Council resolution to date on North Korea. Beijing appears to be attempting to maintain some stability in the relationship, but notably high-level exchanges (at the vice ministerial-level and above) between China and North Korea have decreased since the beginning of 2015 compared to the previous two-year period, continuing a negative trend from years prior.

▶ As North Korea increases the frequency of its missile tests, especially those using ballistic missile technology, and the UN Security Council and countries in Northeast Asia call for increased pressure on Pyongyang, Beijing continues to emphasize stability and the status quo above denuclearization as its guiding strategy regarding North Korea policy. Given its fear of instability in North Korea making its way into China and its desire to retain a strategic buffer between itself and U.S.-allied South Korea, Beijing will almost certainly not cut off trade of critical resources with Pyongyang, including coal and oil, or other sources of hard currency for North Korea.

▶ Although it is still too early to judge the full extent of China's enforcement of UN Security Council Resolution 2270, thus far Beijing has unevenly enforced sanctions and used to its advantage a significant loophole that allows China an exception to continue importing North Korean coal, iron, and iron ore for "livelihood purposes." While certain areas of progress and gaps are evident in Chinese enforcement thus far, China's lack of accountability and transparency in enforcing sanctions increases the difficulty for international observers to determine its level of enforcement.

▶ In accordance with the North Korea Sanctions and Policy Enhancement Act of 2016 (which became law in February 2016), the U.S. Department of the Treasury in September for the first time sanctioned Chinese entities with economic ties to North Korea, designating Dandong Hongxiang Industrial Development Co. and four Chinese nationals who directed and managed the firm for sanctions evasion activities and froze their assets. In addition, the U.S. Department of Justice indicted the individuals and entity for sanctions violations, conspiracy, and money laundering. It also confiscated funds in 25 Chinese bank accounts allegedly belonging to the firm and its front companies. These actions could compel Beijing to increase regulatory measures on Chinese firms doing business with North Korea, but such measures will probably be constrained by China's desire to support the Kim regime.

- ▶ China claims the decision by South Korea and the United States to deploy the U.S. Terminal High Altitude Area Defense (THAAD) ballistic missile defense system to South Korea to defend against North Korea's increased nuclear and missile capabilities is a direct threat complicating its own security environment. Beijing has used the announced deployment to obstruct international and regional cooperation on North Korea and to reduce certain areas of economic cooperation with South Korea. Over the near term, THAAD is likely to encourage China to move closer to North Korea, while increasing frictions between China, the United States, and South Korea.
- ▶ China's close economic ties with North Korea are unlikely to diminish significantly in the near term. In 2015, China accounted for approximately 91 percent of North Korea's legitimate foreign trade of \$6.25 billion (excluding trade with South Korea). One of North Korea's main sources of hard currency (which is not covered by sanctions) is from foreign labor, which generates revenue in the low hundreds of millions of dollars annually, mainly in China and Russia. According to an estimate in August 2016, approximately 70,000–80,000 North Korean workers are employed in China, and around 34,000 North Koreans work in two Chinese border cities, with this number set to rise in the coming years.
- ▶ As the North Korean threat increases, placing U.S. alliances and security interests at risk, China's skepticism about the U.S. role in the region poses obstacles to the productive engagement necessary to achieve the goal of denuclearization of the Korean Peninsula. Chief among these obstacles is Beijing's view that U.S. policy on North Korea is designed to strengthen U.S. alliances to contain China, and that U.S. military exercises with South Korea incite Pyongyang to conduct further provocations.

## Chapter 4: China and the U.S. Rebalance to Asia

Since its inception in 2011, the Rebalance to Asia strategy has been a defining feature of U.S. international relations and of U.S.-Asia Pacific and U.S.-China relations in particular. Following on efforts begun under the previous administration, the Obama Administration adopted this strategy in order to bolster U.S. engagement and leadership in a region of growing importance to U.S. interests, and thereby promote a rules-based international order featuring security, shared economic prosperity, and good governance. Although China's aggressive and coercive behavior intensified preceding the Rebalance, the Administration has sought to tie the strategy to defending international norms rather than to any one country in particular, and affirmed repeatedly that it welcomes "the rise of a peaceful and prosperous China."

