

Co-Existing with a Rising China: U.S. Economic, Security, and Environmental Challenges

> March 28 - April 4, 2016 Beijing and Nanjing, China





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Co-Existing with a Rising China: U.S. Economic, Security, and Environmental Challenges

Rapporteur's Summary

Robert Daly

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The Aspen Institute Congressional Program convened a conference March 28-April 4, 2016 in Beijing and Nanjing, China on Co-Existing with a Rising China. Nineteen members of Congress met with 21 U.S. and Asian scholars to discuss a number of issues affecting Asian and U.S. security, economic, and energy/environmental interests. The Prime Minister of China, Li Keqiang, addressed the group. Participants were also briefed by members of the U.S. embassy. Educational site visits in Nanjing included the Ford Motor Research and Engineering Center, the Amity Bible Printing Plant, the Hopkins-Nanjing Center, and the Memorial to the Victims of the Nanjing Massacre. In Nanjing the group also engaged with American and Chinese students and faculty at the Hopkins-Nanjing Center. The conference was held amidst the longest period of deep Sino-U.S. mistrust since diplomatic relations were established thirty-seven years earlier. Despite an atmosphere of suspicion, members of Congress sought new opportunities to cooperate with China throughout the seminar, even as they struggled to find solutions to security and economic concerns. At the conclusion of the program, one participant said, "I'm more interested in China now, but I'm feeling less threatened by it. The U.S. has problems; China has troubles... China is changing and will be a very different enterprise in the not-too-distant future." While the views expressed during the conference were too diverse to capture in several sentences—or indeed an entire report—this statement is a suitable epigraph for an intense, wide-ranging seminar that considered Chinese and American foreign policy in light of their histories and domestic challenges. The conference followed a roundtable discussion format and was

organized into major themes that are addressed under the subheadings that follows. Consistent with the offthe-record nature of the proceedings, no remarks are attributed to any individual by name

Financial Engagement, Trade, Economy

In his overview of China's economy, one economist emphasized that, under the "new normal," slowing growth rates were not a sign of economic weakness, but the inevitable result of a necessary and difficult transition to slower, more sustainable growth. China had the resources and flexible labor markets needed to meet the challenges of the "new normal" and could probably achieve annual GDP growth of 5% to 6% over the coming decade.

Another scholar argued that pervasive corruption justified Communist Party General Secretary Xi Jinping's effort to centralize decision-making in Communist Party (CCP) instruments under his control. Necessary as Xi's anti-corruption campaign had been over the past three years, however, it had a chilling effect on economic activity: officials were hesitant to innovate or approve projects and private businesses were unwilling to invest for fear of drawing the attention of Beijing's anti-corruption watchdogs.

One main concern was the tension between the CCP's desire to monopolize decision-making and its quest for economic growth, which required decentralization. After thirty-five years of reform, China faced a conflict between the desire for social stability and the demand for market-based development, yet Xi seemed uncomfortable with tradeoffs between control and prosperity. His dilemma had been evident in the poor handling of the Shanghai

stock market crash and the Chinese currency (RMB) exchange rate adjustment in 2015. Those missteps had sent confusing signals to international markets. However, recent difficulties should not obscure contributions China had made to the global economy over the past twenty years. China had become the world's largest trading nation during that time and was now a major international investor. One economist contended that 2016 was only the beginning of the era of China's export of capital and most Chinese investment would be beneficial to target countries and unthreatening to security. While issues of reciprocity remained—China's inbound investment laws remained strict even as it took advantage of liberal regimes elsewhere—China's role as a global investor should, in the main, be welcomed.

An Asian economist tried to reassure participants that, despite the many challenges facing China, its economic fundamentals and seventy years of experience were sufficient to meet them. The Chinese government supported the continued development of a market economy and would provide the political stability necessary for growth. Human capital was still improving—China's workforce was healthier than ever despite poor air quality and food safety issues. Because today's 65 year-olds were as healthy as 58 year-olds in the past, the retirement age could be lifted and China's labor force would not be an issue despite the graying of the population. Improved education also strengthened the workforce. This economist predicted that these factors, combined with its "economic openness." indicated that China would enjoy 7% growth for the next thirty years. By 2050, China's economy would be two to three times larger than America's. There was a risk, however, that the CCP might prove "too busy with political issues and consolidating power" to enforce the reform plan adopted in 2013 (which promised that markets would play a decisive role in allocation of resources).

A third economic expert wasn't worried about China's 2016 economic growth, because "GDP targets are more political than economic, so if they want to reach a goal, they will." He was less sanguine about China's near-term economic prospects. He warned that pursuing growth through government investment would increase excess capacity and raise the number of non-performing loans in state-owned banks. Keeping employment high by shifting workers to services was unleashing the service sector's potential, but productivity in traditional industries could languish as a result. China's banking system, moreover, was

unaccustomed to structural reform and didn't know how to work with service sector clients. He worried that deleveraging China's corporate sector could trigger a hard landing and rampant unemployment.

He hoped the Trans-Pacific Partnership (TPP) would be adjusted to accommodate China and that bilateral investment treaty negotiations would improve opportunities between the two "highly complementary" economies. If China opened up its service sector, he advised, health services would be a good investment for American companies: China's ageing population had an urgent need for doctors and nurses and Chinese policymakers could win political support if they made reforms that would allow American companies to train Chinese medical personnel.

The three experts advocated, in different ways, for a moderate, cautiously optimistic view of China's economic reform and U.S.-China trade and investment relations. Conferees' questions, however, indicated that they were less sanguine about China's domestic conditions or its role in the global economy, as the following extracts from the discussion illustrate.

Q: As the workforce ages, more people (retirees) will consume more than they produce and draw energy from the workforce. How can China's demographics after 2030 not be catastrophic?

A: There is room to expand working life spans. China's ratio of workers to retirees is 5 to 1 today, but will be 2 to 1 after 2030.

Q: Are China's capital flight and the managed exchange rate of its currency (the RMB) big problems?

A: Most of this year's "flight" is, in fact, normal investment outflows and the reasonable restructuring of debt. People aren't fleeing with cash in suitcases. Chinese domestic bank deposits grew 13% last year. The RMB is about where it should be and is probably slightly over-valued. China's main objective is to stabilize capital flows, not manipulate exchange rates.

If the RMB traded freely, it would depreciate and we don't know where the bottom would be. Competitive devaluations would harm the global economy.

Q: Should China be part of the TPP?

A: The TPP is not a big deal for China, which already has free trade agreements with 8 of 12 TPP members. China won't be willing to deal with TPP members one-by-one, as it did during its World Trade Organization accession. The TPP can't succeed without the world's biggest trading nation, so

policymakers should find a way for China to join the TPP without a WTO-type process, an Asian economist responded

- Q: With huge losses for U.S. software and film companies, aren't China's use of cyberspace and its intellectual property rights (IPR) violations serious issues? There have been huge losses for U.S. software and film companies.
- A: Chinese policymakers are aware of these concerns and work proactively with the U.S. to make ground rules. Cybersecurity is trickier. Beijing's biggest concern is that dissidents will use the Internet to mobilize support against the government. U.S. tech companies have suffered due to Chinese piracy, but some of the loss claims are highly notional. Chinese who used pirated Microsoft products in the 90s wouldn't have paid full price for Windows if they hadn't stolen the software. Poor market access, compulsory licensing, and forced technology transfer are bigger issues for American tech companies in China than IPR.
- Q: There is a bipartisan turn against trade in the U.S. A study by American labor economists says Chinese exports to the U.S. lower American wages and cost American jobs.
- A: Most American companies operating in China are profitable. In the view of an Asian economist, China helped create quality jobs in the U.S. by increasing American corporate profits. The study demonstrated that Chinese exports have had a major impact on U.S. employment. The benefits of an open trade regime are dispersed while losses are concentrated. The U.S. needs trade adjustment policies for people harmed by free trade, an American economist contended.
- Q: In terms of economic policy, what can the U.S. learn from China?
- A: The virtues of pragmatism. China has become more pragmatic, while the U.S. has become more polarized and ideological. It's an odd role-reversal.
- Q: Over 50% of Americans have a negative view of China. How will China respond if the next U.S. administration raises tariffs on Chinese exports?
- A: A 45% tariff on Chinese exports to the U.S. will trigger a trade war.
- Q: Will Chinese investment in the U.S. become a political issue?

- A: The past 6 to 9 months have seen a rapid increase in Chinese investment in the U.S. because private Chinese investors want to diversify portfolios as domestic growth slows. Some Chinese acquisitions have national security implications, but most don't.
- Q: Will China's state-owned enterprises (SOEs) be reformed?
- A: Beijing thinks it can't conduct SOE reform and an anti-corruption campaign simultaneously.
- Q: American firms are concerned about having to give up source code, trade secrets, and intellectual property as the price of admission to China. Is China even a viable market?
- A: The best strategy for American companies is to come to China and work patiently with Chinese partners and the Chinese government to shape rules over the long term.
- Q: What is the rate of women's participation in labor market? Are adequate child care policies in place? Do men and women have the same retirement age?
- A: Big changes are coming in next five years. The retirement age for women will be raised. China has high female labor participation rates up to age 45; then it falls off. Chinese women have less title to property than men. Many real estate transactions are conducted in men's names. Women are largely shut out of the real estate boom and there is therefore a wealth gap.
 - O: What is the condition of China's state finances?
- A: China's fiscal accounts remain opaque. Income tax has remained at 6% of tax revenue for 15 years. The income tax should be higher, but Beijing is hesitant to raise rates because that would result in demands for greater accountability.

Energy and Environmental Resources

While the discussion of economics focused on tensions in bilateral relations and had a skeptical, accusatory tone at times, the emphasis during the energy and environment presentations was on cooperation. One expert noted that China's growth has been powered by coal, which was 60% of China's energy mix. Still, coal use had declined 3.7% since China announced that its carbon emissions would peak by 2030. Electricity use was growing, however, and it was not yet clear whether it would be generated by clean energy or coal.

The expert argued that China's greatest environmental challenge, like America's, was lack of

regulatory oversight. Developing cost-effective, reliable, environmentally friendly energy was the point of common interest at which the two countries should work. The U.S. had regulatory design and policy analysis experience. China was a good testing ground for new technologies, regulatory regimes, and pricing

policies. Collaboration was the key. Another expert said that China's concerns about environmental and energy policy weren't political; they were about technology and outcomes—things like refrigeration standards and fuel efficiency. He listed the major challenges facing China as: (1) Water, land, and soil pollution caused social unrest, but simply closing redundant facilities with no pollution controls would result in massive unemployment; (2) China needed a national program to cap carbon and would likely have one by 2025; (3) Carbon-reducing policies had to be socialized through government ministries. These reforms amounted to a revolution in urbanization, which was essential, as China was building the equivalent of one Houston per month.

Participants were encouraged to recognize that the futures of the U.S. and China were intimately linked. China needed technical analysis and training on clean economic strategies. The U.S. therefore had an opportunity to "help set the DNA of China's economy at a low cost," which would serve America's national interest.

Q: How serious is China about meeting its aggressive low-carbon targets? Does China have the expertise? What can the U.S. and China can do together?

A: As the two top automobile markets, the U.S. and China can set strong gas mileage standards—higher than 50 mpg.

Both countries underinvest in energy research and development. State Department and Department of Energy funds could be used to build "tiger teams" that would help China design strategies, structure utilities, write building code, etc.

Q: What is the status of nuclear power in China?

A: China has the largest nuclear program in the world and plans to double its capacity by 2020. Still, nuclear will be only 10% of the non-carbon side of China's energy portfolio.

Because of its ability to invest in major projects and to scale up, China is best positioned to build safe, cheap Generation IV reactors (the next generation of nuclear reactions, not yet commercially available). It will cost billions of dollars to test each Generation IV design concept, and the U.S. can't afford the investment.

Q: Does the U.S. export pollution to China?

A: Pollution in trade is an issue. Twenty percent of China's pollution is caused by manufacture of trade goods and U.S. consumption contributes to that.

O: Does China have a carbon tax?

A: Carbon taxes are an effective way to reduce emissions, but are no panacea. People who put up buildings don't pay utility bills, so a carbon tax does nothing in the building sector. It also does little in transportation.

Q: Is lead in water an issue in China? Is the government engaged?

A: A Chinese-American team has tracked blood samples over time to look at the effects of pollution on brain development in China. China is moving toward right-to-know provisions that inform citizens of what is emitted. The right to sue is expanding. A transparency revolution is beginning in China.

Q: Where do food and agriculture fit in?

A: Agriculture could become a greater problem than energy for China. Usable water resources are shrinking and the level of waste is high.

Security and Global Responsibility

The security dilemma facing the U.S. and China in the Western Pacific was addressed with greater urgency than any other issue considered by the conference. One American analyst posited that, until the mid-1990s, China saw its maritime neighborhood as an unthreatening environment conducive to development. But military allocations had risen with GDP growth and Beijing now looked at its near oceans as a defensive barrier. China's leaders reasoned that if they could dominate the seas out to the first island chain, they could regain lost territories and improve security. They had built weapons and planned a major military reform in pursuit of this goal and had begun to assert territorial claims in the Western Pacific beginning in 1996. The U.S. was toughening its stance in the South China Sea, but had no coherent strategic response to Chinese actions in the region. Although tensions were rising, one scholar nevertheless thought the situation was manageable, "if we're smart and avoid violence."

An Asian analyst attributed Chinese and U.S. concerns about each other's strategies in the Western

Pacific to differing interests and misunderstandings. One American misunderstanding was that China was not a responsible stakeholder. China now saw global governance in the political, economic, security, and social spheres as a major task. Beijing had worked successfully with Washington on climate change and some regional security issues, but differences remained. The most serious were frictions in the East and South China Seas, in the Taiwan Straits, and on the Korean Peninsula. This analyst claimed the U.S. believed that China's goal was to change the status quo and dominate the region, squeezing the U.S. out of East Asia. This was not true, according to this analyst. Many Chinese believed the American "Rebalance to Asia" was aimed at containing China. He argued that this was also untrue.

Q: Does China understand the U.S. commitment to Taiwan and the importance of the Taiwan Relations Act (TRA)?

A: Under the TRA, the Pentagon must develop, maintain, practice, and commit a war plan so that the U.S. can prevent China from taking over Taiwan, if the President orders it. The Chinese commander in Nanjing has a planning directive to take Taiwan by force if Beijing orders it. The risks are high on both sides, but higher for China, which has been careful to articulate the conditions under which it would attack Taiwan. China opposes Taiwan's independence more than it desires reunification and believes it would be foolhardy to invade Taiwan.

Q: Is the U.S. presence in the region adequate to maintain freedom of the seas and air space?

A: China knows that the U.S. wants to maintain a dominant role and that other countries in the region support it. China wants the U.S. to play a constructive role. Trilateral and quadrilateral talks are needed to develop a multilateral security architecture in the region, explained one Asian analyst.

Q: Is the U.S. ultimately going to roll over in the South China Sea?

A: China's maximum ambition is to establish everything within China's so-called "9-Dash line" as its territorial sea. That's intolerable to American interests, one American analyst argued. China had legitimate claims in the Paracel Islands and some of the Spratlys, however, so the U.S. should support a durable, multilateral agreement that attends to all

claimants, including China. An Asian analyst said that China didn't believe that the whole South China Sea belonged to China. Within the "9-Dash line", China had sovereignty over land features and therefore also had territorial seas and exclusive economic zones (EEZ). China also had historical rights in the region, although some contested this. Recent Chinese actions had been necessary, but it would never use force, he contended.

It was argued that this explanation, while coherent, was intolerable to the U.S. because China's interpretation of EEZ rights exceeded those of most other countries. The U.S. should support a multilateral negotiation or arbitration to come up with an equitable distribution based on claims. China would not agree to participate in such an exercise, so the U.S. should leave an empty chair at the table and consider China's claims in its absence. Then the U.S. should support actions of the Philippines and Vietnam to develop their islands, with military force if necessary. Unless the U.S. underwrote a solution in this way, it would have to wait until China pushed it too far and then react under disadvantageous circumstances.

