



FOR IMMEDIATE RELEASE

November 14th, 2012

The U.S.-China Economic and Security Review Commission was created by Congress to report on the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China. For more information, visit www.uscc.gov or call 202-624-1407.

2012 REPORT TO CONGRESS RELEASED

Washington, D.C. - The U.S.-China Economic and Security Review Commission released its 2012 Report to Congress today.

This year's report covers recent developments in the U.S.-China trade and economic relationship; the role of state-owned enterprises in China, the U.S.-China trade and investment relationship, recent developments in China's military, China's cyber capabilities, developments in China's nuclear and strategic abilities, China in the South China Sea, Taiwan, Hong Kong, China in Europe, China's demand and control of global resources, China's efforts to become a more innovative society, and the Chinese political transition.

At the release event, the Commission's Chairman, Dennis Shea, and Vice Chairman, William Reinsch, made the following statements:

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

Good morning and thank you for joining us for this introduction to the tenth Report of the U.S.-China Economic and Security Review Commission. Each year, in accordance with our mandate, we survey some of the most critical issues in the U.S.-China bilateral relationship. This Report conveys our findings from the past year, along with providing recommendations to Congress about how best to respond to some of the problems we have identified.

In the wake of elections here in the United States, and amid China's parallel leadership transition, this Report could not be timelier. A new generation of younger Communist Party leaders is poised to assume control over the levers of power in China. Although their predecessors will affect important decisions into the future, these new leaders will seek to forge a new consensus on the major issues of the day. Throughout 2012, against a backdrop of

developments like Chen Guangcheng's escape from house arrest and the Bo Xilai crisis, China's political agenda has centered upon ensuring that this transfer of power is smooth and successful. Many of the policies Beijing has pursued throughout the year become clearer when viewed through that prism. On macroeconomic and domestic policy issues, continuity appeared to be the dominant consideration.

Conversely, China's political transition appeared to create the conditions for more muscular and uncompromising security and foreign policies. China's approach to the East and South China Seas, for example, demonstrated a new assertiveness in the region. Although Chinese fishermen and civil maritime enforcement agencies may have been initially responsible for some of the incidents that elevated tensions with China's neighbors, subsequent hard-line diplomacy from the central government appeared to result from an inability to take a more moderate course. While appealing to nationalistic elements of the Chinese population, these disputes had negative consequences for regional relations. Japan, with which China clashed over the Senkaku/Diaoyou islands, and the Philippines, with which China clashed over Scarborough Shoal, both perceived an attitude of belligerence from Beijing.

China's ability to pursue such policies follows from the capabilities provided by its increasingly modern military forces. Decades into a multi-front modernization, the People's Liberation Army is demonstrating new advancements at a remarkable rate. Just within the past year, China has commissioned its first aircraft carrier; test flown a second potentially stealthy, advanced fighter aircraft prototype; substantially improved its indigenous satellite navigation system; and expanded the scope of its military exercises and training activities.

China is also pursuing a variety of strategic military capabilities with far-reaching implications. For example, the PLA reportedly tested a variety of new nuclear ballistic missile systems in 2012, including a submarine-launched intercontinental ballistic missile. When this system comes online, perhaps within the next two years, China will for the first time have a real "nuclear triad." This will provide China with a more flexible, survivable nuclear arsenal. China also reportedly tested another new class of ballistic missiles, probably called the DF-41, that is likely to incorporate a Multiple Independently-targetable Reentry Vehicle (or "MIRV") capability that would allow it to reach multiple cities simultaneously, including those within the continental United States. Amid these developments, considerable ambiguity remains about China's nuclear posture, including basic information such as the total number of warheads it holds.

Moreover, given that China is not party to some of the most important nuclear arms limitation and control agreements, we have recommended that Congress seek details from the U.S. State Department about its plans to engage Beijing in discussions or negotiations to this end.

In cyberspace, a domain of great strategic importance, China has continued to develop and refine its military strategy. In parallel, hackers in China have waged aggressive cyber espionage campaigns targeting a wide range of U.S. and international military, government, commercial, and other nongovernmental organizations. The sophistication of these activities varies markedly among different actors. Some demonstrate extremely advanced techniques, but even rudimentary tactics can be effective when applied on such a broad scale. These hackers seek to

compromise targets ranging from smart phones to deployed military platforms, such as naval ships at sea.

We have recommended that relevant Congressional committees further review Chinese cyber espionage practices and report their findings in an unclassified format. In addition, we have recommended that Congress review acquisition and procurement guidelines to ensure that the U.S. Department of Defense has the necessary tools to mitigate cyber-related supply chain threats.