**TABLE 5: U.S. GOODS TRADE WITH ASIA AND CHINA, 2003-2015 (US\$ BILLIONS)**

| Year | Asia    |         | China   |         | China's Share of U.S.-Asia Trade |         |
|------|---------|---------|---------|---------|----------------------------------|---------|
|      | Exports | Imports | Exports | Imports | Exports                          | Imports |
| 2003 | \$206   | \$493   | \$28    | \$152   | 14%                              | 31%     |
| 2004 | \$231   | \$581   | \$34    | \$197   | 15%                              | 34%     |
| 2005 | \$252   | \$659   | \$41    | \$243   | 16%                              | 37%     |
| 2006 | \$291   | \$743   | \$54    | \$288   | 19%                              | 39%     |
| 2007 | \$327   | \$783   | \$63    | \$321   | 19%                              | 41%     |
| 2008 | \$359   | \$825   | \$70    | \$338   | 19%                              | 41%     |
| 2009 | \$308   | \$644   | \$69    | \$296   | 22%                              | 46%     |
| 2010 | \$387   | \$796   | \$92    | \$365   | 24%                              | 46%     |
| 2011 | \$439   | \$900   | \$104   | \$399   | 24%                              | 44%     |
| 2012 | \$457   | \$966   | \$111   | \$426   | 24%                              | 44%     |
| 2013 | \$475   | \$973   | \$122   | \$440   | 26%                              | 45%     |
| 2014 | \$481   | \$1,018 | \$124   | \$468   | 26%                              | 46%     |
| 2015 | \$458   | \$1,007 | \$116   | \$483   | 25%                              | 48%     |

Source: U.S. Census Bureau, U.S. Trade in Goods by Country. <http://www.census.gov/foreign-trade/balance/index.html>.

The Rebalance strategy includes security, diplomatic, and economic components. To increase and sustain its regional security presence, the United States has most notably begun rotations of U.S. marines to Australia; strengthened deployments on Guam; implemented new access agreements with Australia, the Philippines, and Singapore; announced an initiative to fund maritime capacity building in Southeast Asia; and planned to base 60 percent of its Navy in the region by 2020. These initiatives will likely be affected by future U.S. budget decisions and resulting total force numbers. In diplomatic terms, the Rebalance has increased the number of visits to the region by senior officials, expanded engagement in regional governance institutions, and invested heavily in regional bilateral relationships, notably upgrading relations with Burma and Vietnam. The Asia Pacific still receives only a small fraction of total U.S. funding for diplomatic engagement, foreign assistance, and security assistance funding, however. The United States has also sought to increase its regional economic engagement and establish an economic framework for the region through new agreements such as the Trans-Pacific Partnership (TPP), which is regarded by administration officials as the centerpiece of the economic side of the Rebalance. Although other initiatives have been launched, none have been of a scale comparable to that of TPP. U.S. trade with Asia has increased during the Rebalance, but China has claimed the lion's share of the growth in U.S. regional trade.

**TABLE 6: SIMULATED EFFECTS OF TPP AND RCEP ON CHINESE ECONOMY (US\$ BILLIONS)**

|                 | TPP Passed | TPP Not Passed |
|-----------------|------------|----------------|
| RCEP Passed     | \$72 gain  | \$88 gain      |
| RCEP Not Passed | \$22 loss  | No Change      |