Q: If China really wants negotiations, why not invite everyone in for reasonable discussion?

A: Two Asian analysts argued that China has resumed discussions with Vietnam, but this was only possible because China "had done something" (built out new islands) which forced Vietnam to negotiate. China is willing to have multilateral talks on security, but not on territory. Multilateral talks sound good, but how would they work? What would be the basis for the talks? China would feel an American influence behind any multilateral forum.

Q: How should we view China's military reform?

A: Military modernization is necessary. Xi Jinping can use it to strengthen his power base and the CCP's control of the armed forces. Military modernization was about flexibility, jointness, mobility, and rational management. Chinese military leaders had been advocating for it for years.

Several members of Congress said that China seemed tone deaf to the concerns of the United States and other nations. Other members stressed that mature great powers must do everything possible to cooperate in order to lower the risk of conflict when cooperation seems impossible.

The discussion moved on to the American "Rebalance to Asia" and the role the TPP played in it. Members said there was a sense in Asia that, if the TPP failed, the Rebalance in its entirety would collapse and

the U.S. would pull back from the region. One participant countered that his constituents were concerned about jobs and by climate change, and "didn't care about the South China Sea."

An American analyst closed by saying there were two ways of looking at South China Sea friction: it was either a road to conflict or the various players were building up cards and chits to use in negotiation. The course taken would depend on the skill of both governments. A member of Congress added that he worried about miscalculation on both sides, but worried more about Beijing. He wasn't sure China's leaders understood that the U.S. took its alliances and interests in East Asia seriously and was determined to remain a world and regional power.

The morning ended with a non-partisan discussion of Chinese and American strengths and weaknesses. One member remarked that this conversation alone had made the 14-hour flight to China worthwhile. Another said that China's assertiveness had united Democrats and Republicans in common cause.

Governance and Civil Society in Hong Kong and Taiwan

Twenty years ago, Taiwan and Hong Kong wouldn't have belonged in the same discussion, according to one analyst, as they had little contact with each other and each was mired in its own middle income trap. China's opening had spurred economic integration and helped Taiwan and Hong Kong escape the trap. Youth in both places, now facing slower growth and increasing income disparity, rejected integration with the Mainland and celebrated "Hong Kong" and "Taiwan" identities. Mainland authorities were unsure of how to respond. The U.S. could not support independence for Taiwan or Hong Kong, but would like to help them maintain autonomy. The U.S. role was to press for further political and economic reform within China that would align its institutions more closely with those of Hong Kong and Taiwan.

Reviewing Taiwan's 2016 elections, another analyst noted that the Blue (KMT) camp favored closer ties with the Mainland and might be open to reunification with a more democratic China, while the Greens (the Democratic Progressive Party, or DPP) were inclined to build a new and distinct political entity. This analyst saw three factors that were conducive to stability in Cross-Straits relations, and three major risks. Stability would be provided by (1) Taiwan adhering to the 1992 Consensus (a vague compromise under which the Mainland and Taiwan

agreed that there was only One China, but tacitly recognized that each side had its own interpretation of that phrase); (2) the U.S. provision of a defensive capability, which made it hard for the PRC to be assured of victory at an acceptable cost; and (3) China's ability to be satisfied with preventing independence, rather than seeking unification. The risks were (1) that newly-elected Taiwan President Tsai Ing-wen's formula of maintaining the status quo and abiding by the Republic of China's constitution wouldn't satisfy China; (2) that Tsai would use nationalism to build political support if Taiwan's economic malaise continued; and (3) that the U.S. might lose interest in Taiwan.

Another analyst added that three million Taiwanese lived in the PRC and that many more depended on it for their incomes. Such economic links were bringing the two sides closer together.

Q: What does the Taiwan Relations Act (TRA) commit the U.S. to and does it deter the Mainland?

A: The TRA commits the U.S. to being gravely concerned about unilateral attempts at coercion and to supply defensive arms to Taiwan. It isn't a defense treaty. It has served its purpose so far.

Q: Is there a possible joint solution for Taiwan and Hong Kong?

A: Young Taiwanese and Hong Kong activists are reaching out to each other. *One Country Two Systems* was originally conceived as a solution for Taiwan. It was applied to Hong Kong only later. Taiwan has lost interest in it. Perhaps a federal system with guarantees of autonomy could work. Many Taiwanese don't accept the parallel with Hong Kong. Taiwan is the world's 20th largest economy and is a vibrant democracy. It doesn't want a tacit alliance with Hong Kong.

Q: How might China put more economic or diplomatic pressure on Taiwan?

A: China could lure countries that recognize Taiwan to switch their recognition to the Mainland and it could reduce the number of Mainland tourists visiting Taiwan. But any pressure from the PRC would increase President Tsai's popularity, at least during her honeymoon period.

Roundtable on Chinese and American Leadership

One American analyst urged participants to bear in mind that China was trying to reinvent itself and that it both honored and sought to overcome its history. He provided a thumbnail sketch of China since the overthrow of the Qing Dynasty in 1911, emphasizing China's attempts to cancel its disruptive past. A nullification of the past was attempted when the CCP came to power in 1949. Today, Xi is attempting to carry out an ideological and institutional revolution that would transform China's domestic politics and international relations. He had bolstered the security state to ensure his personal control of as many spheres of Chinese life as possible. While Xi had enjoyed considerable success and seemed to be popular among ordinary Chinese—primarily due to his anti-corruption campaign—his efforts had also paralyzed the bureaucracy, alienated intellectuals and creative classes,

and pushed China's Asian neighbors closer to the United States. Xi's strongman approach, in short, may have reached the limits of its usefulness. It appeared that Xi sat atop a fragile system that could not reconcile the claims of Chinese particularism and global modernity.

Another analyst struck a more optimistic chord, noting that many problems in U.S.-China relations could be mitigated if misperceptions were overcome. Mutual mistrust was at a dangerous level, due to differing interest and ideologies, but also because of misunderstandings. The China Dream, the Great Rejuvenation of the Chinese Nation, and Xi Jinping's proposal for a New Model of Major Country Relations between the U.S. and China were all consistent with China's longstanding *Peaceful Rise* policy. The Asian Infrastructure Investment Bank and "One Belt, One Road" programs demonstrated China's commitment to providing global public goods. The key to a peaceful, prosperous future in East Asia would be the ability of the U.S. and other nations to adjust to the reality of Chinese influence, even as China acknowledged the benefits of a multilateral order in the region, this Asian analyst proposed.

A second American analyst focused on China's continuing evolution. China was learning to be a great power and making adjustments along its way; it was not a monolith moving inexorably in a sure direction. The U.S. and China should focus not on the threat of each other's maximal demands, but on ways of guaranteeing each other's minimal security needs. The question in the Western Pacific was not what the U.S. and China wanted, but what they would settle for. According to this analyst, the greatest threat China posed was its desire to have its domestic standards for the treatment of individuals, information, and institutions accepted as legitimate alternatives to more

liberal practices on the world stage. Thanks to its purchasing power, China was poised to become a tastemaker to the world. Its consumption and regulatory frameworks would increasingly dominate world markets and shape and constrain American choices. For example, when Hollywood fashioned scripts for China's box office, China was handed a means of exporting its censorship regime.

A Changing Status for Foreign Entities in China

Representatives of non-governmental organizations (NGOs) were paying close attention to the draft law governing foreign NGOs in China, which would be promulgated soon. The proposed law could be a positive step in that NGOs had long been operating in a legal gray area, but there were concerns that the Ministry of Public Security and not the Ministry of Civil Affairs would have jurisdiction over foreign NGOs. This meant that "it's really about foreign influence and national security concerns" rather than fostering the development of civil society. One speaker noted that, under existing laws, most foreign NGOs in China registered as companies or didn't According to another NGO register at all. representative, the law applied to human rights organizations, foundations, religious organizations, and a wide range of other non-corporate activities. Another speaker noted that some U.S. university centers would be classified as NGOs under the new law.

Q: Are there any foreign NGO success stories in China?

A: Many are successful because they've supported China's reform and opening. The Energy Foundation (energy policy consulting) and Smile Train (surgery for children with cleft palates and hare lips) were cited as good examples.

Q: Can we invoke reciprocity by, for example, making Confucius Institutes register through onerous processes in the U.S.?

A: That would violate important American principles.

Q: Do American universities operating in China have to compromise their academic freedom to comport with Chinese law?

A: In this regard, and many others, the draft law betrays great misunderstanding of how the rest of the world operates. The debate about how foreign NGOs should be governed is part of an internal debate about what sort of country China should be.

The Asian Infrastructure Investment Bank

Jin Liqun, AIIB President, spoke to the group over lunch. He stressed that the AIIB would only fund projects that were financially sustainable, environmentally friendly, and socially acceptable. With 57 member countries and 30 more waiting to join, the AIIB was not a Chinese bank; it was multinational.

China had supported the Bretton Woods system since its inception, Jin said. The AIIB would not upend existing frameworks, but would enhance them through its "lean" (meaning it had no resident board), "clean" (meaning it would not tolerate corruption), and "green" operations. Americans with World Bank experience had designed the AIIB's environmental and social systems. Most AIIB projects would be co-financed to spread risk. American companies could participate in international bidding whether or not the U.S. became a member of the bank.

Q: Will individuals and groups in countries affected by AIIB loans be permitted to object and

appeal, as they are when they question other multilateral development bank (MDB) projects?

A: It was "inconceivable" that AIIB wouldn't have the same standards as other MDBs. AIIB could "showcase China's good governance," but would not act alone. If it wanted to run things by itself, China could make all of its loans through the China Development Bank.

Q: Will AIIB have a program for civic engagement? Will the human side be factored in to infrastructure financing?

A: AIIB loans will result in the training of large numbers of people. The bank is interested in health education, which it considers to be non-physical infrastructure. The bank will also invest in "productive sectors" such as education and environmental improvements.

Should We Worry about China's Economy?

Arthur Kroeber

Nonresident Senior Fellow, Foreign Policy, Brookings-Tsinghua Center Founding Partner and Head of Research, GaveKal Dragonomics Editor, China Economic Quarterly

Just how much economic trouble is China in? To judge by global markets, a lot. In the first few weeks of the year, stock markets around the world plummeted, largely thanks to fears about China. The panic was triggered by an 11 percent plunge on the Shanghai stock exchange and by a small devaluation in the renminbi. Global investors—already skittish following the collapse of a Chinese equity-market bubble and a surprise currency devaluation last summer—took these latest moves as confirmation that the world's second-biggest economy was far weaker than its relatively rosy headline growth numbers suggested.

In one sense, markets overreacted. China's economy grew by 6.9 percent in 2015; financial media headlines bewailed this as "the lowest growth rate in a quarter century," but neglected to mention that this is still by a good margin the fastest growth of any major economy except for India. Even at its new, slower pace, China continues to grow more than twice as fast as developed economies. Some doubt the reliability of China's economic statistics, of course, but most credible alternative estimates (based on hard-to-fake indicators of physical output) still suggest that China is growing at around 6 percent, and that if anything there was a slight pickup in activity in late 2015.

It's true that construction and heavy industry, which drove China's growth from 2000 to 2013, are now nearing recession levels. But services—which now account for over half of China's economy—and consumer spending remain strong, underpinned by solid employment and wage gains. The latest Nielsen

survey of consumer confidence ranked China eighth of 61 countries in consumer optimism, and confidence actually increased in the last quarter of 2015. All in all, another year of 6 percent-plus growth should be achievable in 2016.

Markets also exaggerate the risk of financial crisis, with their breathless talk of capital fleeing the country. Most of this so-called "capital flight" is simply a matter of companies prudently paying down foreigncurrency debts, or hedging against the possibility of a weaker renminbi by shifting their bank deposits into dollars. In the main, these deposits remain in the mainland branches of Chinese banks. Domestic bank deposits grew by a healthy 19 percent in 2015 and now stand at \$21 trillion—double the country's GDP and seven times the level of foreign exchange reserves. The continued fast rise in credit is an issue that policymakers will need to address eventually. But they have time, because lending to households and companies is backed one-for-one by bank deposits. By contrast, the United States on the eve of its crisis in 2008 had nearly four dollars of loans for every dollar of bank deposits. As long as China's financial system stays so securely funded, the chance of a crisis is low.

Yet while we should not worry about an imminent economic "hard landing" or financial crisis, there are reasons to be seriously concerned about the country's economic direction. The core issue is whether China can successfully execute its difficult transition from an industry- and investment-intensive economy to one focused on services and consumption, and how much

disruption it causes to the rest of the world along the way. History teaches us that such transitions are never smooth. And indeed, China's transition so far has been much rougher than the gradual slowdown in its headline GDP numbers suggests.

Remember that when China reports its GDP growth, this tells you how much its spending grew in inflation-adjusted renminbi terms. But to measure China's impact on the rest of the world in a given year, it is better to look at its nominal growth—that is, not adjusted for inflation—in terms of the international currency: the U.S. dollar. This is because nominal U.S.-dollar figures better show how much demand China is pumping into the global economy, both in volume terms (buying more stuff) and in price terms (pushing up the prices of the stuff it buys).

When we look at things this way, China's slowdown has been precipitous and scary. At its post-crisis peak in mid-2011, China's nominal U.S.-dollar GDP grew at an astonishing 25 percent annual rate. During the four-year period from 2010 to 2013, the average growth rate was around 15 percent. By the last quarter of 2015, though, it had slowed to a tortoise-like 2 percent (see chart). In short, while investors are wrong to complain that China distorts its GDP data, they are right to observe that, for the rest of the world, China's slowdown feels far worse than official GDP numbers imply.

This dramatic fall in the growth of China's effective international demand has already hit the global economy hard, through commodity prices. In the past 18 months, the prices of iron ore, coal and oil, and other commodities have all fallen by about two-thirds, thanks in part to the slowdown in Chinese demand and in part to the glut of supply built up by mining companies that hoped China's hunger for raw materials would keep growing forever. This has badly hurt emerging economies that depend on resource exports: Brazil, for instance, is now mired in its worst downturn since the Great Depression. The slowdown also hurts manufacturers in rich countries like the United States and Japan, which rely on sales of equipment to the mining and construction industries.

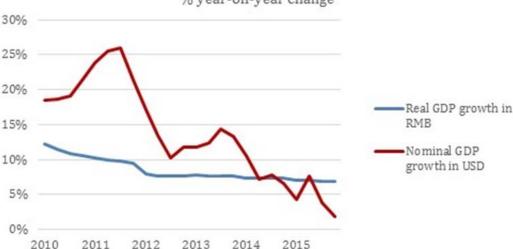
This helps explain why markets react so fearfully at every hint the renminbi might fall further in value: A weaker currency reduces the dollar value of the goods China can buy on international markets, creating more risk of a further slowdown in an already languid world economy.

There is a silver lining: The flattening of its commodity demand shows China has turned its back on an unsustainable growth model based on ever-rising investment. The question now is whether it can succeed in building a new growth model based mainly on services and consumer spending. As we noted above, growth in services and consumer spending is

solid. But it is still not strong enough to carry the whole burden of driving the economy. For that to happen, much more reform is needed. And the pace of those reforms has been disappointing.

The crucial reforms all relate to increasing the role of markets, and decreasing the role of the state in economic activity. China has an unusually large state sector: OECD researchers have estimated that the value





of state-owned enterprise assets is around 145 percent of GDP, more than double the figure for the next most state-dominated economy, India. This large state sector functioned well for most of the last two decades, since the main tasks were to mobilize as many resources as possible and build the infrastructure of a modern economy—tasks for which state firms, which are not bound by short-term profit constraints, are well suited.