One of the central themes the Commission observed in 2012 was an extension of China's global reach. Although the military and security developments I have described are a key enabler, the leading edge of this extension, in many cases, has been in commerce. China's quest for fishery, mineral, and particularly energy resources, has led to a great expansion in Chinese activities and interests abroad. China has taken a strategic approach to acquiring these resources, and in some cases, such as the critical mineral industry, has positioned itself as the dominant player in the market.

This Report resulted from an ambitious agenda throughout the year of public hearings held here on Capitol Hill; a field hearing in Manassas, Virginia; private meetings with experts in a variety of fields; classified briefings from the Intelligence Community; and a fact-finding trip the Commission took to the Philippines and China in May.

These inputs have allowed us to produce what I believe is a frank assessment of some of the key challenges in our bilateral relationship with China. I speak for my fellow Commission members when I say that we look forward to working with Congress throughout the coming year to address the issues we have identified and monitor new developments as they arise.

With that, I yield to Commission Vice Chairman Bill Reinsch for his introductory remarks. Thank you.

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

Thank you, everyone, for coming today.

I want to talk about some key economic developments and trends that are identified in our Annual Report this year. Some of these issues were the subject of Commission hearings and some excellent, thought-provoking testimony from experts in their fields. The transcripts of those hearings and supplemental research, as well as our Annual Report, are available on our website, USCC.gov.

Sadly, we note that China's leadership has continued to retreat from its professed goals in one very important area: China has taken a sharp turn to the left--toward a larger role for the government in its economy. China's policies are expanding the power and international reach of state-owned and state-controlled enterprises, which already tend to be the largest and most

politically influential companies in China. All levels of the Chinese governments, even down to the villages, act in support of these government-owned companies and shower them with subsidies and other favors, including trade and investment restrictions designed to hobble their foreign competitors. China has also grown more explicit in its attempts to wrest technology from these foreign competitors.

At the same time, China's leaders have acknowledged that their decades-old practice of running an economy based on exports and massive fixed investment is unwise and unsustainable. But they are finding it politically difficult to rebalance the economy from serving the interests of the growing state sector to serving the interests of Chinese workers and families.

During the year, the Commission also examined the role of innovation in economic growth. We don't have to look any farther than the United States to see the positive role that innovation plays in growing the economy and spreading the wealth among our citizens. China, too, would like to create a climate of innovation, for these same reasons. But doing so is difficult and will require a serious commitment to intellectual property protection. China has promised many times to improve the enforcement of laws and regulations protecting intellectual property that are already on the books, but the efforts of local officials throughout China have fallen far short.

While China still lags in conducting basic research, it has demonstrated a growing ability to undertake second generation innovation to commercialize the technology obtained from others—a process also known as applied research. China deserves credit for its efforts to expand its universities and to extend educational opportunities, particularly in science and engineering, and particularly to many rural areas. But unless China can provide its entrepreneurs, designers, scientists and engineers the rewards for their invention, the country will not reach its potential for innovation.

I should also note that the Commission issued 32 recommendations to Congress for specific legislative or policy actions relating to China. I'll mention just a few, but I urge everyone to read them all. By some estimates, China's state sector now accounts for as much as half the Chinese economy. The Commission has recommended that Congress examine the implications of this trend and consider whether we need to better monitor the activities of Chinese state-owned enterprises, especially those that seek to invest in the United States, either by acquiring U.S. companies or through start-ups. We also recommend that Congress increase the disclosure requirements of state-owned companies that seek to be listed on U.S. stock exchanges. The Securities and Exchange Commission generally requires publicly listed companies to disclose information that has the potential to influence a stock's market price. The actual owner of a state-owned company and the method by which the company's directors and management are chosen seem to qualify for that level of disclosure.

Two other economic issues also occupied the Commission's attention: Chinese investment in the United States and the development of more sophisticated accounting tools for understanding international trade flows among nations.

While foreign investment in America is generally viewed positively because it creates jobs by adding productivity-enhancing capital to skilled U.S. labor, there may be some exceptions to the general rule. For example, if the foreign investor is a state-owned company that enjoys unfair advantages over its American competitor. In such a case, a state-owned company's cost of capital may be lower, particularly if it benefits from below market-rate financing from a government-owned bank. In fact, this scenario is expected increasingly to confront U.S. policymakers as China seeks to diversify its \$3.2 trillion in foreign exchange reserves by acquiring U.S. companies and other assets. The U.S. government must also take into account national security concerns when the acquisition is of a company with sensitive technology, for example. The Commission has recommended further study of this complicated and important issue.

Finally, the Commission examined the need for a more sophisticated accounting methodology when tracking the transfer of manufactured products that involve supply chains that traverse multiple borders. Determining the effects on trade, investment, and employment in such cases is complex and challenging and will require international standards on accounting for cross-border transfers.