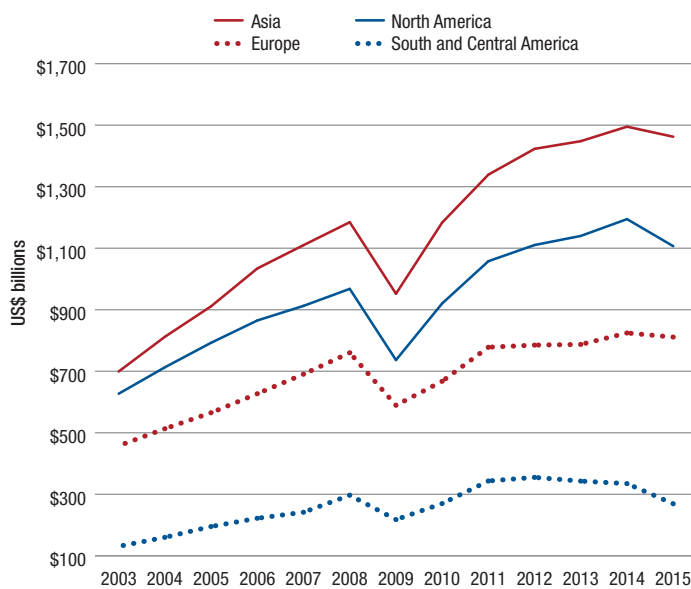
*Source:* Ronglin Li and Yang Hu, “The Regional Comprehensive Economic Partnership, the Trans-Pacific Partnership, and China’s Free Trade Strategies,” in Harsha Vardhana Singh, ed., *TPP and India: Implications of Mega-Regionals and Developing Countries*, Wisdom Tree, 2016, 209-210.

China’s rhetorical response to the Rebalance and its policy decisions since the strategy was announced indicate how its regional approach may unfold in the long term. China at first officially responded to the Rebalance by welcoming it cautiously, but Beijing has since criticized the military component in particular and increasingly sought to attribute tensions in the South China Sea to the strategy. Official statements aside, many in China appear to hold deeply suspicious and negative views of the Rebalance, describing the strategy as pursuing “containment” or reflective of a “Cold War mentality.” Concurrent with the Rebalance, China has promoted the Conference on Interaction and Confidence-Building Measures in Asia (CICA) as a potential alternative regional security framework to that offered by the United States; continued its rapid military buildup and investments in conventional regional strike capabilities targeting U.S. facilities in the Asia Pacific; and, most significantly, persisted in its coercive actions against neighboring states in the maritime realm. In 2016 alone, China conducted exercises in disputed waters; continued to warn off U.S. aircraft and warships; militarized its artificial islands in the South China Sea contrary to public commitments; declared the July 2016 ruling by the Permanent Court of Arbitration on the disputes “null and void”; and reportedly conducted activities around Scarborough Reef (a strategically important disputed area) that raised concerns it might begin land reclamation, among other actions. Beijing’s willingness to challenge the rules-based international order—both before and after the United States initiated the Rebalance—remains a key point of friction between the two countries and their respective visions for the region.

In economic terms, China has worked over the course of the Rebalance to create new institutions such as the Asian Infrastructure Investment Bank to enhance its role in regional economic development. It has also sought to establish new trade agreements such as the Regional Comprehensive Economic Partnership and bilateral free trade agreements with U.S. allies such as Japan, Australia, and South Korea. These agreements may lessen the negative trade distortion effects on China that might arise if TPP were approved and impose fewer constraints on China than would a U.S.-led trade agreement, due to their weaker provisions. China has also sought to place itself at the center of a new network of regional infrastructure projects by pledging massive resources to its OBOR initiative.



**FIGURE 19: U.S. GOODS TRADE WITH ASIA, EUROPE, NORTH AMERICA, AND SOUTH AND CENTRAL AMERICA, 2003-2015**



Source: United States Census Bureau, *U.S. Trade in Goods by Country*.  
<http://www.census.gov/foreign-trade/balance/index.html>.