Now, however, the infrastructure is mostly built and the main task is to make the most efficient use of resources, maximize productivity, and satisfy evershifting consumer demand. For this job, markets must take a leading role, and the government must wean itself off the habit of using state-owned firms to achieve its economic ends. And the big worry is that, despite the promises in the November 2013 Third Plenum reform agenda, Beijing does not seem all that willing to let markets have their way.

The concerns stem from the government's recent interventions in the equity and currency markets. Last June, when a short-lived stock market bubble popped, the authorities forced various state-controlled firms and agencies to buy up shares to stop the rout. This stabilized the market for a while, but left people wondering what would happen when these agencies started selling down the shares they had been forced to buy. To enable these holdings to be sold without disrupting the market, the authorities instituted a "circuit breaker" which automatically suspended stockexchange trading when prices fell by 5 percent in one day. Instead of calming the market, this induced panic selling, as traders rushed to dump their shares before the circuit breaker shut off trading. The government canceled the circuit breaker, and the market remains haunted by the risk of state-controlled shareholders dumping their shares en masse.

Similarly, Beijing got into trouble in August when it announced a new exchange-rate mechanism that would make the value of the renminbi more market determined. But because it paired this move with a small, unexpected devaluation, many traders assumed the real goal was to devalue the renminbi, and started pushing the currency down. So the People's Bank of China (PBOC) intervened massively in the foreign exchange markets, spending down its foreign-currency reserves to prop up the value of the renminbi. This

stabilized the currency, but brought into question the government's commitment to a truly market-driven exchange rate.

Then, in December, PBOC made another change, by starting to manage the renminbi against a trade-weighted basket of 13 currencies, rather than against the dollar as in the past. Because the dollar has been strong lately, this in effect meant that PBOC was letting the renminbi devalue against the dollar. Again, PBOC argued that its intention was not to devalue, but simply to establish a more flexible exchange rate. And again, it undermined the credibility of this intention by intervening to prevent the currency from falling against the dollar.

One could argue that these episodes were merely potholes on the road to a greater reliance on markets. This may be so, but investors both inside and outside China are not convinced. The heavy-handed management of the equity and currency markets gives the impression that Beijing is not willing to tolerate market outcomes that conflict with the government's idea of what prices should be. This runs against the government's stated commitment in the Third Plenum decision to let market forces "play a decisive role in resource allocation."

Another source of unease is the slow progress on state enterprise reform. Momentum seemed strong in 2014, when provinces were encouraged to publish "mixed ownership" plans to diversify the shareholding of their firms. This raised hopes that private investors would be brought in to improve the management of inefficient state companies. Yet to date only a handful of mixed-ownership deals have been completed, and many of them involve the transfer of shares to stateowned investment companies, with no private-sector participation. Plans to subject the big centrally controlled state enterprises to greater financial discipline by putting them under holding companies modeled on Singapore's Temasek have been incessantly discussed, but not put into action. Meanwhile the number of state firms continues to grow, rising from a low of 110,000 in 2008 to around 160,000 in 2014.

So long as Beijing continues to intervene in markets to guide prices, and fails to deliver on the key structural reforms needed to create a sustainable consumer-led economy, markets both inside and outside China will continue to be nervous about the sustainability of growth, and we will see more "China scares" like the one we endured in January. A clearer sense of direction is required, as is better communication.

For three decades, China sustained fast economic growth by steadily increasing the scope of markets, even as it preserved a large role for the state. Because investors were confident in the general trend towards more markets and more space for private firms, they were happy to invest in growth. Today neither private entrepreneurs in China, nor traders on global financial markets, are confident in such a trend. By the end of 2015 growth in investment by non-state firms had slowed to only about two-thirds the rate posted by state-owned firms, ending nearly two decades of private-sector outperformance.

Doubts are amplified by the government's failure to communicate its intentions. During the last several months of confusion on foreign exchange markets, no senior official came forth to explain the goals of the new currency policy. No other country would have executed such a fundamental shift in a key economic policy without clear and detailed statements by a top policymaker. As China prepares for its presidency of the G-20, the government owes it both to its own people and to the global community of which it is now such an important member to more clearly articulate its commitment to market-oriented reforms and sustainable growth.

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Endnotes

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How will China Shape the World Economy?

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We attempt to provide an outlook for China's role in the world economy over the coming decades, an exercise which would not be possible without an analysis of the prospect for China's continued economic growth. Based on international and historical comparisons, we argue that today's China meets all three key conditions for continued economic growth, including a stable government that is supportive of a market economy, high and increasing quality of human capital, and openness to developed economies. Dependent on China's continued growth, we explore how China will impact many other economies through trade and investment, creating winners and losers in the world economy. Moreover, we argue that China will become a more active player in changing global economic governance not only through participating in reforms of existing institutions but also leading efforts to establish new ones.

1. Introduction

How will China shape the world economy? This is an important and difficult issue to address. Indeed, since the size of the Chinese economy reached over \$10 trillion, accounting for over 13% of the global GDP, contributing about 25% of global economic growth and becoming the largest nation in international trade of goods and second largest source and destination of Foreign Direct Investment (FDI), any influence of the Chinese economy on the rest of the world is significant.

We attempt to address this issue by first exploring the prospect of continued economic growth of China, which is a foundation for further analyses. After surveying existing literature, we argue that China will most likely be able to sustain a moderately fast pace of growth in the coming two decades, mainly because of its still low per capita income relative to advanced economies and its overall sound economic fundamentals including a stable and market-supporting government, improving human capital, and openness to advanced economies.

We then argue that China's continued growth will have an increasingly large impact on the rest of the world in three ways. Through international trade, China's continued growth will benefit many poor economies which will substitute China's low-end exports. The world's most advanced economies will also benefit from China's continued growth through international trade, since China will continue relying on advanced economies for high-tech imports. Through international investment, China will not only help build up infrastructure in many economies along the new silk belt and the maritime silk road, it will also see an increase in portfolio and financial investment in advanced financial markets. In global economic governance, China has adopted a dual track approach to reform, pushing for reforms with existing global economic institutions and establishing new ones on the

2. The Prospect of China's Continued Growth

There are abundant studies on China's economic growth potential. In general, Chinese scholars are pessimistic. Most believe that China's current economic slowdown is not cyclical or external, but the result of a painful structural transformation, the effects of which include excessive investment, the loss of demographic dividend, the decline of total factory

productivity, and constraints created by environmental problems. The Research Group on China's Economic Growth (2012) argues that with an improved rate of urbanization, accelerated service-oriented industrial structure and declining demographic dividend, an economic slowdown will be inevitable without continuous improvement in labor productivity. Lu and Cai (2014)¹ believe that the change in the demographic structure is likely to produce a sharp decrease in China's growth potential. Liu (2015)² projects that China's economic growth will be around 6.2% over the next 10 years.

The issue of China's potential growth is also widely discussed by foreign scholars, who conduct comparisons international and total decomposition in making their analyses. Researchers outside China have expressed overall mixed views on the prospects for China's future economic growth. Perkins and Rawski (2008)³ decompose contributing factors to GDP by capital, human capital, labor and productivity, and they project that China's GDP growth will be 6% to 8% between 2005 and 2025. comparisons, making international By Eichengreen, Park and Shin (2012)⁴ argue that the potential growth in China will range between 6.1% and 7.0% from 2011 to 2020 and will decline to between 5.0% and 6.2% in the decade after 2020. Pritchett and Summers (2014)⁵ are more pessimistic. By claiming that the regression to mean is the most empirically robust feature of economic growth, they predict that China's GDP will amount to \$21 trillion in 2033, but the economic growth rate at that time will be less than 4%.

Li and Fu (2016)⁶ adopt a different approach to studying the growth potential of the Chinese economy and have a more optimistic conclusion than most of the recent research. They start with a convergence model arguing that it is the gap in per capita GDP between China and the U.S. (the world's most advanced market economy and technology leader), rather than the low absolute level of per capita GDP, that drives the growth potential. The larger the gap, the larger the potential. By 2015, on a purchasing power parity (PPP) basis, China's GDP accounts for just 22.4% of that of the U.S., suggesting substantial room for improvement. At the moment, China has been following the U.S. path regarding business models such as the Internet, Facebook, online-shopping and E-business, which are all booming in China. In addition, over the last three or four decades, China has been learning from U.S. technologies, such as those involving the Boeing 737 and it is now building the C919.

However, several conditions are critical in order to transform the growth potential into reality. Utilizing the Penn World Table, Li and Fu (2016) found that during the past 70 years, only 13 economies actually improved in per capita GDP from 20% to over 40% relative to the U.S. per capita GDP. They have found that those who succeeded have three factors in common, and those who did not succeed in catching up failed to meet at least one of the three criteria.

The first critical condition, according to Li and Fu (2016), is a stable government that is overall supportive of market-oriented economic institutions. There are six sub-indices that measure different dimensions of government quality. Positive examples in this regard include Singapore, Hong Kong, Taiwan, Korea and Japan. In their research, they found that the Chinese measure of the indices is similar to these economies.

The second critical condition is a high and improving quality of human capital. More specifically, the quality of public health and education must be sustained at a relatively high level. Again, today's China passes this criterion. According to World Development Indicators (WDI), life expectancy in China has risen rapidly since 1960, exceeding the world average in 1968. The gap between life expectancy in China and the U.S. is narrowing. Specifically, the life expectancy of Chinese males jumped from 65 in 1980 to 74 in 2013 while that of Chinese females increased from 69 in 1980 to 77 in 2013, which means the health of a typical 55-year-old male blue collar worker is much better than his father's at the same age and therefore making the workers more productive. If proper incentives are provided, they can work many years longer than their parents before choosing retirement.

Similarly, the quality of education in China is good, improving, and conducive to economic growth. According to 2014 statistics from China's Ministry of Education, the enrollment rate for all Chinese colleges has reached 37.5%, suggesting that almost 38% of the nation's young people are receiving or have received higher education – equal to that of the UK 25 years ago, according to WDI. Over one third of China's seven million college graduates major in engineering every year, making the cost of employment in the corresponding area low. As a result, the design and construction of many of China's industrial projects,

including high-speed trail, enjoyed significant boosts. In a way, Chinese engineering graduates are more professionally trained than their counterparts in the UK and the U.S., although the Chinese college engineering students may lack a broad education in humanities and social sciences. According to a recent US News and World Report account, undergraduate engineering education at China's Tsinghua University outranked that of MIT, demonstrating an improvement in China's higher education in engineering.

The third critical condition for a poor economy to realize its growth potential is that it must be economically open to advanced market economies through international trade and investment. This is obviously important. How else can a poor economy gain technology, business know-now, and the ethos of market economy in order to catch up? In this regard, China has been doing well. Over the past three and half decades, China has been opening its market, completing a great deal of investments from and trades with Europe and the U.S.

Based on the analysis of the three critical conditions, Li and Fu (2016) project the future path of Chinese growth by referring to the history of the thirteen successful economies which take off from around 20% of U.S. per capita income. The projected path of China's future growth indicates that China's per capita in PPP terms may reach 75% of that of the U.S. by 2050, implying that the total size of the Chinese GDP may become three times that of the U.S.

How fast will the Chinese economy grow? One way to answer the question is to look at the history of Japan, Korean, Taiwan, and Singapore when their per capita income was 22% of that of the U.S. History shows that they grew at the pace of 6-8% in the ensuing two decades. Therefore, one possibility is that China follows these historical precedents and maintains a reasonably fast pace of growth in the next 10-20 years. One may object to this prediction by raising the issue that China is now a much larger economy than the others so that it cannot duplicate their success by relying upon exports. In response to this argument, Li, Shi and Jin (2016)⁷ point out that being a large economy, China has an advantage it has not fully enjoyed, that is internal trade due to large regional differences. According to their analysis, if the large inter-regional differences across provinces can be gradually narrowed to a level of the U.S. in a decade, this will contribute to 1% annual GDP growth for the next five years. Overall, we tend to agree with the prediction of Perkins and Rawski (2008) that the Chinese growth will be 6-8% from now till 2025.

Despite being relatively optimistic about China's continued growth for the coming decades, we readily recognize that the economy is currently facing a difficult time due to multiple factors, one of which is overcautious local governments. In the face of China's ongoing anti-corruption campaign, governments at the local level have become overly cautious when facilitating investments, as they are not sure whether their decisions would be in line with orders from Beijing. However, we do not think this current situation will persist for long, since top leadership has shown a clear recognition of the importance of local government incentives for economic development. The on-going draconian anti-corruption campaign most likely will be replaced by institutions emphasizing prevention of corruption rather than punishing past behavior of government officials.

3. The Impact of China's Continued Growth: The Channel of International Trade

Should China's economic growth continue as analyzed above, it will first make its impact felt through the channel of international trade. How can we measure the influence of the Chinese economy on others? One index is the exposure of an economy to the Chinese market. Feng (2014)⁸ calculated for each economy the share of its export to China in its total export and he defined it as the China Dependency Index (CDI)⁹. The higher the CDI, the more dependent the economy is on the Chinese market. The following is a table of the average CDI from 2012 to 2014.

Two groups stand out in their reliance on their exports to China. Group one consists of the resource-based economies, such as Mongolia, Angola, Mauritania, et al. They export natural resources to China. Group two are China's neighbors, such as the Republic of Korea, Malaysia, Thailand, Singapore, Vietnam and Philippines. They have been taking advantage of geographic proximity to China and have a wide range of exported products and services, including tourism. There are also some small economies, such as the Solomon Islands and Gambia, greatly relying on China's economy.

Who will be the beneficiaries of China's continued growth through international trade? We argue that they will most likely include a large number of economies which are at a lower or similar level of economic development. There are two reasons for this. First, as China's growth continues, Chinese economic structure

continues to be upgraded. The low-end goods that China now produces and exports, such as shoes and garments, are being transferred to other countries. Take Vietnam as an example, its per capita income is significantly lower than China's, and labor in Vietnam is cheaper than in China. Figure 3 shows that since 2011, main Vietnamese exports have maintained rapid growth in the area of textiles, garments, shoes and hats. In 2015, the year-on-year growth of Chinese garments, shoes and auxiliaries shifted from positive to negative, while Vietnamese exports continued to demonstrate rapid growth.

The second reason that many economies with lower income levels than China will benefit from China's growth is that Chinese exports are upgrading, from shoes and hats and other low-end products to the base stations of mobile communications produced by Chinese companies such as Huawei and Zhongxing. As a result, international competition is becoming fiercer in a larger number of capital and technology products. As a result, the terms of trade of many low income economies will improve. Take telecommunication for example, despite the restrictions imposed due to American political factors, China's Huawei base stations are already exported around the world. Huawei is not the only Chinese supplier of mobile base stations. Zhongxing, another Chinese supplier, competes fiercely with Huawei to the benefit of clients all over the world.

In 2015, Huawei provided the largest quantity of smart phone units for the four largest operators in the U.S. According to the 2014 annual report from Huawei, sales revenue reached 101 billion yuan in Europe, the Middle East and Africa, approaching the 108.9 billion yuan in China, where sales accounted for 37.8% of total sales. This fully demonstrates how Huawei's business spread across the world in 2014. In terms of the American market, basic network sales in Latin America showed a strong growth pattern while the North American market declined, which dragged the year-on-year growth in the American market to 5.1%. This had a negative impact on the company's 20.6% year-on-year growth. Zhongxing also has a comparatively huge international business. As its 2014 annual report shows, it produced 40.58 billion yuan in sales from the domestic market and 40.89 billion yuan from the international market. Both examples prove that Chinese exports are on the upgrade.

Another example of how China's upgrading of its export products benefits many other economies pertains to high-speed rails and construction

equipment. For instance, Brazil's mining giant Vale has been importing a large number of mining machines from China. When the second author of this paper asked why the company bought Chinese equipment instead of German equipment, two reasons were given. One is that Chinese equipment is much cheaper than the German; the second and the more important reason is that delivery time from China is shorter. Delivery from Germany requires one to two years, while China requires only several months. This is closely associated with the low cost of engineers.

