

2013

Report on the Congressional U.S. – China Working Group Members’ Trip to China

“China 101: New Leaders, New Action on Old Issues”



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The views and observations expressed in this report are solely those of the Co-chairs of the U.S.-China Working Group and are not representative of the other members of the Congressional delegation, the National Committee on U.S.-China Relations, or the University of Michigan.



The Congressional Delegation, with embassy staff, at the U.S. Embassy in Beijing on January 28, 2013.

INTRODUCTION

The United States and China begin 2013 at an inflection point.

Political leadership transitions in both countries, along with economic and government reforms and an evolving security landscape in the Asia-Pacific region, have added complexity to an already complex relationship. But though these complexities have taken center stage in recent months, there is also reason for optimism in the U.S.-China relationship moving forward.

For the first time since the Chinese Communist Party (CCP) came to power in 1949, the United States and China have undergone leadership transitions at the same time. Transitioning governments, with a mix of new and old leaders, present the U.S. and China an opportunity to build on areas of mutual benefit, and to round the edges of sharp policy disputes. The U.S. relationship with China, itself a web of intersecting political, economic, security, and cultural relationships, is prime for further development. As China seeks to slowly enact governance and economic reforms, and as the United States continues to grow its economy and break down political stagnation, constructive engagement between both countries will become more significant.

The U.S. and China view constructive engagement as an essential part of a concrete, cooperative, and comprehensive bilateral relationship. One year ago, just before then Vice President Xi Jinping's visit to the United States, General Secretary Xi and President Obama forged an initial relationship where he told the *Washington Post* that "frictions and differences are hardly avoidable in our interactions, but frictions and differences would not be allowed to undermine the larger interests of our co-operation." A year later, President Obama and now Communist

Party General Secretary Xi are in an even stronger position to strengthen the U.S.-China relationship.

In this context Rep. Rick Larsen (WA-02) co-chair of the U.S.-China Working Group (USCWG) in the House of Representatives, along with Reps. Michael Turner (OH-10), Jim Costa (CA-16), Leonard Lance (NJ-07), and Billy Long (MO-07) travelled to Shanghai, Beijing, and Hong Kong from January 24 to January 31, 2013. The National Committee on U.S.-China Relations sponsored the trip, the Foreign Affairs Committee of the National People’s Congress (NPC) served as our host in China, and the Hong Kong government served as our host in Honk Kong. The trip which focused on resetting our understanding of China through the lens of the recent leadership transitions in the U.S. and China, economic and governance reforms in China, regional security issues, the U.S. business environment in China, and Hong Kong-Mainland relations.

The Congressional delegation met with Foreign Minister Yang Jiechi, Deputy Chief of the People’s Liberation Army (PLA) General Staff Qi Jianguo, as well as Chinese officials from the National People’s Congress (NPC) Foreign Affairs Committee, the National Development Research Center of the State Council, and Chinese and American academic and business leaders. The Congressional delegation also met with Chinese Vice-Premier Wang Qishan at the Zhong Nanhai (CCP leadership compound) to discuss the new leadership transition and its impact on the U.S.-China relationship, and to discuss his new role as the Secretary of the Central Commission for Discipline Inspection.

This report is broken up into six “issues” that were prominently discussed during the Congressional delegation trip. These issues include: the leadership transition in the U.S. and China, China’s economic rebalancing and reforms, the environment in China for American companies, domestic challenges facing the new Chinese leadership, regional security issues, and developments in Hong Kong – Mainland relations.

Issue One: Leadership Transitions in the United States and China—New Leaders, New Opportunities, Similar Challenges.



Politburo Standing Committee Members appointed following the 18th Party Congress last November.

HISTORIC OPPORTUNITY

For the first time since the Chinese Communist Party (CCP) came to power in 1949, the United States and China in 2012 underwent leadership transitions within the same month. In November 2012, Xi Jinping was elevated to become the General Secretary of the CCP, consolidated power by concurrently being named the Chairman of the Central Military Commission, and will soon take over as the President of the People's Republic of China (PRC), effectively making him first among equals in the Politburo Standing Committee. Li Keqiang was named the CCP's number two official, and is expected to be named Premier of the State Council as the National People's Congress in March 2013; he will be principally responsible for the administration of the PRC's state bureaucracy and overseeing the economy.

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Xi and Li will use their first term to consolidate power throughout the CCP and NPC organizations, strike a balance between “at the margin” reforms aimed at placating reformers and maintaining stability, and satisfying the vested interest of their Politburo colleagues.

Although key Party officials have been named, many questions remain on how they will govern. Some China watchers believe that intraparty frictions were more public in this transition than in previous leadership transitions. The frictions were perceived to be between the offspring of colleagues of the People's Republic of China's founding leader, Mao Zedong, known as “Princelings,” and officials with a background in the Communist Youth League and a loyalty to the former General Secretary, Hu Jintao, known as the Tuanpai. “Princelings” are seen to have been more likely to work their way up the ranks of the party in economically developed east coast provinces, while Tuanpai officials rose through jobs in poorer central and western provinces.

