Statement before the House Foreign Affairs Subcommittee on Asia and the Pacific

"A NEW ERA OF U.S.-CHINA RELATIONS?"

A Statement by:

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Distinguished members of the Subcommittee, good afternoon, and thank you for this opportunity to come before you today. I'm especially pleased to know that, despite the complex challenges the United States currently is facing with ISIS in Iraq and Syria, as well as Russia's brinksmanship with the West over Ukraine, there is an eagerness among the members to discuss these important issues with regard to the future trajectory of U.S.-China ties under the leadership of Chinese President Xi Jinping. Although these other challenges represent issues of concern, and, in the case of ISIS, a clear and present danger to U.S. interests and the lives of our citizens, I would submit that they ultimately should be viewed as near-term, **tactical** issues to be skillfully managed by policymakers. By contrast, getting our relationship with China right should represent the fundamental **strategic** preoccupation of U.S. foreign policy thinkers in the 21st Century. So let me spend a few moments sketching out for you my assessment of the state-of-play in the relationship as well as some of the specific issues I've been asked by the Subcommittee to address in this testimony.

Overview of the State of U.S.-China Relations

Relations between Washington and Beijing, while generally stable, are under stress. Chinese leaders and officials are at best confused by what they see as a lack of consistency from the Obama Administration with regard to its policy toward China, and at worst convinced that the United States, in large part through the rebalance—or "pivot"—to Asia, is bent on containing China's rise through destabilizing the Chinese Communist Party (CCP) leadership at home and seeking, in conjunction with its allies and partners, to place hard limits on China's strategic freedom of action in the Asia-Pacific region. For their part, U.S. policymakers are deeply concerned by Beijing's exceptionally forthright assertion of its sovereignty claims to disputed territories in the East and South China Seas, as well as the new Chinese leadership's seemingly more active—some would say disruptive—foreign policy approach in regions outside China's traditional areas of foreign policy interest and focus. Add to these persistent U.S. concerns with regard to Chinese cyberespionage and, in the bilateral economic relationship, issues relating to intellectual property rights (IPR) protection, currency valuation, and market access, and it is easy to see why the relationship appears more tense than it has in some time.

Moreover, senior officials in both capitals bemoan the lack of meaningful strategic dialogue between the two leaderships. This is despite the informal summit between the two presidents at the Sunnylands retreat in California a little over a year ago—set to be repeated on the Chinese side when President Obama visits for the APEC summit in November—and the existence of more formal, high-level dialogue channels between the two sides such as the Strategic and Economic Dialogue (S&ED). Some of this relates to personalities. There is a general consensus that there is very little observable chemistry between Presidents Obama and Xi, especially when compared to Xi's seemingly solid relationship with Russian President Vladimir Putin.

At the next level down, the Chinese generally view their S&ED interlocutors as largely disinterested in Asia or too domestically-focused. Similarly, on the U.S. side, there are questions about portfolio mismatch arising from the fact that, unlike his predecessor, Wang Qishan, Vice Premier Wang Yang, Treasury Secretary Lew's counterpart, does not oversee financial affairs within the Chinese State Council, or cabinet. Likewise, there are uncertainties about whether Secretary of State Kerry's interlocutor, State Councilor Yang Jiechi, commands the same level of authority over foreign affairs management that his predecessor, Dai Bingguo, seemed to wield.

The practical implications of a set of such relationships that frequently seem out of sync is the absence of strategic trust between the two leaderships and the resultant drift in bilateral ties brought on by policy stagnation. This year's S&ED would seem a case in point. If that mechanism were functioning normally, it would have been used as a crucial policy springboard for paving the way for an important summit between the two presidents, especially one where Xi, as a still relatively untested ruler, is keen to show off his foreign policy acumen in playing host to all of the region's most important leaders at the APEC summit. Instead, the meeting released a relatively bland series of pronouncements which, after the summer in both capitals and an intense focus early in the fall on critical domestic events in each country, leaves precious little time to think about policy solutions for elevating the relationship at the summit. Still, none of these trends is irreversible; it simply requires leadership and a commitment on both sides to building a **truly** new style or relations between the two nations going forward.