The second group of beneficiaries of China's continued growth are advanced market economies such as the U.S. and Germany. The reason is that despite China's edging into some of the production sectors of the advantaged economies, in most cases, China cannot leapfrog and still requires key technology and products from the advanced economies. In this regard, China's continued growth generates more demand. For example, 20% of the value of the critical equipment for Chinese high-speed rails is now imported from Germany. With a rapid increase in demand for Chinabuilt rapid rail and subway equipment, the demand for German components in turn will be increasing quickly.

The third group of beneficiaries are resource-based countries such as Brazil and South Africa, despite the on-going low prices of commodities. The continued growth of the Chinese economy will lead to increases in demand for raw materials. More importantly, with labor costs ever increasing and heightened public awareness of environment protection, China will accelerate substituting domestic mining production with imports.

Which economies will face challenges from China's continued growth due to international trade? Most likely they include the economies that are now at a slightly higher income level than China and have an economic structure similar to China's. Take Turkey for example. In 2015, Turkey's six groups of export products accounted for 31.4% of its total exports, including iron and steel, heavy metals and machine manufacturing. These are exactly the sectors in which China will likely expand. Currently, China is undertaking a round of reforms to enhance its competitiveness in such areas. For example, polluting iron and steel plants are being closed and new plants will be built along the coast, relying on imported coal and iron ore and producing with higher energy and environmental efficiency than the old plants. These plants will certainly reply more upon the export market, thus putting pressure on existing suppliers of identical or similar goods.

4. The Impact of China's Continued Growth: The Channel of International Investment and Finance

With its huge amount of savings, China has become and will most likely remain one of the world's leading international investors. Currently, China's national savings account for 45% of GDP according to official statistics, which aggregates output of nine sectors to calculate GDP and utilize household surveys for private consumption and then back out the amount of national savings. Since medium and high income households usually do not want to cooperate with the National Bureau of Statistics in household surveys, the official number for private consumption grossly under reports due to sample selection error. Li and Xu (2015)¹⁰ reconstructed China's private consumption by using the retail statistics and taking out institutional procurement and adding household service. They found that private consumption should account for 45% of GDP by 2013, with national savings at 38%, government expenditure at 15% and a current account surplus of 2%. Despite the lower estimates of China's national savings, we argue that because of the diminishing marginal returns on domestic investment after decades of intense investment, China will see a slower pace of domestic investment and therefore continue to have a current account surplus. Thus, China will still be a major source of international investment. Figure 5 shows the amount of China's current account balance and the total amount of foreign assets.

There are three types of outward international investment from China. The first type is investment by Chinese government agencies. So far, China's official development agencies have accumulated a large number of loans, most to emerging market countries. After a thorough examination of various reports published by the China Development Bank and the Export-Import Bank of China, we estimate that the total amount of outstanding foreign lending of these two agencies is around \$350 billion, almost equal to the total assets of the World Bank and far beyond the total assets of the other three development banks, as shown in Figure 6a and 6b.

The second type of Chinese foreign investment is outward Foreign Direct Investment. These are investments meant to obtain control rights of foreign corporations. China's outward FDI has increased since the financial crisis, amounting to \$116 billion in 2014, nearly as high as the \$128.5 billion inward FDI. Figure

7 shows the growth of China's global share in inward FDI and outward FDI, respectively. Aside from the continued increase in the total amount, the breadth and depth of Chinese outward FDI has also increased. Current Chinese outward FDI does not only pertain to building railroads in Africa, but also delving deeply into all fields around the globe, generating significant changes. Since 2013, the Chinese government has been promoting the New Silk Belt and the Maritime Silk Road initiative (i.e. the One Belt, One Road,), which is now the most important policy to facilitate deeper integration of the Chinese economy with the rest of the world. Among many things, the strategy aims to promote China's outward infrastructure development and to stimulate the economic development of neighboring countries.

The third type of Chinese foreign investment, which will become larger and increasingly important, is portfolio investment; that is, investment to buy foreign financial assets. Until now, Chinese households have demonstrated an extreme form of home bias in their asset allocation, although each household is allowed to convert as much as \$50,000 each year. Most households do not know how to allocate part of their assets to foreign assets. As the Chinese economy continues to grow, this situation will change, since many domestic investment funds will be given more freedom to invest in foreign financial markets and, in turn, they are promoting the idea of portfolio diversification across countries. For example, asset management companies such as Credit Ease and Noah Group are positioned to become China's Fidelity Investments and Black Rock and are increasingly international in their operations and asset allocation. More and more funds will be allocated to buy risk diversified financial products from America and Europe. Take Apple Inc. as an example; their products are made in China, while China is Apple's largest consuming country. Apple benefits from low labor costs and sells 14% of its mobile phones to China. So Apple makes profits on both ends. According to estimates, one third of Apple's \$600 billion value is created by China. But because Apple is a U.S.-listed company and it is not common for Chinese to invest in U.S. stocks, the profits from Apple's value increase are mainly earned by foreigners. As capital accounts continue to be opened up. Chinese institutional and individual investors will more diversely arrange their assets on a global scale and allocate more funds to the stocks with sound fundamentals, such as Apple Inc.

As a consequence of China's changing composition of international investment, the share of official reserves in foreign assets has been gradually declining. Even so, the government still holds 60% of reserves. The Chinese central bank prefers low risk financial assets, such as U.S. Treasury Bonds. In the future, with more and more foreign reserves now being held by private Chinese investors, there will be a continued decline in Chinese holdings of the U.S. Treasury Bonds. Figure 10 provides an interesting reference point by comparing China's foreign asset holdings with that of the U.S.

The capital flow in the next decade will be bidirectional as China's renminbi plays a more important role in the international monetary system. Li and Wu (2016)¹¹ calculated that the non-residence holdings of the yuan-denominated financial assets were only \$2.76 trillion in 2013, compared to the U.S. dollar-denominated assets of \$31.63 trillion and the euro-denominated assets of \$30.55 trillion. The internationalization of renminbi will lead to an increase in the inward investment of foreign investors. Moreover, as the renminbi is more widely accepted as an international reserve currency, there will be less necessity for the Chinese government to hold the vast amount of foreign reserves to fight against external shocks, therefore, the structure of China's international investment position tends to converge to that of the U.S. position.

5. The Impact of China's Continued Growth: The Channel of Global Economic Governance

As the relative size of the Chinese economy continues to increase, China is becoming more proactive in global economic governance. Take the IMF as an example. Its quota allocation rule gives a member country voting shares based on a weighted average of international comparable GDP, degree of openness, economic volatility and international reserves, with GDP accounting for 50% and the degree of openness up to 30%. As the second largest economy and the largest goods trading country, China until now has been only given 3.81% of the vote rights in the IMF, far lower than many developed countries, such as the U.S. and Japan. The U.S. alone accounted for 16.74%. At the beginning of 2016, the International Mutual Fund's 2010 quota and governance reforms will take effect. This reform, though extremely marginal, took 6 years, demonstrating how difficult it is to change the voting rights. According to IMF rules, any proposal needs more than 85% approval votes to pass, meaning that the U.S. (with 16.74% of the votes)

has veto power over the important affairs of the organization. There are also similar issues with the World Bank, where America's vote share is 15.85% while China's is merely 4.42%.

Given the difficulty in reforming existing international institutions such as the IMF, China is now taking a dual-track approach to reform the system of global economic governance. Instead of aggressively "shaking up" existing international institutions, China will moderately push for a reform agenda in such institutions and seek to establish new international institutions on the side, fashioning a new style of governance. For example, instead of seeking much needed and drastic increases in voting rights in the World Bank and the Asia Development Bank (ADB), etc., China has established the Asian Infrastructure Investment Bank (AIIB) along with more than 50 countries. It is too early to determine how different the AIIB will be in its operations and governance, but one thing is certain: China has much more say in the AIIB than in the World Bank and the ADB. Besides the AIIB, there are several other new international economic agencies either already announced or under deliberation, such as the New Development Bank of the BRICS, the Silk Road Fund, the Shanghai Cooperation Bank, the One-Belt One-Road Bank.

What will be the impact of increased Chinese influence on global economic governance? First, there will be many more funds available for international development and improvement of financial stability. So far, the total amount of usable funds under the World Bank, the IMF, the ADB, et al, all combined, are in the area of \$1 trillion. This is way below the amount needed to sufficiently boost investments in developing economies and in stabilizing financial and fiscal crises such as those seen recently in Europe. China's contribution will easily double this amount. Second, there will be more diversified voices and policies. For example, during the 1998 Asian financial crisis, the IMF responded ineffectively, which it later readily recognized. Should another regional financial crisis erupt, it is now likely that different opinions will be heard and diverse policies will be applied. Uncoordinated policies are often undesirable but they at least can avoid extreme mistakes created by a single inferior policy. Third, as China becomes more involved in international finance, the RMB will become increasingly international. The RMB will be used more frequently in international finance. This should be a welcome development for the global economy, since the rest of the world will be less influenced by decisions of a single economy's central bank, i.e., the U.S. Fed. Having more diversified international currencies means more diversified sources of international monetary policy shocks.

6. Concluding Remarks

We attempt to address the issue of China's role in the world economy by first analyzing the prospect for China's continued economic growth. We argue that China, having only 22% of the U.S. per capita income, still satisfies three important conditions for continued economic growth: a stable and market-supporting government, the high and increasing quality of human capital, and the openness to developed economies. Therefore, China's economy still possesses the potential for a moderately fast pace of growth over the next decade, although China's economy is facing numerous problems in the short run.

Depending on China's continued economic growth in the coming decades, China will affect the rest of the world economy through three channels. First is international trade. China's demand for raw materials will stimulate the development in resource-based countries. The upgrading of the Chinese exports structure will also be beneficial for two groups of countries. One group consists of countries such as Vietnam, which will replace China in the exporting of low-end products. The other group includes developed countries such as Germany, which feed China with much needed high-technology products. Meanwhile, there will be a negative impact on countries with structures similar to China in regard to their exports.

The second channel is investment and international finance. Over many years, China's trade surplus has left the government with substantial foreign exchange reserves. Ever since the global financial crisis, the situation has been changing. The global share of Chinese outward FDI has increased dramatically since then. In recent years, along with the RMB becoming an international currency and the capital market being gradually opened, private sectors are holding more foreign reserves, stimulating outward FDI by entrepreneurs. As the openness continues, Chinese companies are accumulating even more foreign reserves. More and more corporations will participate in international financial investments and more and

more funds will be allocated to purchasing financial assets from advanced market economies. In addition, foreign pension funds may buy more Chinese government bonds and some Chinese firms' stocks. Thus a pattern of bi-directional capital flow will develop.

The third channel is international governance. China is adopting a dual track approach to change global economic governance. While actively participating in reforming existing rules and international institutions such as the IMF, China is now establishing new institutions such as the AIIB; the New Development Bank of the BRICS; the Silk Road Fund, etc., directly boosting China's voice in global economic governance.

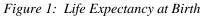
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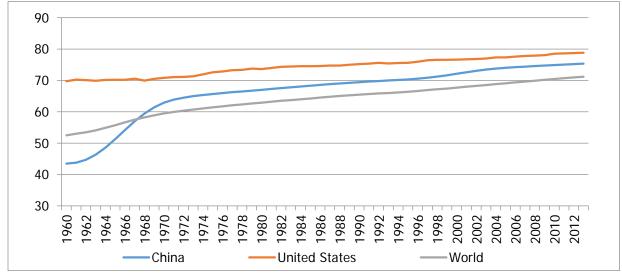
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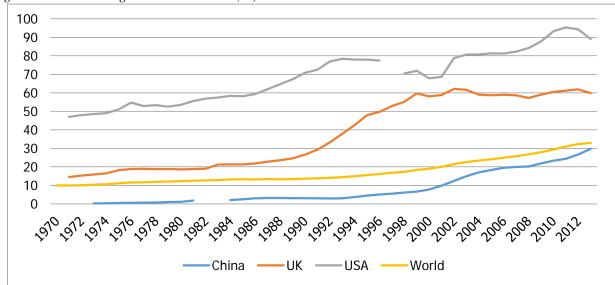
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Data Source: WDI

Figure 2: Gross College Enrollment Ratio (%)



Data Source: WDI

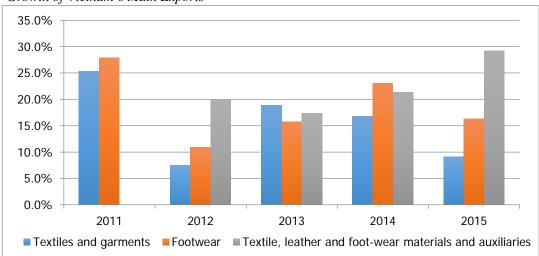


Figure 3: Growth of Vietnam's Main Exports

Data Source: Vietnamese General Department of Customs

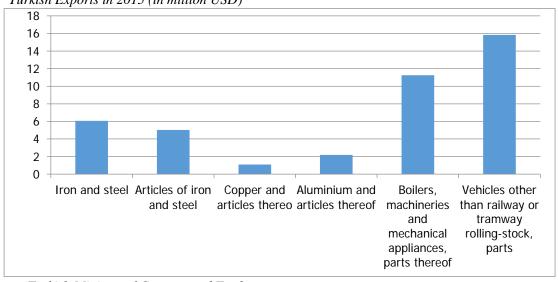


Figure 4: Turkish Exports in 2015 (in million USD)

Data Source: Turkish Ministry of Customs and Trade

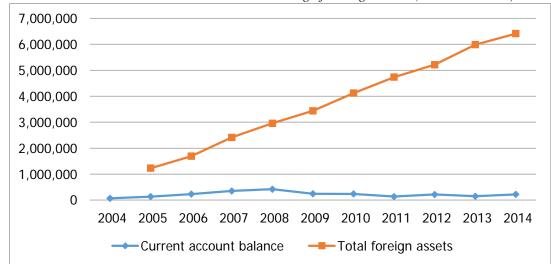
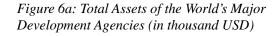
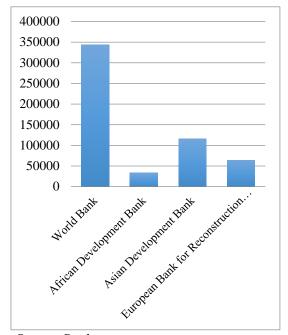


Figure 5: China's Current Account Balance and Total Holding of Foreign Assets (in millions USD)

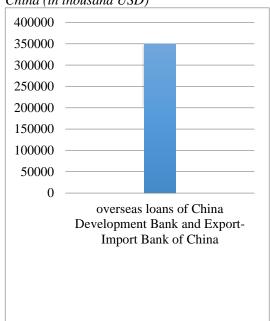
Data Source: The State Administration of Foreign Exchange of China





Data Source: Bankscope

Figure 6b: Overseas Loans of China Development Bank and Export-Import Bank of China (in thousand USD)



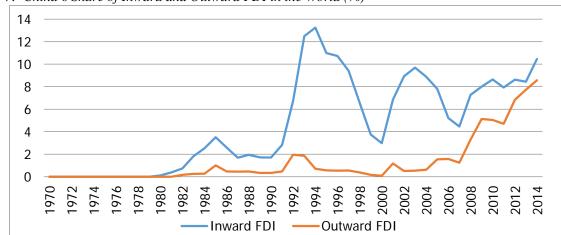


Figure 7: China's Share of Inward and Outward FDI in the World (%)

Data Source: UNCTAD

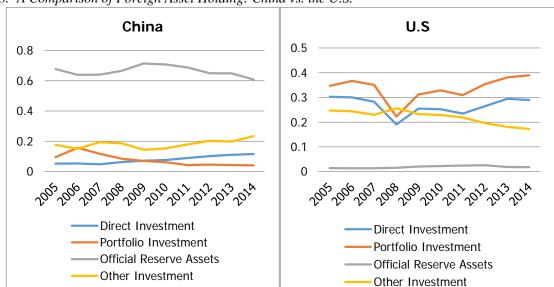


Figure 8: A Comparison of Foreign Asset Holding: China vs. the U.S.