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According to Cheng Li, a scholar of Chinese elite politics at the Brookings Institute, five of the top seven new Politburo Standing Committee members identify with the Princeling or elitist coalition. Li considers these officials to be more conservative in their outlook, and to be protégés of Jiang Zemin, a party elder who stepped down as Communist Party general secretary in 2002, and a chairman of China's Central Military Commission in 2004, but who returned to the political scene this year and successfully lobbied for his loyalist at the expense of officials linked to the Tuanpai faction. At this point, perhaps one of the most notable features of the recent leadership transition has been the degree to which CCP power brokers allowed internal dissension to leak to domestic and international press. It is too early to tell if this lifting of the veil is one sign of things to come, or merely a passing moment.

Discussions with Chinese and American academics, business leaders, and government officials, indicate that the jury is still out on whether Xi and Li will be able to translate minor crisis prevention responses into wholesale political and economic reforms in their first five-year term. Instead, the more likely scenario is that Xi and Li will use their first term to consolidate power, strike a balance between “at the margin” reforms aimed at placating reformers and maintaining stability, and satisfying the vested interests of their Politburo colleagues.

Xi and Li must also be cognizant of overpromising on reforms and inflaming Chinese citizens who expect better standards of living and who have little patience for the slow pace of reform.

INITIAL IMPRESSIONS

Early comments and actions from Xi and Li indicate that reforms will move forward, albeit slowly. The new leadership team has faced a series of incidents that have tested their ability to maintain control of the Standing Committee factions and to maintain image with the Chinese people. Xi's condemnation of the CCP's aggressive censoring of the *Southern Weekly* was widely seen as an astute response to mitigate rising instability in Guangdong province, while also garnering respect internationally for rebutting initial reports of interference from "outside influences." From Xi's decision to remove the pomp and circumstance from Party functions, to his handling of the *Southern Weekly* incident, and his acquiescence in the media's measured acknowledgement of increasingly bad air, water, and soil quality, Xi has provided tangible, if minor, evidence of his desire to move China forward in the next five years. As these issues and more arise, Xi and Li can be expected to spend a majority of their time looking inward, and delegating most of the foreign policy interactions, wherever possible, to subordinates.

However, Xi Jinping is a leader who has experience in foreign policy and has personal experience visiting the United States. Mr. Xi has spoken of his desire for the U.S. and China to develop a "new type of relationship between two great powers." This is promising as both sides calculate how an emerging power and an established power can coexist in a peaceful way that promotes economic prosperity and regional stability.

OBAMA 2.0

On the other side of the Pacific, President Obama and Vice President Biden won reelection and are in the process of assembling a second term cabinet. Although it is expected that President Obama's second term cabinet will continue to build upon the policies of the previous four years (increased enforcement of trade rules through the WTO, rebalancing military and diplomatic resources to the Asia Pacific region, and creating deeper engagement through more state-to-state, people-to-people, educational, and tourist exchanges) it remains to be seen whether leaders from both countries can expand on past progress and build a level of mutual trust necessary for stable relations.

Over the next four years questions also remain on whether the Obama Administration can maintain its focus on the Asia-Pacific region in light of continued unrest in the Middle East and Northern Africa. Instability in the Middle East and North Africa could sidetrack some of the military components of the Rebalance strategy of President Obama's first term. However, it is assured that the Obama Administration will maintain its diplomatic involvement in Asia-Pacific regional forums, and will maintain a robust bilateral relationship with China.

More concerning than China's rise, has been the inability of the Executive and Legislative branches to come together to pass laws to increase the United States' competitiveness internationally. Chinese officials and academics who met with the Congressional delegation

highlighted how the credibility of U.S. views on China's opaque political system is weakened by Chinese perceptions of democratic dysfunction in the United States since the 2010 midterm elections. The longer the United States' political system appears unable to deal the country's economic and political challenges, the more the U.S. risks losing influence among Asia-Pacific partners that have recently wanted the U.S. to be more active in the region, but are also closely linked economically with China.

As new leaders in China take over and President Obama begins a second term, observers in both countries many will be waiting to see if these transitions portend change or continuity in U.S.-China relations. They will also be waiting to see if domestic challenges in both countries will hinder bilateral relations. In the context of building a new type of relationship between two great powers, change and continuity could both occur. China's and America's leaders should seek continuity in strategic goals while remaining fluid in the tactical steps necessary to build mutual trust.

ISSUE TWO: CHINESE ECONOMIC REBALANCE AND REFORMS

CHINA'S ECONOMIC PAST AND FUTURE

Over the last 30 years, China has undergone unprecedented economic growth. Since Deng Xiaoping began opening China's economy to foreign trade and investment in 1989, China has become the world's largest developing country, and the world's second largest economy overall. China's economic growth is especially impressive when looking at where the country was 30 years ago. Prior to reforms, China's economy was centrally planned and suffered from massive inefficiencies, stagnant growth, and global economic isolation. As a result of this economic policy, China's population, especially in rural provinces, was very poor.

Fast forward to today and China's economy is well positioned for continued prosperity. According to the China 2030 report, co-authored by the World Bank and the Development Research Center of the State Council with the right reforms now, "even if growth moderates, China is likely to become a high-income economy and the world's largest economy before 2030." China's growth has also lifted hundreds of millions of Chinese people out of poverty. But China's economic rise has had its limitations. Chinese officials still contend that even with its market reforms, China is a "socialist economy with Chinese characteristics." According to the World Bank, although China allows market principles in a few strategic growth industries, China has become one of the world's most active users of industrial policies to support domestic industries. China's continued commitment to some socialist ideals is most evident in its continued, albeit shrinking, reliance on State Owned Enterprises (SOE) to generate economic growth.