## Conclusions

- U.S. government statements have tied the Rebalance strategy to the upholding of the “liberal, rules-based international order” in the Asia Pacific, viewing the preservation of this order as broadly aligning with U.S. interests. It represents a tactical adjustment rather than a strategic shift in U.S. policy, seeking to maintain U.S. commitments to the region in an era of new challenges to these interests.
- Although China has voiced measured criticism of the Rebalance in official statements, opposition at other levels indicates a deeply negative perception overall. China has also expressed support for alternative regional security and economic frameworks, pursued coercive actions against neighboring countries in violation of its international commitments, and sought to promote its own free trade agreements since the Rebalance began.
- China alternately supports or challenges the international order based on varying interests, a point of friction in the Asia Pacific, where proximity and core territorial interests factor into Beijing’s views. China’s current leaders probably do not have foreign policy goals that are fundamentally different from those in the past, but are more assertive in making tactical decisions. These observations shed light on why Beijing has undertaken its current regional approach.
- The United States has attempted to emphasize that the Rebalance is focused on upholding principles, not on countering China for its own sake.

- To date, the Trans-Pacific Partnership is the only fully-developed significant economic component under the Rebalance. By its very nature as a free trade agreement, it does not address all U.S. economic interests and objectives in the region.
- Other economic initiatives under the Rebalance have been relatively small. Trade with Asia has increased under the Rebalance, and U.S. trade with China has grown faster than in other Asian countries.

# Comprehensive List of the Commission's Recommendations

The Commission considers 10 of its 20 recommendations to Congress to be of particular significance. These recommendations are denoted in **bold blue text**.

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

### SECTION 2: STATE-OWNED ENTERPRISES, OVERCAPACITY, AND CHINA'S MARKET ECONOMY STATUS

The Commission recommends:

1. Congress amend the statute authorizing the Committee on Foreign Investment in the United States to bar Chinese state-owned enterprises from acquiring or otherwise gaining effective control of U.S. companies.
2. Congress direct the U.S. Government Accountability Office to prepare a report examining the extent to which large-scale outsourcing of manufacturing activities to China is leading to the hollowing out of the U.S. defense industrial base. This report should also detail the national security implications of a diminished domestic industrial base (including assessing any impact on U.S. military readiness), compromised U.S. military supply chains, and reduced capability to manufacture state-of-the-art military systems and equipment.
3. Congress require that under antidumping and countervailing duty laws, Chinese state-owned and state-controlled enterprises are presumed to be operating on behalf of the state and, as a result, do not have standing under U.S. laws against unfair trade to block a case from proceeding.
4. Congress create an office within the International Trade Administration whose sole purpose is to identify and initiate antidumping and countervailing duty cases to ensure a more effective and timely response to China's unfair trade practices.
5. **Congress enact legislation requiring its approval before China—either the country as a whole or individual sectors or entities—is granted status as a market economy by the United States.**

### SECTION 3: CHINA'S 13TH FIVE-YEAR PLAN

The Commission recommends:

6. **Congressional committees of jurisdiction hold hearings to:**
  - **Analyze the impact of China's state-directed plans such as the Made in China 2025 and Internet Plus on U.S. economic competitiveness and national security, and examine the steps Congress can take to strengthen U.S. high-tech and high-value-added industries such as artificial intelligence, autonomous vehicles and systems, and semiconductors.**
  - **Ensure that U.S. government agencies such as the U.S. Department of the Treasury, U.S. Department of Commerce, and the Office of the U.S. Trade Representative have sufficient personnel, funding, and Chinese-language capabilities to examine China's economic and trade policies and China's compliance with its bilateral and multilateral commitments, including the World Trade Organization.**
  - **Examine U.S. access to China's domestic market, particularly for services and high-tech sectors. This hearing should assess how U.S. government agencies such as the U.S. Department of Commerce and the Office of the U.S. Trade Representative are seeking to increase market access for U.S. firms and explore what additional policy options could be pursued.**
7. Congress direct the U.S. Department of the Treasury to prepare a report analyzing U.S. exposure to China's financial sector and the impact of China's financial sector reforms on the U.S. and global financial systems. This report should also identify the policies the U.S. government is or should be adopting to protect U.S. interests in response to this changing environment.