Data Source: CEIC databases

Table 1: The China Dependency Index (CDI) (2012-2014 average, %)

Resource-based	CDI	China's	CDI	Small	CDI	Others	CDI
economies		neighbors		economies			
Mongolia	30.95	Malaysia	9.00	Solomon Islands	35.13	France	0.70
Mauritania	26.84	Republic of Korea	14.28	Costa Rica	0.73	U.S.	0.71
Republic of Congo	34.09	Vietnam	7.90	Malta	0.14	Italy	0.60
Angola	22.61	Thailand	6.41	Yemen	8.96	U.K.	0.42
Democratic Republic of the Congo	9.24	Singapore	15.99	Gambia	8.14	Germany	1.99
Oman	25.61	Philippines	2.57	Laos	9.75		
Turkmenistan	19.50	Indonesia	2.27				
Zambia	6.22	Japan	2.60				
Equatorial Guinea	13.74	Hong Kong SAR, China	90.07				
Chile	6.95	India	0.75				
Australia	5.45						
United Arab Emirates	3.05						
Canada	1.04						
South Africa	2.80						
Brazil	1.79						
Russia	1.83						

Data Source: Feng (2014), IMF Direction of Trade Statistics (DOT), WDI, author's calculations

Table 2: The IMF Quota and Votes Shares

Member	Quota (%)	Previous Votes (%)	New Votes (%)
United States	17.68	16.74	16.48
Japan	6.56	6.23	6.14
Germany	6.12	5.81	5.31
France	4.51	4 29	4.02
United Kingdom	4.51	4.29	4.02
China	4	3.81	6.07
Italy	3.31	3.16	3.02
Saudi Arabia	2.93	2.8	2.01
Canada	2.67	2.56	2.21
Russian Federation	2.5	2.39	2.59

Data Source: IMF

Luncheon Remarks

March 30, 2016

Jin Liqun

President Asian Infrastructure and Investment Bank

Honorable Members of Congress, distinguished guests, ladies and gentlemen.

I would like to begin today by extending my heartfelt thanks to the Aspen Institute for arranging this opportunity to share with you my vision for the Asian Infrastructure Investment Bank. I attach great importance to the U.S. Congress and have visited Members of Congress over the last few decades when I served in the Asian Development Bank and China's Sovereign Wealth Fund. It helps for us to have an exchange of ideas. You are the legislature, and have a crucial role in shaping U.S. foreign policy.

I have been involved in bilateral dialogues with the U.S. Administration over the last three decades, and multilaterally I have also engaged my counterparts from the U.S. side. I have enjoyed this close relationship, and I have consistently been positive and constructive towards the Sino-U.S. relationship in many dimensions.

There is a symbiotic relationship between the economies of the U.S. and China, and I believe open dialogue like we are having today is essential to maintaining a strong bilateral relationship.

Now about our Bank. Questions are legion about AIIB, this new multilateral development bank (MDB). No sooner had the idea of building such a new MDB been kicked off than the skeptics around the world questioned the governance of AIIB and motivations of the Chinese government in its establishment.

Every day I am asked the same questions. Does China have an axe to grind? Is AIIB just a tool of the Chinese government? Do we seek to undermine existing multilateral institutions? Will we simply give contracts to Chinese firms? Will we hastily push projects, disregarding environmental and social safeguards?

As human beings, we all tend to put things we do not understand into boxes. For example, when analyzing China's political economy, foreign commentators are often quick to define an individual as a 'reformist' or a 'nationalist', distilling a complex situation into a single word to rationalize a view. In the same way, foreigners tend to generalize about America's presumptive political candidates. I would not dare to venture into the complexities of the presidential campaign going on across the Pacific Ocean. Everywhere in the world, we tend to draw sharp black and white distinctions where there are really large swathes of grey.

I do not want AIIB to be put in a box. Please, do not simply put us in the government policy tool box. We are not. Do not confine us to the "One Belt One Road" box. We may finance such projects if they meet our standards, but we were not created to exclusively finance "One Belt One Road" projects.

It is true: AIIB is born with the birthmark of China. But it is not a Chinese bank. It has been, and will continue to be, nurtured by our global shareholder

base. We currently have 57 member countries, with more than 30 others having requested to join.

Three months into operation, this bank is already demonstrating its new features of management and operation. We are aware of the high expectations placed on this bank by the shareholders. They watch the way this bank is being run with satisfaction, and the new applicant countries are eagerly waiting for their membership before the end of this year.

AIIB's mandate is to promote infrastructure, paving the path for broad-based economic and social development. Largely owing to the broad-ranging benefits of improving infrastructure, China managed to lift over 500 million people out of poverty by the World Bank's standards in a little over two decades, with the percentage of the population living in poverty falling from 65% in 1981 to just 4% in 2007. China has just 70million more people to pull out of poverty by its own standards, and it aims to complete this task by 2020.

Now that China is more developed, and thus can afford to provide financial resources to other developing countries, it is its turn to do something for the rest of Asia. As President Xi Jinping said at the signing ceremony of our Articles of Agreement:

"We in China have benefited from the generous support of the World Bank, of the ADB, and from bilateral support. The Chinese people will never forget this. We are grateful. It is now our turn to contribute."

Recently, Chinese Premier Li Keqiang was asked whether the AIIB presented a rival to the international financial system. When discussing the role that this Bank will play, I think it is important to distinguish between the system and its components.

When one talks about the system, they mean the global financial order dating back to Bretton Woods.

Speaking of the components, they mean institutions like the World Bank, the IMF, the ADB, the EBRD, and now the AIIB.

By introducing a new component meeting the needs of present-day Asia, we can enhance, rather than upend, the whole system.

When you, in America, amend your Constitution, are you rewriting it in its entirety? No, of course not. Just as it is silly to compare a Constitutional amendment to rewriting the foundation of American law, so too is it absurd to think AIIB will single-handedly overhaul the existing system.

A system cannot be overthrown by one single component. But a component can be the catalyst for reform and change. We do believe that change is needed to render the existing MDBs more adaptable to changed circumstances. As a new component, AIIB can contribute to the good governance and standards of the existing system while also providing a boost for reform in its existing components. A system can only be full of vigor and vitality if all the components are rejuvenated on a continuing basis, like the cells of a living organism.

I do believe the business model of MDBs will change, as the other MDBs are supportive of what we are doing. They see our efforts to adopt a lean structure as something that will ultimately benefit them if we can be successful.

We have very strong working relationships with the World Bank, Asian Development Bank, the EBRD, and others. Many of our professionals have decades of experience working in MDBs, and the other MDBs have been helpful throughout our establishment process, helping us to put in place sound governance structures.

In June, we expect to submit a few socially acceptable, environmentally friendly investments to our Board for approval. We will have a good mix of stand-alone and co-financed projects. We are working on co-financing with the other MDBs I mentioned.

You see, infrastructure projects by their nature are very large. In the future, co-financing should be the norm. It is practical to share the costs. It is not feasible, or else too risky, for one bank to single handedly finance a project that can exceed one billion Dollars in value. The best way for all of us is to work together.

While we have worked with other MDBs from the beginning, this is only just reaching the public domain. As the public becomes more aware, the international perception of the Bank is slowly changing.

Just as AIIB should not be seen as an attempt to undermine existing MDBs, it should not be a hot spot for conflict between China and the United States. It is actually just the contrary. AIIB should be a new platform for China and the U.S., as well as many other countries, to work together.

As for whether the United States can join – the door is open and will remain that way. Regardless of the U.S. membership, the U.S. will not be excluded in the Bank's operations. We have global procurement and global recruitment. American companies can participate in competitive international bidding, and I am proud to tell you we have already benefited greatly

from the contributions of a number of U.S. nationals working for this institution. I'm grateful to their dedication and contribution. Of course, being a member, a sovereign country will have a greater role to play in an institution.

I hope that I have given you some insight into my thinking about the AIIB. In the end, I know I cannot stand here and convince you what we will be. One can only earn credibility through action.

I do not expect to be given anyone's trust at this moment; it is only something that can be earned with hard work. It is through this hard work that I hope to live up to the high expectations of our shareholders.

Cleaning the Environment in China

Hal Harvey

CEO Energy Innovation LLC

Introduction

China has industrialized more quickly than any nation in history, building capacity for electric utilities and major industries like cement, steel, aluminum, glass, pulp and paper, and chemicals at a scale never seen before. This rapid development has created a mix of first world and third world problems and opportunities. In some places, China's economy is as advanced as anywhere, but in others, large swaths of poverty remain—and pollution is a problem throughout.

Most of this development has happened without significant environmental controls, and the consequence of that is a deluge of problems—poisoned waterways, soils, and air. On its worst days, air pollution in Beijing and other northern cities of China is more than 20 times the maximum level recommended by the World Health Organization. Put another way, even with a 95 percent reduction in pollutants, these cities would still exceed the maximum WHO recommendation.

The symptoms of this pollution are profound: living in Beijing has an environmental tax of 5.5 years of life compared to living in Shanghai.² Children are being diagnosed with lung cancer. This has become a health emergency, a livability emergency, and it threatens to become a political problem. In a 2014 report by the Chinese Academy of Social Sciences, of the 871 mass incidents analyzed, half of the largest incidents (those involving over 10,000 people) were sparked by pollution.³ The Communist Party's political credibility will depend to some extent on whether it can address the pollution problems.

China is of course not the first country to deal with severe pollution. London had its famous smog problems, which killed tens of thousands. Not many years ago, Los Angeles was home to some of the foulest air on earth. And we have to remember the Cuyahoga River in Ohio catching on fire.

The Chinese leadership is well aware that others have important lessons to share and is eager for technical assistance to help solve its urgent environmental challenges. The U.S. has direct national interests in play, most clearly in the realm of climate change but also in public health and air quality in the western U.S. states.

Building an Environmental Enforcement System

Most countries in the west have built serious and effective environmental institutions to control air pollution, water pollution, and toxic poisoning of land. This took serious investments in science and the development of regulatory institutions capable of guiding industrial development and products. The Chinese government is keen to do the same, but it faces a suite of challenges that we did not have.

Building a strong air pollution control program, for example, requires a thorough inventory of air pollution sources and a control strategy for each major source. The standard method for doing that entails five broad steps:

- 1. Develop an ambient air quality monitoring system for a whole variety of pollutants.
- 2. Develop an inventory of air pollution sources—factories, vehicles, refineries, power plants, chemicals, and even home heating.

- 3. For each source, build a reduction strategy based on both efficacy and cost.
- Apply that strategy with a mix of permits, standards, and pricing, depending on which are most effective. Build a monitoring and enforcement system up to the task of pollution control.
- 5. Update and upgrade this system as science and technology advance.

Doing this requires skills, time, the right institutions, and, emphatically, political will. Success also requires a careful balance of economic and environmental interests.

In China, heretofore, environmental authority has been nominally vested in the Ministry Environmental Protection. There are regional environmental protection bureaus for each province, but they have not historically reported to the Minister of Environmental Protection; instead, they answer to the local economic development commissions. This creates deep conflicts of interests and has left environmental protection a weak sister in China's development. For China to build an effective pollution control program, it needs to create a vertical authority for permits, standards, and enforcement.

The central leadership in Beijing understands the severity of the problem and is committed to repairing it. They have brought in a very brilliant and powerful Minister of Environmental Protection, Chen Jining, and are in the process of vesting his ministry with vertical authority. Senior leaders, from President Xi and Premier Li on down, have made it clear that environmental clean-up and protection is a priority.

That said, there are still important obstacles. Many provincial leaders give lip service to environmental protection but proceed apace with economic development as their sole priority. In fact, historically, the Organization Department of the Communist Party, which doles out political jobs, has promoted regional officials to higher positions based principally on the success of their economic development. They are working to include environmental performance for promotion criteria, but this is still a weak incentive for most officials.

Second, there will be very serious dislocations as part of the process of cleaning up pollution. China has gross overcapacity in most basic industries. Thousands of factories and mines must be shut down, and millions, perhaps tens of millions, of workers must be

laid off. This is an opportunity to shut down the least inefficient and most polluting facilities, but it creates the potential for severe social strains, and the government officials are keen to avoid riffs that undermine stability. Chinese officials have to balance the jobs impacts with other social issues, including outrage at skyrocketing pollution levels.

The upshot of all this is that China must now develop an environmental protection system that is as effective as the Chinese economy is large. To be sure, that requires a great deal of political authority, but also a great deal of system knowledge about the best way to build pollution control programs. Chinese government officials are looking to the U.S. EPA and the California Air Resources Board—and their counterparts in Europe and Japan—for guidance. It is now an ideal opportunity for cooperation between our two countries, as reducing pollution in China is helpful to all Asian neighbors, and indeed to the U.S. Up to a quarter of background air pollution on the west coast of the United States originates in China.⁴ In a very real sense, we need China to clean up in order to meet our own national goals.

Climate Change and Greenhouse Gases

The greenhouse gas emissions story in China is intriguing in every respect. China's rapid economic development has vaulted it into the dubious distinction of top global emitter of greenhouse gases, now producing approximately twice as much as the United States, which held the record for the last century. There is little prospect of landing at a reasonable climate future unless China is aggressive and successful in controlling greenhouse gas emissions.

Fortunately, the leaders of the Chinese government are steeped in the science of climate change, and understand the potential consequences for China and for the world. Desertification, caused in part by a long-term drought in the north, is affecting much of northern China. There are sandstorms in Beijing, and as you come in to land at the Beijing airport, you can see sand dunes encroaching on the city. The government has planted hundreds of millions of trees to try to hold this in abeyance, but they recognize that climate change will accelerate the problem. Indeed, much of the northern agricultural belt is now threatened by persistent drought, which climate change exacerbates.

In southern China, there is the opposite threat of massive potential flooding and sea level rise. China will have over 50 million people at risk from flooding—more people at risk than any other country.⁶

Drainage systems in Chinese cities have not kept up with extensive urban sprawl, exacerbating the threat of flooding. According to Nature Climate Change, Guangzhou will be the most vulnerable of the world's coastal cities in terms of potential damage from flooding, with a predicted \$13.2 billion of damages in a single year by 2050. 8

In general, climate change has increased the price tag of natural disasters for China; earthquakes, floods, droughts, snow storms, and other disasters cost the country over \$69 billion in 2014, double the cost incurred in 2013 and 2012. China's Third National Climate Change Assessment Report, released in 2015, found that over the next 30 years, the East China Sea could rise by 7.5-14.5 centimeters. This may sound infinitesimal, but the report predicts that every centimeter of sea level rise could push the coastline back by more than 10 meters—a serious concern for China's coastal cities.

Policy Actions and Commitments

So, climate change poses existential threats to the environmental integrity of China, just as it does for much of the rest of the world. In response to this, the Chinese government has shed its reluctance to act on climate change, and has instead become a leader. This is a rather dramatic transformation, and it is evident not just in international commitments, but especially in domestic action. In the last two five-year plans, China's national leadership has committed to the largest reductions in the economy's energy intensity energy used to produce a dollar of goods—of any country in history. And they hit their targets. Over the last two decades, China is responsible for over half of global energy savings. ¹⁰ From 1980 to 2010, while economy increased 18-fold. energy consumption increased only 5-fold. Energy intensity per unit of GDP declined by about 70 percent during the same period.¹¹

Of course, because their economy started this decade with enormous energy waste, there is still much room for improvement: China uses almost twice as much energy to produce a dollar of goods as does the United States, which in turn uses about twice as much as most of Western Europe and Japan.

Besides this commitment to energy efficiency enshrined in successive five-year plans, China has also grown into the world's largest market for electric cars and it has become home to by far the largest global commitment to renewable energy within the past decade. As the graph below shows, China led the

world in renewables growth—particularly in hydropower and wind power—during this time period.