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Chinese officials and academics who met with the Congressional delegation highlighted how the U.S. position on China's opaque political system is weakened by the perceptions of democratic dysfunction that has been evident since the 2010 midterm elections.

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WORLD BANK REPORT: CHINA 2030

Last year, at the direction of incoming Premier Li Keqiang and in partnership with the World Bank, Li Wei, head of the Development Research Center of the State Council published *China 2030: Building a Modern, Harmonious, and Creative High-Income Society*. In the report, Li and the World Bank team lay out the case for a new development strategy for China to rebalance the role of government, and the socialist-market model to reach the goal of becoming a high-income country by 2030. Recommendations from the report highlight steps to deal with the risks facing China over the next 20 years, including the risk of a hard landing in the short term, as well as challenges posed by an aging and shrinking workforce, rising inequality, environmental stresses, and external imbalances.

This report is significant given the freedom the Development Research Center was given by the State Council to work with the World Bank team. It is likely that the findings from *China 2030* will play an instrumental role as China's new Politburo Standing Committee members, most prominently Li Keqiang, develop China's future economic strategy.

Li Wei argued to the delegation that—the current Chinese economic model—characterized by high export growth, high levels of investment in fixed assets, and excessive air pollution—cannot be sustained, and that China needs to bolster internal demand. China's protection of SOEs through industrial policies has limited private sector and foreign competition, causing oversaturation in strategic industries, and leading to an overreliance on fixed asset investment and cheap exports to propel its economy. By relying heavily on fixed asset investments and cheap exports to expand, China's strategy of growth at all costs has led to long-term social and structural problems. Income disparity between urban and rural communities has increased the Chinese government's fear of instability. China's natural resources, especially its water supply, have also been badly degraded by industrial pollution. Finally, China's investment-heavy strategy has prioritized the growth of certain industries over others, focusing on manufacturing at the expense of China's service sector.

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For future growth to continue at its current rate, and for China to avoid falling into the “middle-income trap,” China must continue to liberalize its markets, scale back its household registration system to allow for more urbanization, and it must institute a reliable social safety net to decrease the high levels of income savings that burden most Chinese
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WHERE DOES CHINA GO FROM HERE?

For Xi Jinping and Li Keqiang, the next five to ten years presents an opening to rebalance China's economy away from fixed asset investments, heavy reliance on low-wage manufacturing, and lopsided trade balances, into an economy more dependent on domestic consumption and growth through the private sector. The vast majority of Chinese academics, think-tanks, and government officials have recognized that China has squeezed the last amount of juice out of its current economic model. For future growth to continue at its current rate, and for China to avoid falling into the “middle-income trap”—where countries who make it from low-income to middle-income have a difficult time making the next leap to high-income because escalating costs erode their competitive advantage—China must continue to liberalize its

markets, scale back its household registration system to allow for more urbanization, and institute a reliable social safety net to decrease the high levels of income savings.

There is reason to believe that China will take the steps necessary to rebalance its economy. As the world economy continues to bounce back from the financial crisis, China will again start the gradual process of rebalancing its economy on pace with global economic growth. The incoming economic team in China recognizes that future economic development must be paired with environmental and social considerations. The real challenge for the central government will be ensuring top-down edicts get carried out by government officials at all levels of government to the local level.

In 2011, the CCP released its 12th five year plan (FYP), focusing on five key areas: promoting consumer demand, bridging the income gap between rural and urban residents, curbing pollution, improving the rule of law through enforcement, and investing in sustainable energy sources. One of the questions surrounding the leadership of Xi and Li early in their tenure has been whether they will confront the vested interests that have prevented rebalancing efforts from being actualized and whether they will they commit to the goals put forth in the FYP. Initial reports out of Beijing indicate that Xi and Li favor rebalancing but at a gradual and sequenced pace.

Among leaders in Beijing, there is strong sentiment that China's ability to enact economic reforms, while continuing strong economic growth, is intricately linked to the United States getting its economy in order. Given the weak levels of demand for Chinese exports emanating from the Eurozone, China is more reliant on U.S. demand to maintain growth. It is the hope of China's leaders that the re-election of President Obama will provide stability in U.S. economic policy.

Issue Three: U.S. Businesses – “In China for China”

In Shanghai, Beijing, and Hong Kong, the Congressional delegation met with representatives of the American Chamber of Commerce, China (AMCHAM China), the American Chamber of Commerce in Shanghai (AMCHAM Shanghai), the American Chamber of Commerce in Hong Kong (AMCHAM Hong Kong), and representatives of the U.S.-China Business Council (USCBC) to discuss the business climate for American companies in China.

Overall, while challenges exist for U.S. firms operating in China, the wide consensus of

“In China for China”

For a majority of U.S. companies doing business in China, there is a heavy reliance on an “in China for China” business model. Under this model American firms locate their operations in China and produce a majority of their products for sale in the local Chinese market. The “in China for China” strategy also allows American companies to utilize higher quality business standards, which can be adopted by China's still nascent regulatory bodies, and which could provide American companies with a competitive advantage over Chinese private firms.