## Chapter 2: U.S.-China Security Relations

### SECTION 2: CHINA'S FORCE PROJECTION AND EXPEDITIONARY CAPABILITIES

The Commission recommends:

8. Congress require the U.S. Department of Defense conduct a study identifying the risks and gains associated with the United States pursuing a burden sharing strategy that utilizes emerging People's Liberation Army expeditionary capabilities to help stabilize the Asia Pacific region during a crisis or to counter a shared threat such as the spread of terrorism in Southeast Asia.

### SECTION 3: CHINA'S INTELLIGENCE SERVICES AND ESPIONAGE THREATS TO THE UNITED STATES

The Commission recommends:

9. Congress direct the U.S. Department of State to develop educational materials to alert U.S. citizens living and traveling abroad about recruitment efforts by Chinese intelligence agents, and to make these materials available to U.S. universities and other institutions sending U.S. students to China. Congress should also direct the U.S. Department of Defense to develop and implement a program to prepare U.S. students studying in China through Department of Defense National Security Education Programs to recognize and protect themselves against recruitment efforts by Chinese intelligence agents.
10. Congress direct the Federal Bureau of Investigation to provide a classified report to Congress on what risks and concerns have been identified as associated with information systems acquired by the U.S. government, and how those risks are being mitigated. This report should identify information systems or components that were produced, manufactured, or assembled by Chinese-owned or controlled entities.

## Chapter 3: China and the World

### SECTION 2: CHINA AND TAIWAN

The Commission recommends:

11. Members of Congress and Congressional staff seek opportunities to advance U.S.-Taiwan economic, political, and security relations, support Taiwan's participation in international organizations, and draw attention to Taiwan's democratic achievements and contributions to the international community.
12. Congress urge the executive branch to make available to Taiwan, consistent with the Taiwan Relations Act, defense articles and services required to address the continuing shift in the cross-Strait military balance toward China.

13. Congress direct the U.S. Department of State to reexamine its policy guidelines on reciprocal visits by senior U.S. and Taiwan military officers and civilian officials with the aim of increasing high-level exchanges.
14. Congress request briefings by the Office of the U.S. Trade Representative on the status of the Trade and Investment Framework Agreement negotiations with Taiwan and direct the Office of the U.S. Trade Representative to identify enhanced negotiating procedures to resolve outstanding issues and ensure an accelerated path to conclude such talks.

### SECTION 3: CHINA AND HONG KONG

The Commission recommends:

15. Congress express that China's apparent abduction and detention of five Hong Kong and foreign national booksellers based in Hong Kong for selling banned books to customers in mainland China violates its commitments to maintaining a "high degree of autonomy" in Hong Kong under the "one country, two systems" framework. In addition, members of Congress in their meetings in China should continue to express support for human rights and rule of law in Hong Kong.
16. Congress continue to renew annual reporting requirements of the U.S.-Hong Kong Policy Act of 1992, in an effort to ensure policymakers have the most up-to-date and authoritative information about developments in Hong Kong.
17. Congress direct the U.S. Department of State to prepare a report that assesses whether Hong Kong has maintained a "sufficient degree of autonomy" under the "one country, two systems" policy, due to the deterioration of freedom of expression in Hong Kong and Beijing's increasing encroachment.

### SECTION 3: CHINA AND NORTH KOREA

The Commission recommends:

18. Congress require the U.S. Department of State to produce an unclassified report assessing China's compliance with UN resolutions on North Korea.

## Chapter 4: China and the U.S. Rebalance to Asia

The Commission recommends:

19. Congress express support for more frequent U.S. freedom of navigation operations in the South China Sea in conjunction with U.S. allies and partners.
20. Congress direct the U.S. Department of Defense to include a permanent section in its *Annual Report on Military and Security Developments Involving the People's Republic of China* on the role and activities of China's maritime militia and the implications for U.S. naval operations.

## Notes

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2016 Report to Congress  
of the  
U.S.-China Economic and  
Security Review Commission

Executive Summary and Recommendations