Last year alone, China installed 15 GW of solar capacity, which is more than 60 percent of the U.S.'s cumulative solar capacity. As the graph above illustrates, China's solar growth has accelerated far faster than the U.S. market over the past few years.

The country's wind capacity is 145 GW, of which 30.5 GW was added in 2015—a 26 percent growth rate. Over the last decade, China's wind industry has grown to be the largest in the world, and is also expanding at a faster pace than in the United States.

Looking ahead, one can get a sense of the rapid change afoot by considering China's submission to the United Nations Framework Convention on Climate Change (UNFCCC) meeting in Paris last December. The Chinese government committed to installing 800-1,000 GW of zero-emission energy in the next 15 years. 12 That's nearly the same amount of capacity installed in the entire United States, though less electricity will be generated from these non-fossil resources than from the whole U.S. power fleet since they tend to have lower capacity factors than other resources. Right before the Paris meeting. China also committed to new renewables targets to generate 150-200 GW of electricity from solar and 250 GW from wind by 2020.¹³ In 2017, China will launch a national cap-and-trade program to limit carbon emissions, expanding on their seven regional emissions trading programs already operating.

The Grid

China is also in the midst of reforming its electric system. In the past, State Grid has run about 88 percent of the grid—including generation, transmission, and distribution—in a classical vertical monopoly. 14 South China Grid runs the balance. Over the last year, the grid has been broken up, with separated generation from transmission distribution, and the whole lot being overseen by a newish ministry and a new regulatory body.

If this process goes well, it could herald great economic efficiency and pollution reduction as old, obsolete power plants fall by the wayside and clean energy grows. Of course, reforming electricity regulation is complex, and status quo actors rarely like to shed market position, so this process marks a big inflection point in China's energy future.

Early steps offer hope. China has been building long-distance, high-voltage DC lines to move wind

power from the west to the east. They are starting to tear up power supply contracts that guaranteed minimum dispatch for old power plants. Financial incentives for renewable energy are changing too—from rewarding power plant construction (through capacity credits) to rewarding power production (through energy credits), which induces the desired behavior. The renewable energy boom is proceeding apace.

But "there's many a slip twixt cup and lip," and we are likely to see missteps along the way that could set back reform, or inadvertently keep obsolete power plants alive, or over-reward some incumbents. Here, too, is a great opportunity to share expertise, as the stakes are very high.

Urbanization

China's future is, significantly, an urban future. By 2030, one billion Chinese will live in cities, the economic engine of a nation. The *form* of these cities, then, will determine how China prospers. China's energy patterns, water use, and even agriculture will all be driven by choices made in urban form.

Well-designed cities, with high-quality buildings, generous public spaces, a lively mix of uses, world-class transportation, and clean air and water are truly the basis of a prosperous economy and a harmonious society. That seems like a long, even utopian, list. But it turns out that a few crucially important choices made early on can deliver those qualities. Failing that task will leave China with decidedly worse prospects.

What are those key choices? How can urban form drive agriculture, water, and energy? Surveying cities across the world, including in China, makes the answers clear.

Begin with the simple question of urban layout. Imagine two competing models of urban design, each housing the same number of citizens in the same area. One model isolates each use from the other, with housing in some neighborhoods, shopping in others, and business in others still. Each use is concentrated in "superblocks," the half-kilometer compounds we see in many new developments in China. These superblocks are linked with enormous, multi-lane boulevards.

It doesn't take much imagination to understand that this choice of layout creates a car-dependent economy. People have to cover long distances to shop, go to work, visit a clinic, and take the kids to school. What is less obvious is that even large boulevards become quickly congested due to the lack of smaller

secondary roads. All traffic is concentrated onto just a handful of main roads. Paralyzing traffic jams result. Recent studies in China show that this isolated layout of superblocks creates a *trebling* of transportation energy use, compared to mixed-use development with a more permeable transportation network.

The alternative architecture is to mix uses—develop a rich network of transportation options on more, but smaller, streets, and ensure that each neighborhood features parks, recreation, shopping, and the like. By creating neighborhoods that meet the majority of daily needs, and which are attractive for all ages and at all hours, it is possible to cut traffic and increase residents' quality of life. Smaller blocks with small streets make biking, walking, and public transportation more feasible.

Besides the energy and land savings, the big bonus to this kind of configuration is that it is much more livable. It turns out that people like neighborhoods with many different options—shopping, work, school, healthcare, recreation, and housing all intermingled. And, not surprisingly, providing mobility for all citizens, not just those with cars, is important to quality of life. Fewer than one in 10 Chinese currently owns a car, yet most Chinese cities already suffer terrible traffic jams. It's simple math to see that more cars will only exacerbate the situation.

After urban layout, one must consider transportation. No one is satisfied with the state of the field today. The three solutions are simple in concept and low in cost, but require sophisticated execution. They are: first-class public transit (including bus rapid transit), walking, and biking.

Public transit cannot be an afterthought. It must be a core consideration of any Chinese city. To successfully compete against the car, public transit must be fast, clean, reliable, safe, and convenient. Metro lines are a great step in the right direction. They should be complemented with a rethink of buses—employing bus rapid transit.

Bus rapid transit (BRT) is a sophisticated engineering approach that produces subway speeds and capacity at only five to 10 percent of the cost of a subway system. That is a big deal: the same capacity with 90 percent cost reduction is an urban gamechanger.

To see how this works, consider Guangzhou's BRT system. It hauls 800,000 passengers per day—more than any metro line in the city—but it was built in only nine months. How does BRT achieve this? A

half-dozen requirements must be met: First, the buses need exclusive access to the middle lanes; exclusive access avoids traffic conflicts with cars, and the middle lanes avoid delays caused by turning cars. The buses are equipped with transponders that turn lights green as they approach. These two innovations alone give them travel speeds close to metros.

Then, buses roll into stations, not stops. The difference? People pay to get into a station, rather than to get into a bus, so the bus need not wait for people to pay the fare. The buses themselves are double or triple long, with a wall of doors, and they pull up to platforms level with the bus. The wall of doors opens, and everyone piles off and on, just like a subway.

Another dozen refinements await: electronic ticketing, sophisticated control systems and dispatch, coordination with feeder systems, bike and pedestrian links, and so forth. Putting this all together is not expensive, but requires great sophistication. When you get it right, a cheap, fast, high-quality transportation system emerges.

It must be noted that BRT requires a commitment to smart design at the start, and smart management throughout. BRT is not a replacement for metros, but a great supplement. Public transit is crucial, but is not always the right choice for all trips or all people. The other two solutions have a deep history in China, and across the world: biking and walking. These options are mundane, but they are also cheap, healthy, quiet, accessible to all, emit zero carbon, and help make neighborhoods more livable. That's a pretty nice set of attributes.

In February, the country issued new guidelines for transit-oriented and walkable urban development. China has been expanding its BRT coverage as fast as any country, with systems in five cities having won awards of distinction from the Institute for Transportation and Development Policy. 15

An Inflection Point, Domestic and International

China is clearly at a strategic inflection point. A growing middle class is demanding a higher quality of life—including breathable air, drinkable water, and livable cities. While the economic growth in the last two decades in China is nothing short of astounding, it will fray badly unless the environmental imperative can be met.

The national government clearly recognizes this, and has set domestic goals and targets of unprecedented ambition. In a sea change, China has

also taken on new international commitments on heat-trapping gases. The breakthrough came first in a bilateral accord with the United States and then as part of the international agreement reached in Paris late in 2015. After years of rejecting any limits on its emissions, now China has said it will achieve the peaking of its CO₂ emissions around 2030, including efforts to peak earlier if possible. A group of 11 major cities have committed to peaking before 2030, and Beijing and Shanghai have committed to peaking by 2020. ¹⁶

One year does not make a trend, yet a recent peerreviewed study in the journal *Nature Climate Change* indicates that Chinese emissions fell between 2014 and 2015. The research found that the growth of China's CO_2 emissions slowed to 1.2 percent in 2014 and is projected to decline by 3.9 percent in 2015.

The Geostrategic Implications and The U.S. Interest

Nations compete in many realms—for economic strength, political influence, military might, and national prestige. One realm where all benefit is mutual benefit, though, is in environmental protection. The atmosphere and oceans are wholly shared: foul them anywhere and you foul them everywhere. Improper animal husbandry can create pandemics. Biological diversity, too, is a global resource. Energy and materials efficiency anywhere reduces demand-driven pricing (and shortages) everywhere. Even mundane products, like wall board and pajamas and dried milk, cross country borders and their safety becomes our concern.

Because of the ubiquitous benefits of clean environmental practices, it is in the U.S.'s—and European and Japanese—interest to help ensure that China's environmental reforms are successful. That does not require capital or will power. It does require system design, technical assistance, and institutional reform—what, collectively, might be called the DNA of environmental protection.

The U.S. EPA is not well-loved by all, but it has proven successful at slashing acid rain, conventional air pollution, water pollution, and mercury. Where the EPA has blundered, it offers cautionary tales; where it has succeeded, it offers system insight. The larger point, though, is that America has a great deal to offer and a great deal to gain through deeper technical support in environmental protection.

China's leaders want to improve their environmental practices and they have compelling reasons for doing this. But the country is complex, with many competing interests, a mixed economy, differences between the provinces and Beijing, and still an enormous population of the poor. So while the lessons of the west may guide the reform, much will be different. Watching how China builds the science, skills, institutions, policies, and enforcement for environmental protection will offer a huge clue about the country's transition to a modern economy.

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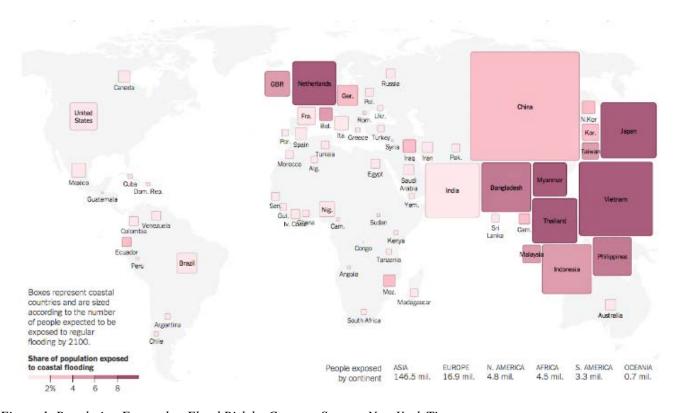


Figure 1. Population Exposed to Flood Risk by Country. Source: New York Times.

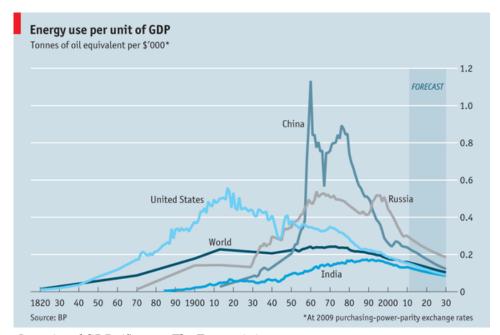


Figure 2. Energy Intensity of GDP. (Source: The Economist)

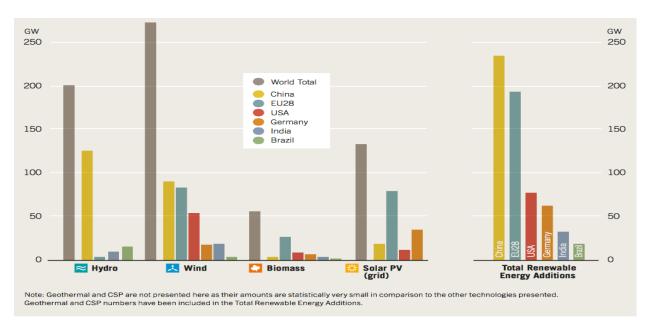


Figure 3. China leads global renewables growth over 2015-2015: Renewable capacity additions by region. (Source: REN21, The First Decade)

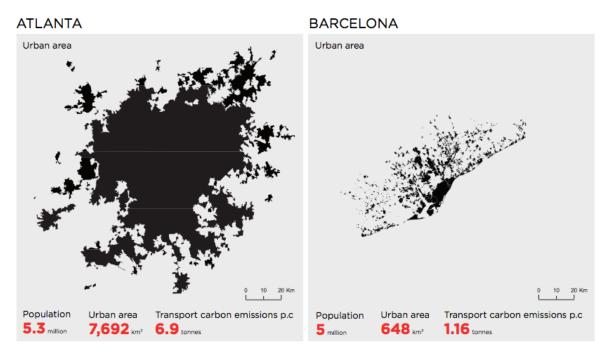


Figure 4. Carbon emissions from passenger transportation are more than five times higher in Atlanta due to sprawl and related differences in mobility choices. (Source: LSE Cities 2014)

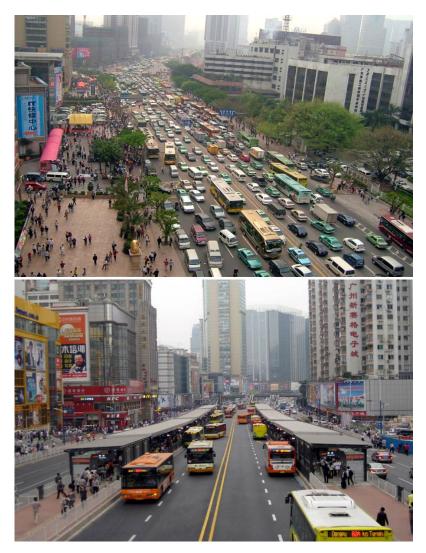


Figure 5. Guangzhou BRT before and after.

Climate: How to Win

Hal Harvey

CEO Energy Innovation LLC

The climate problem is enormous: It threatens much of modern civilization, and its principal source, in burning hydrocarbons, is embedded in most of the modern economy. Because of the ubiquitous nature of the source of climate change, and the varied and frightening, but uncertain, consequences, many opinion-makers, policymakers, and citizens begin to feel paralyzed: Can nuclear power solve the problem? Is a carbon cap the right idea? Forests in South America? What about carbon capture? Solar and wind? Global treaties or local action? National policy or individual behavior change?

A handful of insights, grounded in careful math, can clarify the situation, and point out a straightforward path to a reasonable future. And while the pathway is not easy, it is certainly feasible, especially if our collective work is better focused.

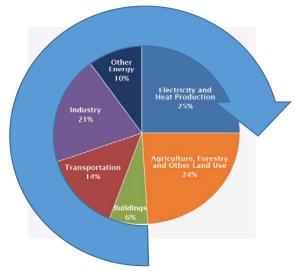
This short paper is designed to cut through the clutter, and point to a reasonable, cost-effective solution, with clear steps to get there.

The paper focuses on energy-created CO2 and other greenhouse gases, which contribute about 75 percent of climate forcing. This is not to minimize the importance of deforestation, but to get at the heart of the problem, and to produce a manageable strategy for this large part.

A word about timing

Both the stakes and the opportunities in climate change have risen markedly over the last few years, and this combination of threat and opportunity argues for a serious, immediate push on a few policies that can make a big difference. To land at a reasonable carbon

Greenhouse Warming Share from Energy



future requires speed, focus on intelligent policy, and intensity.

How have the stakes gone up? The insidious mathematics of carbon accumulation show that lost time creates essentially irreversible damage, and the carbon we emit now creates further damage every year for well over a thousand years. The only way to deal with this imperative is to pursue strategies that deliver large tons, early. There is no reasonable long term future unless we play the short term well. Waiting for miracles is a surefire recipe for losing.

Second, failing to stem concentrations of CO2 soon will begin to unleash runaway feedback loops, such as methane released from thawing arctic tundra, which will accelerate whatever damage humans cause, conceivably beyond any human capacity to control. A

recent paper by Hansen et al argues that ice melt in Greenland and Antarctica could dramatically accelerate, making most coastal cities uninhabitable in a matter of decades to a few hundred years. Only early action can prevent this runaway feedback. And third, the effects of climate change are themselves nonlinear—as weather extremes become the norm. Add it

The economic and social cost of losing functionality of all coastal cities is practically incalculable.