American companies operating in China is that the positives of being in China far outweigh the negatives. For American companies who wish to do business in China, strong growth opportunities and profitability remain. In fact, according to both AMCHAM China and the USCBC, over 70 percent of companies doing business in China saw their revenue grow by 10 percent or more in the past year; with many firms exceeding 20 percent profit. Based on reports from the USCBC, China is a \$250 billion market for American businesses and should only increase in the years ahead. Due to the size and interconnectedness of Chinese and American business interests, it is important that we get this relationship right. China's economic rebalancing efforts provide increased opportunities for American companies who wish to sell consumer and luxury goods to an exploding middle class in China. From estimates given to the people, or a middle class roughly one and half times that of the entire U.S. population Congressional delegation, by 2020, China will have a middle class of roughly 500 million; or a middle class roughly one and half times that of the entire U.S. population.

CHALLENGES IN CHINA

Although the Chinese market is promising for American businesses, it is not without challenges. Each year both AMCHAM China and USCBC conduct surveys of Chinese-based American companies to ascertain the challenges of conducting business in China. The most recent survey found that the top five challenges to doing business in China are human resources and increasing operating cost competition with Chinese companies, technology transfer demands, intellectual property rights protection, and investing to reach the Chinese market.

Human resource restraints and increased operating costs are not new problems for American firms in China. However, due to rising wages, increasing material costs, and an uncertain inflation outlook in the out-years, American firms are more cognizant that the costs of doing business in China will challenge their current growth models. Recruiting the talented middle-management personnel who can steer a company through evolving business climates is also proving a challenge to American firms. Companies that briefed the Congressional delegation steadfastly agreed that the demand for qualified employees frequently outpaces supply, pushing up wages to a level comparable to wages in the U.S. or Europe.

U.S. firms in China are also facing a more complex and competitive business environment. Along with strong competition from other foreign multinationals and Chinese SOE's, American companies must also compete with an expanding Chinese private sector. This competition is viewed by American companies as especially challenging given the preference by the Chinese government for domestic firms in strategic growth industries—both SOEs and private companies.

Just as U.S. companies worry about the use of restrictive industrial policies by the Chinese government, they also continue to be concerned about technology transfer arrangements with Chinese firms. Although not presented as a uniform requirement for entry into the Chinese market, Chinese firms in targeted growth industries often make market access for U.S. firms dependent on technology transfer on a project-by-project basis. Often, the more cutting edge the industry, the more stringent the technology transfer requirements.

Although improved from previous years, intellectual property rights (IPR) enforcement is a challenge still facing by U.S. companies in China. Chinese leaders conveyed to the Congressional delegation that they are committed to ensuring that intellectual property rights are protected and enforced. As more Chinese firms gain technological dominance in international markets, more pressure will be placed on the Chinese government to protect these gains. However, recent improvements aside, no one enforcement strategy works across all industry sectors and IPR enforcement will remain uncertain in identified high-value industries.

More than 90 percent of the USCBC/AMCHAM China survey respondents indicated that they were pursuing the “in China for China” business model to various degrees. Much of these investments are taking place in the central and western provinces where China is investing in rapid urbanization. But challenges also exist in this investment strategy. When American companies invest away from the eastern coastal areas and into new provinces, they must hire a less qualified workforce, and they must interact with less “business-oriented” provincial government regulators.

These challenges to American companies have policy implications for U.S. elected officials in Congress, and for the Obama Administration. Through forums such as the Strategic and Economic Dialogue (S&ED) and the Joint Commission on Commerce and Trade (JCCT), the Obama Administration has secured steady progress in leveling the playing field for U.S. firms in China. In addition to maintaining the effectiveness of these forums, building on the Model Bilateral Investment Treaty (BIT) will be an important task for the Obama Administration and Congress in the next two years.

Beyond its constitutional responsibility to approve treaties, Congress has an instrumental role in ensuring American companies have a fair environment to compete in globally, and are well positioned to invest and grow. The most important action that Congress can take to provide market stability and to benefit American companies is to pass a balanced approach to lowering our debt and deficits, while still investing in areas promoting the foundation necessary for long-term growth.

ISSUE FOUR: CHINA'S DOMESTIC CHALLENGES



China's increased industrialization and proliferation of automobile emissions has denigrated Beijing's air quality. Picture taken in Beijing during the Congressional delegation trip.

Long term, Chinese political and economic reforms pose the most pressing challenge for incoming Politburo Standing Committee members. However, more immediate to the Chinese leadership, and what most likely keeps Xi Jinping and Li Keqiang up at night, is maintaining stability and the legitimacy of the Communist Party with the Chinese people.

Recently, the severe pollution in China's capital has recently led residents to doubting the viability of the current economic model, and the ability of the Chinese government to provide safe air and water for the Chinese people. With air pollution in Beijing at historic levels, Chinese citizens have taken to "weibos" (micro blogs) to complain about what foreign residents have dubbed "smoggeddon," "airpocalypse," and the capital's "crazy bad" air.

Two years ago the United States Embassy placed an air-quality monitoring (AQM) device atop the Embassy compound. The device records the amount of fine particles in the air measuring less than 2.5 micrometers and gives a reading between 0 and 500 – with levels between 301 and 500 being considered "hazardous." During the two days the Congressional delegation was in

Environmental NGOs in China

Due to the rising popular concerns over air pollution in China's major cities, environmental Non-Government Organizations (NGOs) have been allowed to play a larger role than in the past. While in Beijing, the Congressional delegation met with the Institute of Public and Environmental Affairs (IPE) to discuss their efforts into sharing environmental information with the Chinese people. IPE aims to expand environmental information disclosure to allow communities to fully understand the hazards and risks in the surrounding environment, thus promoting widespread public participation in environmental governance.