Finally, the traditional conceptions and cadence of the relationship still are adjusting to the phenomenon that is the leadership of Xi Jinping. While certainly no strongman, Xi is without question the most powerful Chinese leader to emerge in several decades. Two primary factors should command our attention in understanding that Xi's personal preoccupations, and, perhaps occasionally, even his musings are likely to play an outsize role in governing China's foreign policy approach, including relations with Washington, during his tenure. First, Xi has skillfully wielded an often coercive political toolkit to accrete tremendous power to himself in a very short period of time. Second, his perception of himself as a "doer" or a "man of action" means that his appetite for risk, both domestically and externally, is substantially higher than that of his immediate predecessors. His innate confidence as a leader and reliance on an informal, "kitchen cabinet" style of policy advisory means that decision making under him is likely to be more opaque—and far less deliberative—than before.

Although it is far too early in his tenure to be able to predict with any certainty the precise ramifications of his particular brand of foreign policy making, one thing is perfectly clear. Xi is not responding to the traditional messaging and cueing being employed by the United States on issues such as tensions in the East and South China Seas, or at least he is not doing so in the way the U.S. Government would like him to. This reality does not necessarily demand a specific set of policy responses from the United States, but it should give U.S. policymakers pause and a desire to reflect on whether—and how—U.S. actions may need to be recalibrated to deal with this fundamentally different approach. It also suggests that traditional assessments concerning indicators and warning of potentially disruptive Chinese actions may need to be revisited in a much more fluid Chinese policy environment where the previous utility of such tools may be substantially diminished.

Assessment of the Status of and Prospects for Economic Reform

Following on the sense of optimism—and even euphoria—coming out of the bold economic reform vision statement that was tabled by the leadership and endorsed by the Central Committee at last fall's Third Plenum, it is fair to say that reform progress has struggled in the first half of this year. This can be ascribed to several interrelated factors. One is what appears to be a recalibration of the approach by Xi and his team of economic advisors resulting from the collision between unrealistic expectations and political realities. Xi and his supporters seem initially to have believed that they could simply overwhelm the regime's many vested interests through a form of economic "shock and awe" that combined bold reform prescriptions with the Plenum's establishment of a new supra-leading group on deepening reform to guide—and enforce—the process. They have since recognized that the scale of the challenge is much greater and the resistance is far more entrenched. Having concluded that he will need more than "the big idea" and some bureaucratic hijinks to achieve his aims, there are several signs that Xi is at least considering a more transformational approach to undermine his detractors. This would entail putting on hold many of the readily observable reform proposals, such as a deposit insurance scheme or the liberalization of deposit rates, to focus instead on promoting governance reforms that could amount to a reshaping of the party-state to promote his administration's stated goal of assigning the market a "decisive role" in the economy.

Another factor is the pervasive fear that has been engendered among working-level officialdom as a result of the aggressiveness of Xi's anticorruption drive. Officials have been in a near state of paralysis for fear that they may somehow be swept up in the campaign through a particular decision or expression of support for a reform project or action. The bureaucracy also would be aware that Xi had been stoking substantial resentment on the part of other powerful party barons—most notably former President Jiang Zemin—by targeting their support networks with the antigraft campaign. Against this backdrop, few in the working-level bureaucracy have been inclined to offer up radical reform proposals when it was so abundantly clear that there was discord among the senior leadership, and that the outcome of that struggle was not clear cut.

Finally, the economy's sluggish performance also has acted as a drag on reform progress. The deeply disappointing industrial production figures just released for August—where growth slowed to its lowest level since the 2008 global financial crisis—are but one indication of the malaise that seems to have grabbed hold of certain parts of the economy. This will provide all the more incentive for the government to adopt additional stimulus measures for the final quarter of the year in order to meet the leadership's annual growth target of 7.5 percent set in March. Such pressures and practices risk crowding out the room for reform headway as officials, especially at the local level, single-mindedly batten down the hatches to be able to weather the storm.