Hansen et al

up and it becomes clear that climate action in the next 15 years is crucial.

Against those fearsome trends. recent technological developments make solutions available and affordable. The plummeting costs of solar, wind, advanced lighting, new manufacturing techniques, and more mean that clean energy can finally graduate from the boutiques to the mainstream. **Political** commitments in some jurisdictions have proven that this rapid transformation is possible—with a number of states and countries well north of 20 percent renewables in less than a decade, and on a path to 80 percent reductions by 2050. The California and New

York grids, for example, will have 50 percent renewables by 2030; add in existing nuclear and hydro, and their electricity systems will both be close to 70 percent decarbonized in just the next 15 years. The challenge, then, is to accelerate the new technologies, and to turn nascent the political commitments in Paris into unstoppable change.

Here's how.

20 Countries Matter. Win There, and We Win

The first thing to do is focus on the key countries. Carbon reduction can only happen in individual power plants, buildings, vehicles, and factories, so no matter what sort of international regime or treaty is established, it comes down to action in China, France, Mexico, and so forth.

Eighty percent of carbon emissions come from the largest 20 carbon emitting countries, with China and the United States holding the top posts. If these countries have downward trending carbon emissions in the next five to ten years (later for the poorer countries, earlier for the richer), then we can land at a decent future. Failure in these countries means global failure.

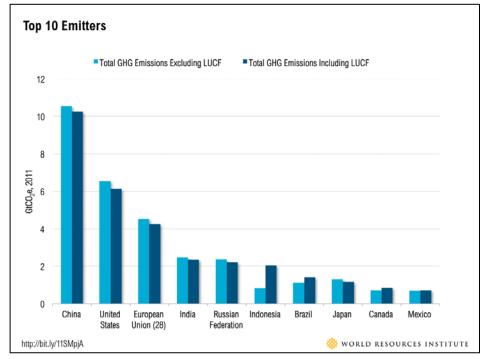
It All Happens In Four Individual Sectors

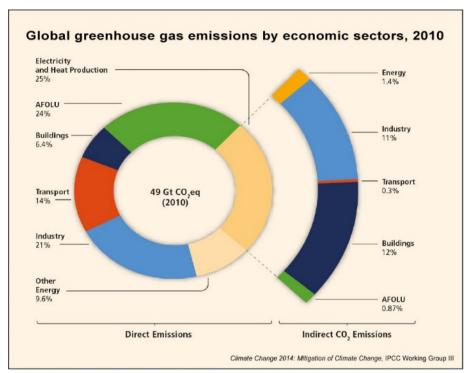
A low carbon economy requires electricity from renewable resources, near-zero energy buildings, vastly different manufacturing processes, and a superefficient transportation sector. The effectiveness of every treaty, every financial instrument, and every policy should be measured by how well it translates into on-the-ground change in these four realms.

As the chart above shows, Electricity (the beige band, broken down in the arc), buildings, industry, and transport are the big sources of energy CO2 emissions—with agriculture, forestry, and land use (AFOLU) taking up the balance. This paper only covers the energy aspects.

A Few Policies Are Killer Apps

In each sector, there are only a small number of policies that make a difference. Selecting the right policies and ensuring they are properly designed and implemented, in the biggest countries, is the path to





victory. When we look at broader strategies, e.g. a global treaty or a financing scheme, we should judge the effort against its potential to drive these specific sectoral policies.

For Buildings

- 1. A **good building** code is the only policy that has delivered large-scale, sustained energy efficiency in building shells. The two caveats: it must be well-designed, and it must be properly enforced. The best building codes set strong performance standards, and then ratchet them up every few years. This **continuous improvement** turns out to be a key feature across the board, as it inspires new technologies and new practices. California's code has gone through a dozen increments in the 30 vears since it was adopted, and new buildings now use about 80 percent less energy than those built before the code. Zero-net energy is the next big Codes that can be met with either a spec step. sheet (e.g. double pane, low-e windows; R19 insulation in the walls) or an overall performance standard, certified on a state-approved computer model offer great flexibility to builders.
- 2. **Energy efficiency standards for appliances and equipment**, getting predictably and steadily tighter over time, have delivered massive energy and consumer savings, and they are far from fully exploited.

For Transportation

- 3. Fuel efficiency standards, or their equivalent, carbon-per-mile, have doubled the fuel efficiency of car fleets, and are in the process of doubling them again. That is heroic. These, too, should have continuous improvement, SO that manufacturers can see the value of R&D, and of developing new technologies—in motors. transmissions. lightweighting. aerodynamic drag reduction, and so forth.
- 4. Standards work best when they are complemented by a **price signal**—a gas tax, or a carbon tax, or a "feebate," which is a fee charged against inefficient cars, rebated to those who purchase the most efficient.

For Utilities

The electric utility industry is already in the midst of a big transition, as old coal-fired power plants are shut down, the grid becomes more sophisticated and flexible, and renewable energy becomes cost-effective. But utility stock turns over slowly, and progress can easily stall. The best utility policies are:

- A renewable portfolio standard requires generators to bring an ever-increasing fraction of renewable energy to the grid. If accompanied by a price-finding mechanism, like a bid system, it is extremely efficient.
- Having the utility devote resources to customer energy efficiency whenever that is cheaper than supply—through "decoupling" or performancebased regulation.
- 7. In general, **restructuring utility incentives** so they earn most when they best deliver the four key services—reliability, affordability, safety, and environmental amenity.

For Industry

8. **Equipment standards** for motors, air compressors, and other industrial equipment drives down waste. Some countries have managed **industry best practice pledges**, wherein companies agree to hit top quartile performance.

Why the emphasis on **getting policies** <u>right</u>? Consider fuel efficiency standards for autos—which can cut energy use in half. A badly designed standard (with examples in parentheses) will:

- Trade-off fuel efficiency for air pollution (EU diesels)
- Reward consumers for purchasing trucks (USA CAFE)
- Bias the market toward heavy cars (Japan, China, India, Korea)
- Regulate the wrong characteristic (China displacement-based standards)
- Fail to improve as fast as technology allows (USA CAFE wasted 30 years of improvements, costing the US more than \$1 trillion)
- Encourage automakers to optimize for tests rather than real-world conditions (ubiquitous)
- Fail to deliver fuels that advanced cars and trucks require (Mexico, China, Brazil)

The list is actually much longer. The point is that getting it right, from the start, really matters. The right goals supported with the wrong policy are expensive, inhibit technology and creativity, and fall short of their goals.

Policies that help all

- 9. **Pricing** carbon according to its social cost is the policy favored by many economists. It reaches across sectors, and affects both capital and use decisions. Pricing carbon is highly useful, but is no panacea, as several sectors and many consumers are effectively indifferent to price signals.
- 10. **Research and development** has a fantastic payoff, especially over the long run. Virtually every major energy technology in use today has either been borne from, or significantly advanced, from smart federal R&D.

These policies, properly designed, in the biggest 20 nations, will land the world on a reasonable carbon future. Each of these policies has proven effective somewhere, though no major jurisdiction has used them all.

It Really Matters to Get the Policy Design Right

There are a hundred ways to misdesign any single policy. If a government fixes a price for a subsidy, it will either be too high, wasting money, or too low, failing to achieve its social objective. Opportunities to game policy abound. A brief summary of policy design principles, to avoid these and other unintended consequences follows, but for fuller treatment, see this paper.

- 1. Set goals and let the market work out the best solutions. Specifying a technology, or specifying a price, risks undermining the power of markets to innovate.
- 2. Require continuous improvement. Setting a fixed target, for e.g. renewable energy supply, becomes a de facto plateau: Instead, use the political moment to set a steady three percent annual improvement, for example.

- 3. Go upstream; aim to capture 100 percent of the market. Where possible, policies such as a carbon tax should be assessed as far upstream as possible—at the mine mouth and well head, for example. This reduces complexity and minimizes gaming.
- 4. Facilitate private sector investment and innovation. There is a concept called "Investment-grade policy" that takes into account the full suite of issues a private sector company must consider—siting, permits, power purchase agreements, and so forth—and builds a policy environment that adds certainty in all realms. This can dramatically cut the cost of new technology.
- 5. Work to design policy that takes advantage of natural capital stock turnover. This can save vast sums of money.

Getting This Done: One Proven, Affordable Idea To Pursue

The Paris agreement in December 2015 was a high water mark for political commitment to climate change reduction. Some 180 countries delivered plans, which ranged from poor to very good, on abating carbon. But few have the expertise to properly select, design, and implement the policies required to meet their own plans.

Designing good policy requires deep system knowledge, access to experience in other countries, a serious dive into the local conditions, consultation with domestic and international experts, and above all the experience to determine what will succeed. Few jurisdictions have those resources on-hand. For the cost of a few hundred thousand dollars to a few million per year, spent on the right domestic and international experts, an outstanding policy package for a country can be developed. That catalytic investment will then

influence billions of dollars in energy infrastructure.

Providing this expertise requires **building and expanding on "best practice" expert teams**, and making them available for free or low cost, on request from decision-makers. The teams must be equipped with case studies, data, computer models, experience in many countries, and top experts. They must be able to rapidly answer questions, and work onsite for months. They must work with, learn from, and help train local experts in every engagement. And they must deliver policy-ready material, in policy-relevant timelines.

This method has been pioneered with the Best Practice Networks of the Climate Works Foundation, with six international centers established, one each for vehicles, utilities, industry, buildings, appliances and equipment, and urban planning. As an example of the power of this mechanism: one of these, the International Council on Clean Transportation, has focused on fuel quality, fuel efficiency, and low-carbon fuels-for cars, trucks, planes, and ships. They have an international staff with about 30 engineers and policy experts in offices in the US, Europe and China. Their work has already helped with policies that will abate 1 GT per year of carbon emissions in 2030, and they have another 1.5GT in their sights. Similar opportunities abound in each sector.

A Best Practice Network is not a consulting company, nor does it offer a menu of undifferentiated options. BPNs are devoted to, and capable of, building great policy in their realm of expertise. They work directly with decision-makers and agencies to assess the potential of different policies, go through the difficult questions of implementation, stick around to help overcome hurdles, and then help fine-tune the solutions as it evolves. They always work with, learn from, and train local experts, so that the work has a long lifetime.

BPNs must have:

- Serious technical depth
 - o Experience designing and implementing policies in many different political settings
 - A library of best practice policies for their sector
 - Computer models ready to adapt to different countries
- Proven ability to work in different cultures, economic systems, and languages.
- Understanding of and commitment to best practices, ready to adjust to local conditions

- Commitment to cost-effective strategies
- O Understanding of the overlay of technical potential, economic necessity, and political reality in driving toward solutions
- Commitment to working in country. Commitment to training
- A serious track record
- Cost-effective structures

Their success must be measured by real-world change—in good policy, well-implemented, making a difference.

BPNs must be free to pursue not only the best carbon abatement policies, but to select venues with the most potential for change. That can be assessed by overlaying the carbon abatement potential with the political commitment. For example, if China wants to lead on super-efficient appliances, and is both a big market and a big exporter, and there is a clear signal from the government that this is a priority, then the appliance best-practice group (CLASP) would dispatch experts. If the carbon abatement potential was small, or the decision-makers reluctant, then the venue would be passed. This kind of triage is necessary to make the rapid advances the world needs to avoid serious carbon buildup. This is also why the effort must operate independently, and not be anchored by e.g. UN politics and practices.

A Suggestion

For roughly \$100 million per year, which could be reallocated e.g. from existing State Department or Aid budgets, Congress could support just such a set of best practice tiger teams, available for dispatch on request from a list of important countries. The work can build on existing DOE programs and great resources at qualified independent groups, so it can be started immediately. Countries are hungry for great technical advice, and there are huge economies of scale in sharing lessons and strategies across political boundaries.

There is no cheaper way to affect carbon trajectories.

Conclusion

Great progress can be made on climate change if, and only if, the major countries adopt smart energy policy, quickly. Helping them gear up to do it, building on existing political momentum, is a winner.

Power Shift: Economic Restructuring and Changing Energy Use in China

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After 35 years of rapid growth, China's economy is going through a major transition, characterized by a slower growth rate, a structural shift to the service sector, and industrial deleveraging—a process to address overcapacity that has built up in key industrial sectors over the past decades.

All of these factors have a profound impact on China's power and energy system. As a result of rapid expansion over the past three decades, China has the largest electric power system in the world, with an installed capacity of 1.36 trillion watts of electricity in 2014. China is also the world's largest energy consumer—a total of 4,334 billion tons of coal equivalent (Mtce) in 2014. Two-thirds of the country's energy supply is from carbon-intensive coal. As such, China is the largest greenhouse gas (GHG) emitter in the world, releasing 8,106 million metric tons in 2012. ²

However, the rapid growth in China's coal and electricity use has come to a halt during the economic transition. In 2014, coal use declined for the first time and it is continuing to dip in 2015. Electricity growth slowed to 3 percent in 2014, and growth from January to November 2015 was 0.7 percent (Figure 1).

The central question is whether such a slowdown in coal and electricity use is a cyclical phenomenon or a permanent shift in China's energy and economic dynamics.

This analysis attempts to examine this question in light of China's economic transition and clean energy revolution.

Hypothesis

Our hypothesis is that the recent slowdown in China's coal and electricity use is more than a cyclical phenomenon. Rather, it reflects a fundamental shift in China's evolving economic transition, characterized by the following:

- 1. An economic slowdown from an average of 10 percent growth for the past three decades to a sub-7 percent growth rate in 2015;
- 2. The growth of the services (tertiary) sector, which is less energy-intensive, as China moves from an investment-based economy to a consumption- and services-based model; and
- 3. A decline in the output of heavy industrial products, due to excess capacity and slowdown in demand for such products.

We argue that these trends are likely to continue in the foreseeable future; therefore, their influence on coal and electricity use is likely to remain negative going forward. In addition, as China strives to peak its carbon emissions before 2030, address severe air pollution problems, and adopt cleaner power sources, social and environmental pressures are also likely to restrict the growth of coal and coal power.

If China's clean energy revolution continues to drive down coal investment, coal use may peak earlier than predicted (by 2020)—if it hasn't already. This would be a profound paradigm shift for China's energy economy.

Slower economic growth

China's national GDP growth rates are no longer in the double digits. Rates have slowed considerably over the past four years. In real terms, China's average quarterly year-on-year GDP growth rate has remained below 8 percent since 2012 and reached a new low of 7 percent for the first two quarters of 2015.⁵ In the third quarter, GDP growth dipped to 6.9 percent (Figure 2). Most economists believe that growth is likely to continue to slow down in the next five years. The latest guideline from the Central Committee of the Chinese Communist Party implies a 6.5 percent target for annual economic growth from 2016 to 2020.⁶

Structural Change

As China reaches a "new normal" with slower GDP growth rates, its economy is also undergoing structural change. Rising shares in the tertiary (services) sector have offset declining shares of economic activity in the secondary (industrial) sector. This is clearly seen in the tertiary sector's rising annual average share of national GDP, increasing from 39.8 percent in 2000 to 48.1 percent in 2014. In the first quarter of 2014, the tertiary sector's share of GDP reached 50 percent for the first time, and its share has remained at or above 50 percent for the first two quarters of 2015 (Figure 3). Given that the services sector is less energy-intensive than the industrial sector, this shift has led to slower growth in China's electricity and energy use.

Industrial Deleveraging

The impact of structural changes can be seen clearly in heavy industry, where energy use is intensive. Industrial output has waned. Specifically, trends over the past 15 years reveal that growth of cement and steel production—two of the largest and most energy-intensive industries in China—has significantly slowed down. Growth has declined steadily since the late 2000s, and recent growth has been much slower compared to the early 2000s. Most notably, cement production has experienced negative year-on-year growth for the past three quarters of 2014, with a 7 percent decline. In the first half of 2015, cement production has continued to decline radically, with negative 6.8 percent growth in the second quarter (Figure 4).