Beijing, the AQM device recorded readings of over 450 both days, eventually spiking to a jaw-dropping 755 before the week was over. These readings are at all-time highs for Beijing and may have jolted the incoming Chinese leadership into a recognition that action is required for what was previously thought of as a problem that could be solved quickly.

In response to continued pressure from the public to provide more transparency into environmental regulatory enforcement, the Chinese government revised their Ambient Air Quality Standards, initiating historic improvements to urban air quality information disclosure. The Chinese government also allowed environmental NGOs more latitude to publically disclose environmental data. But these steps, while groundbreaking, may do little to assuage Beijing Resident's dissatisfaction with their air quality. This is because the causes of the smog in the capital, factories operating in Hebei province, and the astounding multiplication of automobiles traversing Beijing's streets, are unlikely to decrease substantially in the long term.

Power in the Cage of Regulation

Another challenge facing China's new leaders is rooting out corruption within the Chinese Communist Party. Wang Qishan, the newly appointed head of the Party Discipline Inspection Commission, has been tasked with enforcing party discipline throughout all levels of the Chinese

government. According to the self-described “party watchdog,” with Party membership now exceeding 82 million people—the size of a medium sized country—strict discipline and oversight are essential to managing the Party and ensuring strong Party leadership as China presses forward in developing “socialism with Chinese characteristics.” Underscoring the Party’s vital role, Wang insisted that the Party and China’s continued progress were “inseparable,” hence the increased importance of the Party Discipline Committee and anti-corruption efforts at all levels.

Standing atop the Party’s supreme disciplinary organization, Wang explained to the delegation that he was now endowed with specific rights and responsibilities derived from the Party Constitution. In particular, Wang highlighted three specific functions of his position encased within the Party Constitution: one, uphold and protect the integrity of the Constitution, regulations, rules, and decisions of the Party; two, oversee inspections and supervision of Party organizations at all levels, ensuring “good faith” implementation of the work and principles of the Party; and three, making sure Party organizations at all levels are “upright” and maintain their integrity in following the Party’s Central Committee.

Conceding that corruption is a serious problem, Wang noted that China continued to proceed through a stage of accelerated growth that presented numerous challenges to keeping the Party clean. During the struggle to combat corruption and the fight to identify and eradicate its root causes, the Party’s conclusion had been that institution-building was the “key to victory.” Wang forcefully declared that it was his job to create institutions of such strength that Party members “cannot” and “dare not” engage in corruption.

While all indications suggest that Wang Qishan is genuine in his desire to root out corruption, what has been left unanswered is how much latitude he will have with his colleagues on the Politburo Standing Committee.

Xi Jinping, in a recent speech to the Party Discipline Inspection Commission, vowed to crack down on “tigers and flies”—a reference to powerful party leaders and lowly local level bureaucrats—in efforts to eliminate corruption with the CCP. In Xi’s words, “We [the Party] must uphold the fighting of tigers and flies at the same time, resolutely investigating law-breaking cases of leading officials and also earnestly resolving the unhealthy tendencies and corruption problems which happen all around people.”

But outside Xi, Li and Wang, it is not clear whether the other Standing Committee members will get on board with these initiatives, or live up to their conservative reputations and block corruption efforts to protect powerfully vested interests. Further, it is not clear is to what degree anti-corruption campaigns are being used to conceal intra-party frictions still raging before the 18th NPC convenes in March.

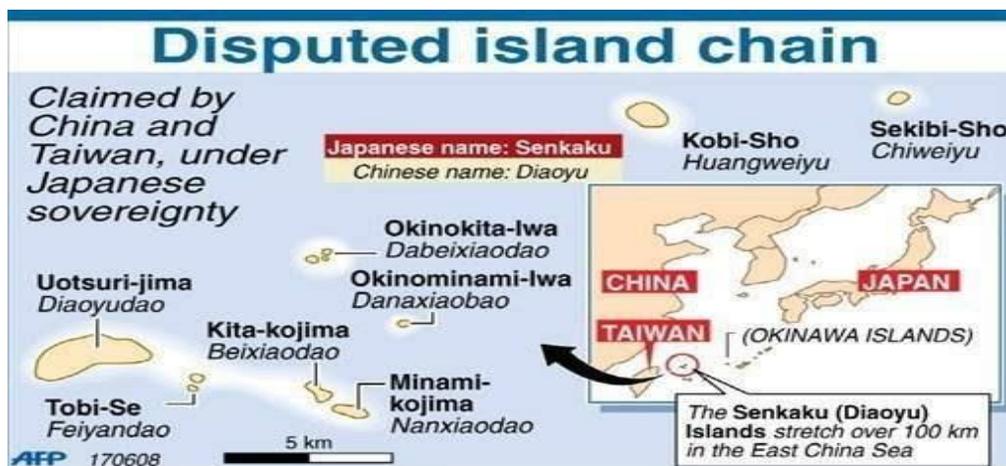
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"We [CCP officials] must have the resolve to fight every corrupt phenomenon, punish every corrupt official and constantly eliminate the soil which breeds corruption, so as to earn people's trust with actual results; Power should be restricted by the cage of regulations." – CCP General Secretary Xi Jinping
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Issue Five: Regional Security issues

The Asia-Pacific region is home to many of the world's largest militaries. According to U.S. Department of Defense officials, the Asia-Pacific region is home to five of the eight internationally recognized nuclear powers, three of the world's top six defense budgets, and six of the world's largest militaries. For the past century, Asia has, in one form or another, been under western influence. But events in Asia, primarily the rise of China's military, are redefining the balance of power in the region. As China rises in power and influence in the region, and as China's expectations of regional hegemony increases, tensions are bound to arise.