Still, there are reasons to believe that prospects for reform progress at the end of this year and going into 2015 may be brightening. With the netting of two major "tigers" (Xi's political catchphrase for senior corrupt officials) in recent months as part of the antigraft crusade, there is some sense that at least the worst of the high-level political tensions in the system may be unwinding enough that officials feel they can start taking some more risks. Similarly, it will be important for the leadership to set the right tone on the pace of reform before the Communist Party's economic planners begin focusing in earnest on drafting the 13th Five-Year Plan which will be approved at next year's plenum. Given that the Plan's life span (2016-2020) will expire precisely when the leadership has set out a major strategic benchmark for achieving "meaningful progress" on the reforms, we can expect Xi, whose legacy will in part be judged by what has been accomplished, will be keen to keep officials' feet to the fire. Moreover, just by the natural cycling of the Chinese political calendar, Xi and his cohort have at most another eighteen months to make substantial progress before the political horse trading begins again in earnest ahead of the next party congress in 2017.

Review of the Market Conditions Facing Foreign Companies Operating in China

The environment confronting foreign companies doing business in China has changed substantially in the wake of the 2008 global financial crisis. The altered landscape is perhaps best reflected in shifting response patterns to annual surveys of the sentiments of business leaders working in China and conducted by their host nation chambers of commerce. While recent surveys have continued to highlight traditional areas of concern such as rising labor costs and inconsistent or unclear laws and regulations, respondents to this year's surveys zeroed in on challenges that they claimed impact foreign business disproportionately. According to the study conducted by AmCham China, for example, fewer respondents than ever believe that licenses are granted equally between foreign and Chinese companies, a strong majority of respondents still characterize IPR enforcement in China as ineffective, and 40 percent of respondents perceive that foreign companies are being singled out in the pricing and antitrust investigations that now are touching a very wide array of industries operating in the country.

There is no one clear answer concerning what may be driving these pressure tactics, and the motives do seem to vary somewhat by industry. In the case of pricing investigations, it is not surprising that products like pharmaceuticals and infant milk powder have been targeted. The central leadership understands full well that it is staring down the barrel of a trillion dollar health care bill by 2020 as it dramatically expands coverage for China's massive population, and there is no doubt that the message has gone down from the leadership to the entire state bureaucracy to do whatever it takes to bring down costs.

In other instances, the motivation appears to be as simple as traditional rent-seeking behavior, or the perception that a substantial financial windfall lies within easy reach. Looking just at the investigation into GlaxoSmithKline, for example, it is hard to imagine that Chinese authorities weren't inspired, at least in part, by the company's agreeing to pay $3 billion in fines to settle fraud charges in the United States. Lastly, we also cannot discount the impact of simple bureaucratic rivalry in explaining the uptick in reports from foreign firms alleging various strong-arm tactics by Chinese regulators. The fact that there are three separate Chinese government entities—the National Development and Reform Commission (NDRC), the Ministry of Commerce (MOFCOM) and the State Administration of Industry and Commerce (SAIC)—competing for dominance in what clearly is a senior leadership-favored policy domain helps at some level to explain the seeming emergence of bureaucratic one-upsmanship between these bodies in their approach to these various types of investigations. In fact, proposals being debated in Chinese policy circles concerning a possible consolidation of these responsibilities under a single authority would suggest that the competition among these regulatory bodies—and concomitantly the pressure on foreign firms—may only intensify going forward.

Still, these explanations, though certainly part of the puzzle, are dwarfed by a single overarching priority of the regime—the preservation and strengthening of China's unique state capitalist system. To some degree, the probes can therefore be understood as the central leadership's effort to reassure the state behemoths as, in keeping with the Third Plenum's pronouncements, the Communist Party deliberates greater liberalization in several previously protected industries. Moreover, and in conjunction with the dramatic expansion of their administrative toolkit, the regulatory agencies appear to be designing a template with these investigations with potential applicability across a wide variety of industries. The specific measures taken will vary on a case by case basis, but it is likely to involve a combination of several techniques, including the threat of price investigations to win concessions; the use of investigations or well-coordinated "exposes" by state controlled media to mar the reputational standing of the targeted firm; and the provision of subsidies and the promotion of consolidation of domestic producers in the targeted industry to boost the competitiveness of designated national champions. Going forward, we can expect that China will continue to use all of the tools at its disposal—including selective enforcement of rules, provision of subsidies, and technology transfer requirements—to create an environment that unduly favors the development of its domestic champions.