During the Congressional delegation's trip to China, China was embroiled in high-stakes disputes with Japan and the Philippines over territorial disputes in the East and South China Seas, and was also grappling with North Korea's continued efforts to develop nuclear weapons and the long-range missile technology to deploy them.

East China Sea



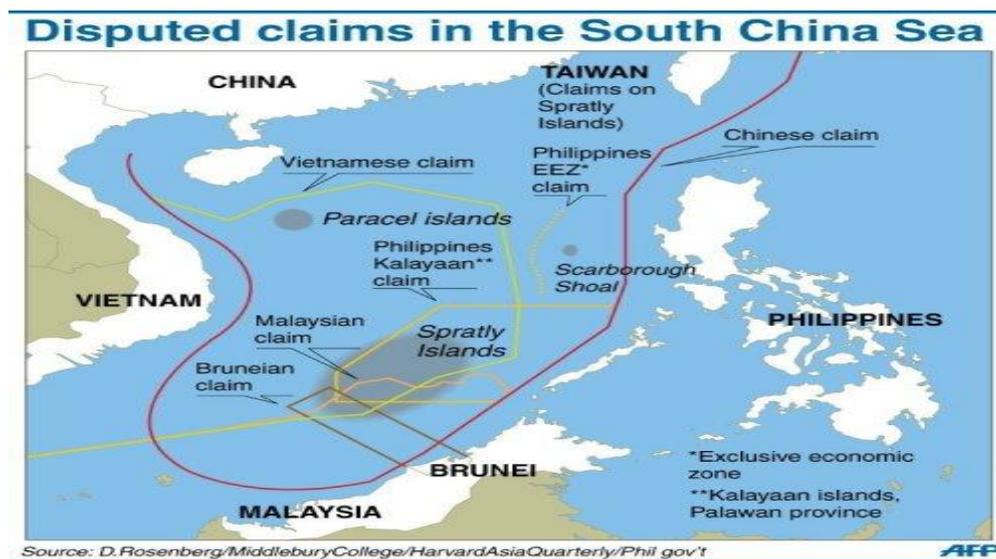
Source: Agence France Press

In the East China Sea, China and Japan are in the midst of an increasingly dangerous dispute over uninhabited rocks known in Japan as the Senkaku, in China as the Diaoyu, and in Taiwan as the Diaoyutai. The latest dispute was set off by the Japanese government's purchase three of the islands from a private Japanese citizen last year. While meeting with the Congressional delegation in Beijing, Chinese Foreign Minister Yang Jiechi condemned Japan's actions, blaming Tokyo for "provocative actions that have led to increased tensions." He restated China's long-held position that the Diaoyu islands have been part of China's territory since ancient times, serving as important fishing grounds administered by the province of Taiwan, and that this is "fully proven by history and is legally well-founded."

On both sides, hyper-nationalist sentiments from the Japanese and Chinese people are driving their governments to escalation. In an example of increased military escalation over the islands, earlier this year both sides sent military aircraft to conduct surveillance over the islands; eventually leading to claims by Japan that China was “targeting” their aircraft in a provocative manner. While these claims have not been verified, they do amplify the concern that as China and Japan send more military assets to the islands, the chances of misreading intentions only increases. In discussions with the delegation, General Qi Jianguo, the Deputy Chief of the PLA General Staff, stressed that China does not wish to go to war with Japan over the Diaoyu Islands, and that they prefer a diplomatic solution to “China’s territorial rights.”

As a result of the dispute, economic ties between Asia’s two biggest economies have also been damaged, with Japanese businesses withdrawing investment, and Chinese companies looking for suppliers elsewhere. Last fall, Chinese citizens in the central provinces also attacked Japanese storefronts and factories, as well as damaged cars and other products from Japan. These actions, and the complacent response by the Chinese government, have further stoked tensions and enflamed nationalist feelings on both sides, making diplomatic “off-ramps” more difficult to achieve. However, it remains unlikely that China’s new Party and Military leadership would risk military actions that would invite U.S. military involvement into the dispute.

South China Sea



Source: Agence France Press

Similar to disputes with Japan in the East China Sea, China has also taken a more aggressive territorial stance in the South China Sea. Recent hostilities with the Philippines and Vietnam have led to increased concerns by ASEAN nations about China’s intentions in the region. After initial flare-ups between China and the Philippines, tensions dissipated as the Philippines concluded it would be weakened in a military dispute with China, and China worried about further pushing its ASEAN neighbors into stronger ties with the United States. Almost immediately after China-Philippines tensions ceased, Vietnam again claimed administrative control over the Spratly and Paracel Island chains. China reacted to Vietnam’s actions by

condemning their actions as a “serious violation” of its sovereignty and by elevating the Sansha county-level government to the prefecture level. At the time this report was printed, tensions between China and Vietnam were simmering but had not escalated to a level of direct confrontation.

North Korea

The most pressing regional security issue relates to the Democratic People’s Republic of Korea (DPRK) and their continued efforts to develop nuclear weapons and long-range missile technology. Both Yang Jiechi and Qi Jianguo reiterated to the Congressional delegation that China supported the goal of denuclearization on the Korean peninsula and strongly denounced the DPRK’s recent missile launch, and that, as the United Nations Security Council Resolution condemning North Korea’s actions reaffirmed, the six party talks were a successful model to build on in the future.

Foreign Minister Yang also pointed out that although China condemned North Korea’s recent actions, the DPRK is a sovereign nation and they view the United States as an existential threat. Some in China’s political, military and academic circles also claim that military cooperation with North Korea is important as a hedge against the United States’ Rebalancing strategy aimed at “containing” China. The seeming contradictions and lack of transparency into DPRK-China military relations has led to much anxiety from regional powers including South Korea, Australia, and Japan, and has led to commitments of increased military hardware being placed in the Asia-Pacific region from the United States.

Among China’s military and political leadership, military-supported think-tanks and academics, there is a debate between two diverging paths on the future of China-DPRK relations. The first camp, generally more hawkish and skeptical of the United States’ intentions in the region, views the DPRK as a necessary buffer in the region and often cites their two countries’ deep historical and cultural ties as a reason to maintain military relations. The second camp, which see the benefit of deeper U.S.-China relations as a means to promote peace and stability around the globe, see supporting the DPRK’s military and nuclear ambitions as short-sighted, eventually leading to regional instability and more nuclear proliferation in the region. For many Asia-Pacific security watchers, the recently conducted third nuclear test by North Korea opens up the possibility that China’s new political leadership may seek to change the calculus in which it engages the DPRK, and may open up an avenue for the U.S. and China to work more collaboratively on nuclear non-proliferation matters.

The United States is closely watching to see how this debate plays out in the years to come, as it will have a fundamental impact on the overall military-to-military relationship between the U.S. and China. The U.S. and China have made much progress in establishing bilateral cooperation in humanitarian assistance and disaster relief missions, combating piracy in the Gulf of Aden, and leading a strong United Nations Security Council action against North Korea’s nuclear ambitions. However, as contentious territorial disputes continue in the South and East China Sea, and tensions in cyber, space, and nuclear policy ensue, both militaries must progress to a relationship based on mutual respect and trust.

Issue Six: Hong Kong-Mainland Relations

Since the British relinquished control of Hong Kong in 1997, Hong Kong has been a Special Administrative Region of the People's Republic of China (PRC). Although it is formally under the control of the PRC, Hong Kong enjoys wide latitude in matters relating to their economy and commerce, as well as customs processes and government leadership. Hong Kong has entered the World Trade Organization (WTO) as a separate customs territory from China, and has retained its separate membership in the Asia-Pacific Economic Cooperation (APEC) forum. Under the Basic Law that governs Hong Kong's relations with Beijing, however, the central government in Beijing is responsible for Hong Kong's foreign affairs and defense.

Last March, a 1,200 member "election committee" selected C.Y. Leung to replace outgoing Chief Executive Donald Tsang. According to press accounts, shortly after the election results were announced around 2,000 protesters clashed with Hong Kong police over what the protestors characterized as a "small-circle election." This exchange was similar to many protests that have occurred since the Hong Kong Legislative Council passed a compromise election reform package in 2010 that could pave the way for universal suffrage in Hong Kong. Vocal minorities of Hong Kong residents do not feel that the 2010 compromise legislation went far enough or would transform the political process quickly enough; leaving universal suffrage reforms in a fragile position that could be again changed or manipulated. During the Congressional delegation's visits with the Chief Executive, Leung expressed his commitment to continued democratic development. Chief Executive Leung also lamented the difficulties of working with a divided Legislative Council, but stressed that although difficulties persist, his Administration "still has time" to achieve universal suffrage by 2017 and that he would begin pushing the process forward after "we deal with a few other issues first."

In addition to electoral reform, Mr. Leung must also navigate an evolving Hong Kong-Mainland relationship. When asked about the relationship between Hong Kong and mainland China, Mr. Leung claimed that Hong Kong's "one country, two systems" model has "proven naysayers wrong" and would remain a durable framework through which to manage growing challenges with the Mainland.

Parallel Trading

One of the most pressing challenges coming from the Mainland is the proliferation of goods being purchased in Hong Kong and resold across the border on the Mainland. The rise of these "parallel traders" is due to the perception from many Mainlanders that basic products produced in China are not safe for consumption after reports surfaced that babies on the Mainland died from dangerous milk powder. The influx of Mainland citizens has driven up demand for goods beyond Hong Kong's capacity to meet supply for its own citizens, forcing the Hong Kong government to crack down at checkpoints, most notably at a border check-point in Shenzhen, which averages 400,000 crossings a day.

Housing and Infrastructure

In addition to the proliferation of parallel traders, Hong Kong officials have also had to introduce

new policies to manage downward demand on Hong Kong's housing and infrastructure after Mainland and foreign investors, following trends in the major Mainland cities, drove up the cost of real state, making it all but unaffordable for a sizable chunk of Hong Kong's population. According to the Society for Community Organization, a social welfare group, an estimated 100,000 people in Hong Kong have inadequate housing. But even with these often strained relations between Hong Kong officials and the Mainland, Chief Executive Leung observed that the attitude of Hong Kong natives towards the Mainland was "more resentment than nationalism."

RMB Internationalization

Perhaps the most internationally watched development between Hong Kong and the Mainland has been efforts by the Mainland to promote the internationalization of the Renminbi (RMB) as a convertible currency.

China has been using Hong Kong as a testing ground for RMB internationalization initiatives since 2004, when Hong Kong residents were allowed to open deposit accounts in RMB denominations. Since these initiatives took off nine years ago, Hong Kong has continued to serve as a laboratory for RMB internationalization, adopting a "national neutral policy" for institutional investors seeking to conduct transactions in RMB, and solidifying its position as a "first mover" offshore center for RMB convertibility. According to Hong Kong Finance Secretary John Tsang, RMB accounts in Hong Kong total RMB 700 billion (USD 114.4 billion). Furthermore, of the roughly 12 percent of overall Mainland trade conducted in RMB, over 90 percent settled in Hong Kong financial institutions. Although RMB platforms in London, Amsterdam, Singapore and Taiwan have taken hold, Hong Kong will remain the cradle of RMB international exchanges for the foreseeable future.

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But in order for the RMB to fully become a global currency, basic tenets must be met. According to Eswar Prasad, a professor at Columbia University and fellow at the Brookings Institute, in order for the RMB to become a global currency it must meet three global currency concepts. One, it must be able to settle cross-border trade and financial transactions; two, it must have a fully open capital account with no restrictions; and three, it must have the economic size, flexible exchange rates, and vibrant financial market development necessary to be held as a reserve currency. Missed through the excitement of China's 30 years of unprecedented economic growth, is the realization that the RMB does not yet meet these global currency standards. Make no mistake, the Chinese currency is making great strides to become an important global currency, but these strides have only taken the RMB through the first lap of the race.

Current Mainland-Hong Kong RMB internalization initiatives have successfully raised the global profile of the RMB without forcing China to liberalize capital accounts. But the current model of offshoring RMB through Hong Kong is not sustainable if China wishes to realize its goal of full RMB internationalization. Without substantial capital account liberalization, it will be difficult to establish financial market development, foreign exchange platforms, and sophisticated

derivatives markets. These realities do not take away from the impressive economic growth China has sustained over three decades, but it does highlight that much of the excitement that has been generated in London, Tokyo, and Sydney about the RMB's viability as a global currency may be premature.

These realities also confirm that China is a long way from challenging the U.S. dollar as the dominant global currency. Through gradual liberalization of its capital accounts, the RMB can cut into the dollar's global standing. However, for the foreseeable future, China's most pressing concerns will be reforming and rebalancing its economy and financial sector; not challenging the dollar for global supremacy.

HONG KONG VISA WAIVERS

Hong Kong business travelers are increasingly frustrated at their inability to qualify for visa waiver status by the U.S. Department of State and Department of Homeland Security. Under visa waiver status, Hong Kong citizens would legally be admitted into the United States for 90 days without a visa, allowing for freer flow of commerce and tourism. This issue has taken on elevated importance to the U.S.-Hong Kong relationship after Taiwan was admitted visa waiver status last year. Richard Vuylsteke, the president of the American Chamber of Commerce in Hong Kong spells out the contending viewpoints: "All of the reasons Taiwan was approved... Hong Kong is also very strong in, but it is unclear if the U.S. government knows how to handle the issues of mainland Chinese with [Hong Kong] resident status."

Conclusion

2013 marks a year of transition in the U.S.-China relationship. Leadership change in China and a changing Cabinet during President Obama's second term presents an opportunity for leaders in both countries to reevaluate and strengthen bilateral ties.

Both the United States and China have internal challenges that will consume much of their attention this year. The U.S. is still debating the best way to decrease its long-term national debt and lower yearly budget deficits. Over two years, this debate has taken a toll on the perception of American-style democracy around the globe. But as noted by former Australian Prime Minister Kevin Rudd, "The U.S. is one budget deal away from being back on top." China also will look inward this year as they take steps to maintain stability. After the 18th NPC in March, China's newly appointed leaders will begin taking steps to gradually reform and rebalance its economy, and will call for increased enforcement of environmental regulations and crackdown on corruption within the CCP.

For American companies who wish to do business in China, strong growth opportunities and profitability remain. But growth and profitability will not come easy. Through forums such as the Strategic and Economic Dialogue and the Joint Commission on Commerce and Trade, U.S. and Chinese officials will continue efforts to break down market barriers and increase investment opportunities.

On the military-to-military relationship, the U.S. and Chinese militaries have made much progress in establishing bilateral cooperation in humanitarian assistance and disaster relief missions, and combating piracy in the Gulf of Aden, and both countries have taken strong United Nations Security Council action against North Korea's nuclear ambitions. However, as contentious territorial disputes continue in the South and East China Sea, and tensions in cyber, space, and nuclear policy continue, both militaries remain skeptical of each other's intentions in the Asia-Pacific region.

Hong Kong will continue to be an integral partner as the Mainland gradually enacts political and economic reforms. As Hong Kong continues down the road toward universal suffrage, it will be interesting to see how, or if, the Mainland intervenes. Hong Kong will also continue to play an integral part in China's efforts to make the RMB a global currency.

These issues highlight the complexities involved in the U.S.-China relationship. But they also highlight opportunities for future growth. Getting this relationship right will require a continued understanding of each country's bottom lines and establishing lines of communication to work through challenges. Over the past half-century our nation's policies towards China have too often adopted a more hostile view rather than recognizing our partnership as an opportunity. In doing so, we have lost countless opportunities to partner with China in the economic and strategic sectors. This trend does not need to continue and does not serve either country's interests.