Steel production growth has also slowed, reflecting

a decrease in domestic demand. However, unlike cement, steel production is still partly driven by exports to the international market, and thus has not experienced as much of a decline as cement.

Oversupply of Coal, Cement, and Steel

Commodity prices for coal and heavy industrial products such as cement and steel have declined sharply since 2012, indicating an oversupply of industrial products (Figure 5). Lower prices are leading to widespread losses in coal mining and heavy industries. While there is a general agreement in China that many heavy industries are facing overcapacity, questions remain over how to deal with the surplus due to concerns about unemployment and social stability. One of the troubling signs is that China may want to export the excess supplies to less-developed regions, which could lead to carbon leakage.

The Rise of Renewables

China has launched a "clean energy revolution" to address its severe air pollution problems and to meet its climate targets. Specifically, China has committed to meet 20 percent of its energy demand with non-fossil sources by 2030. To achieve this, the country must build 800–1,000 gigawatts of solar, wind, hydro, and nuclear-power capacity in the next 15 years.⁷

Investment in renewable energy has increased rapidly in the past 10 years, while thermal energy investments are on the decline (Figure 6). In 2013, new additions of zero-emission power plants exceeded that of coal plants for the first time. Under the current economic and environmental conditions, this trend is likely to continue into the foreseeable future.

Excess Coal Power

In addition to declining investment in thermal energy sources, thermal power plants have also experienced declining hours of operation, suggesting an overcapacity in coal power plants. Total hours began to decline after 2004. By 2014, average annual hours of operation had fallen from a peak of 5,991 to 4,706 hours (Figure 7). The latest numbers indicate this may drop even further to 4,500 hours by the end of 2015—a capacity factor of only 51 percent,⁹ an historical low for China.¹⁰ If China were to operate these thermal plants in a normal range of 5,500–6,500 hours per year, the country would need 20–40 percent fewer coal power. While peak electric demand may

continue to grow, there is really no need for any new base-load coal power plants in the near future.

Coal Use in the Future

Coal use in China declined for the first time in history in 2014. Whether this trend will continue in the future is of tremendous importance to China's success in meeting its air quality and climate goals. Here, we take a closer look at China's coal use by sector.

Coal use in China is dominated by power generation and direct use in industries, each accounting for roughly 50 percent of total coal consumption (Figure 8). Coal use by buildings and other sources is relatively small.

Due to excess capacity in heavy industries (such as steel and cement), caused by a softening in the housing market, it is likely that industrial coal use will continue to decline before 2020. A report by China Investment Capital Corporation indicates that there is 30% excess capacity in heavy material industries. This is consistent with a projected 34% drop in new construction in the next 15 years by a group of think-tanks (Figure 9).

While overall demand for power may continue to grow, it will likely be at a significantly slower pace than it has been in the past. It is estimated that electricity use may grow by under 1 percent in 2015, compared to double digits in the past. With a rapid rise in renewable power investments and the need to meet China's air and climate targets, the demand for coal for power generation is likely to have plateaued. In fact, electricity generation from thermal power sources (mostly coal) has been flat in the last two years.

So with direct use of coal in industries declining and coal use in power generation flat, it is highly likely that the overall demand for coal has peaked in China—or at least plateaued.

Conclusion

Our analysis finds that China's demand for electricity has entered into a slow-growth phase, due to slower economic growth, a shift to the services sector, and a deleveraging of heavy industries. It is estimated that electricity use may grow by less than 1 percent in 2015, compared to double digits in the past.¹³

Under the suggested low-growth scenario, the rapid expansion of clean power to address China's targets for air pollution and climate change voids the need for new base-load coal power plants. In fact, our findings suggest that there is already excess coal-power capacity. Thus, China should seriously consider not permitting any new coal power plants in the 13th Five-year Plan (FYP).

Given the declining rates of coal use for power generation and industrial operations, the overall demand for coal in China may be plateauing. As stated earlier, it may have already peaked. China is about to finalize 13th FYP in the coming months, and thus should re-assess the need for investments in all coal assets. If it fails to do so, the country runs the risk of wasting hundreds of billions of investment in stranded assets in such sunset sectors and hindering its ambitious air and climate goals.

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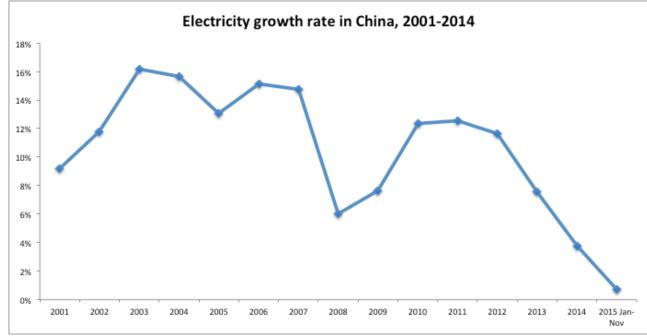
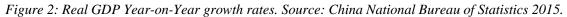
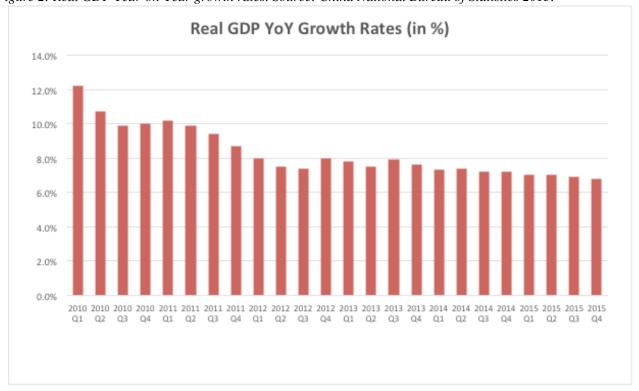


Figure 1: Electricity growth in China. Source: China Electricity Council 2015.





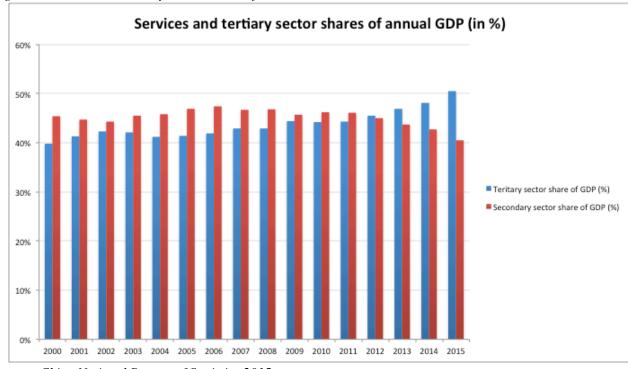


Figure 3: Services and tertiary sector shares of annual GDP.

Source: China National Bureau of Statistics 2015.

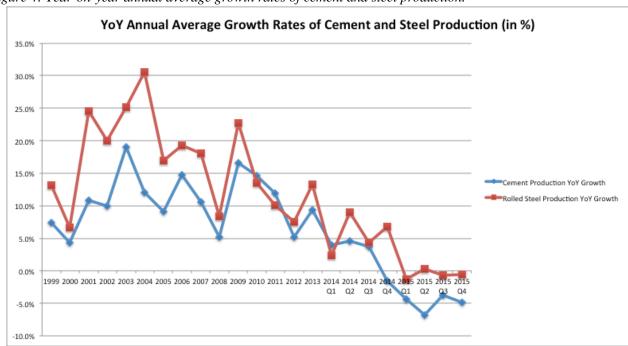


Figure 4: Year-on-year annual average growth rates of cement and steel production.

Source: China National Bureau of Statistics 2015.

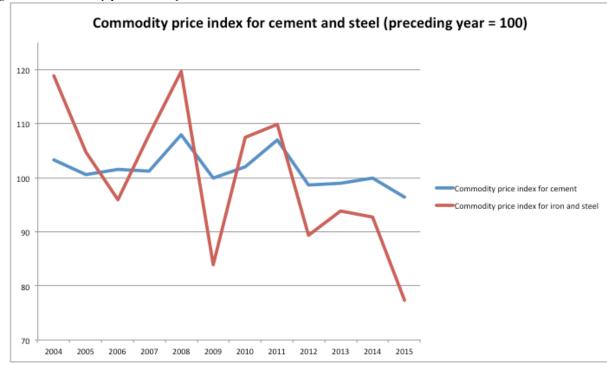
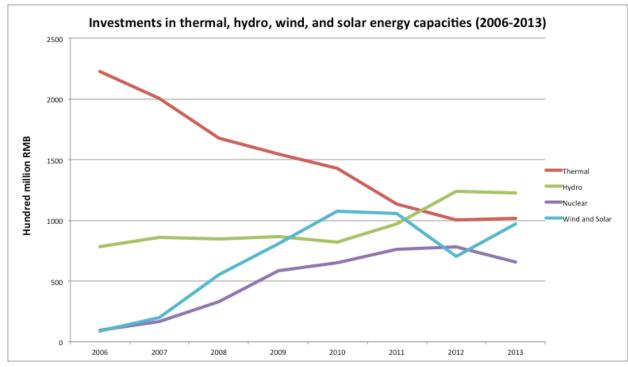
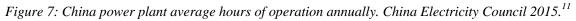


Figure 5: Commodity price index for coal, cement, and steel.

Source: National Bureau of Statistics 2015.

Figure 6: Investments in thermal, hydro, wind, and solar energy capacities. Source: China Energy Statistical Yearbook 2014.





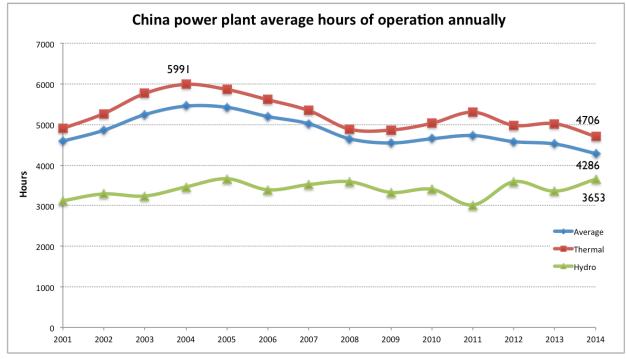
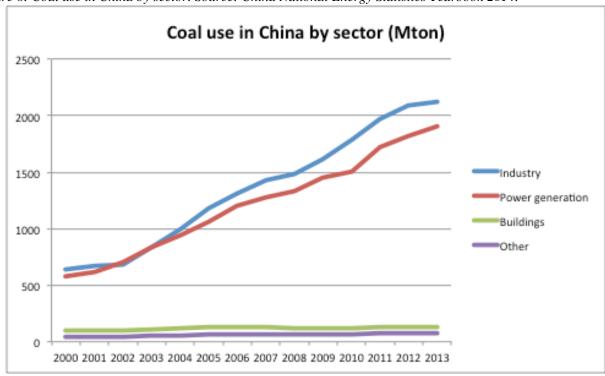
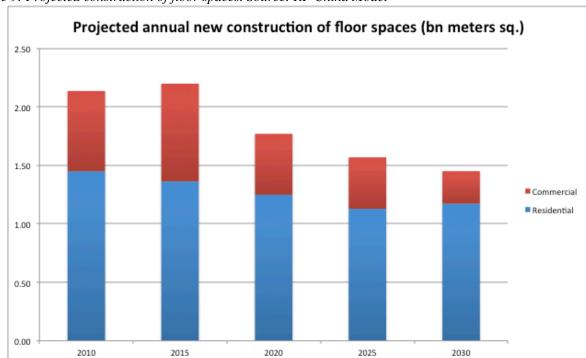
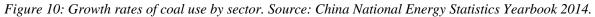


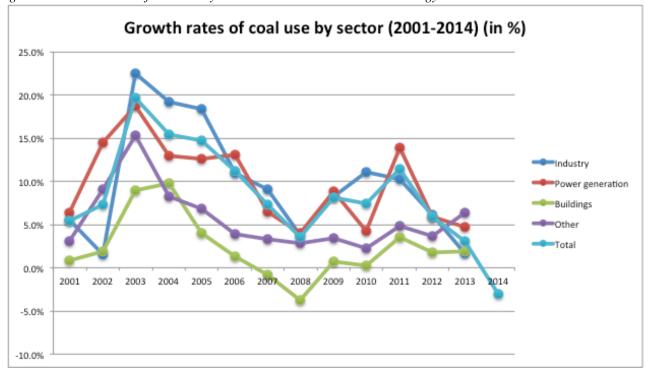
Figure 8: Coal use in China by sector. Source: China National Energy Statistics Yearbook 2014.





Figure~9: Projected~construction~of~floor~spaces.~Source:~RF~China~Model





Assertive Engagement: A New U.S.-Japan Strategy for China

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China's Current Trajectory

It is impossible to predict a single outcome for the China of 2030. There are too many different factors involved and the interaction of the factors is extremely complex. To predict which factors will be dominant and how the factors will interact is simply beyond the capabilities of the social sciences. The United States and Japan need to pursue a strategy that is resilient—a strategy that can be successful across a range of future developments in China.

Chinese Goals

This rapid increase in China's role in shaping both regional and global outcomes indicates Xi Jinping and his colleagues are well on the path¹ to achieving Xi's concept of a "Chinese dream," which culminates in the "great rejuvenation of the Chinese nation" by 2049—the PRC's centennial anniversary. President Xi intends to restore by that time China's historical position of economic, political, and cultural centrality in Asia.

Stable relations with the United States under the umbrella of promoting a "new style of great power relations" provide the fundamental undergirding for the achievement of Xi's Chinese dream. It remains unclear, however, if the Chinese seek to ensure that the competitive elements in the U.S.-China relationship remain firmly under control, in a situation roughly analogous to the period of U.S.-Soviet détente during the Cold War. In a less benign assessment, China is using the framework of a new style of great power relations to seek U.S.

acquiescence to China's definition of its "core interests," including China's current political system, territorial claims, and its own way of shaping and applying international rules and regimes

In the domestic arena, the Xi administration released a comprehensive vision statement after the November 2013 Third Plenum of the 18th Central Committee that contained the most sweeping reform proposals in decades. Upgrading the market's status from "basic" to "decisive" in allocating resources was by far the Third Plenum's most controversial outcome.

Strengths

China's amazing economic accomplishments and the concomitant increase in its global stature and influence, have bolstered the Chinese Communist Party's (CCP's) legitimacy by showing that it (and, the CCP argues, only it) can "deliver the goods." Moreover, the fallout from the global financial crisis further strengthened the narrative among many in the CCP elite that China has somehow discovered a distinct "third way" that allows it to marry relative economic openness with a closed political system. Xi's rapid consolidation of power and his seemingly unflappable disposition in managing China's many challenges represent another key strength of the regime. The smooth and complete handover of power has provided Xi with an unusual level of stability within the leadership core of the Politburo Standing Committee and among the key officials supporting it. His innate confidence as a leader with a born-to-rule leadership style serves to strengthen that sense of stability.

Challenges

There is a growing risk of a destabilizing backlash that undermines China's own stated interest in maintaining a stable periphery. Beijing continues to push its maritime claims and naval reach in the waters of East Asia at a robust clip. China's neighbors are concerned about this development, and now are less likely to simply accept at face value China's claimed commitment to pursuing "win-win" strategies in its relations with the region.



Figure 1: China's Potential Future

There are numerous roadblocks that must be overcome if the Chinese leadership is to successfully implement their bold reform agenda. Xi and his Politburo colleagues have struggled to set priorities in moving toward implementation of the bold reforms tabled at the Third Plenum, risking systemic paralysis. Conversely, it is possible that the reforms presented at the Third Plenum will not be bold enough, proving insufficient to transform the Chinese economy and society over the coming years. Moreover, the quiet but massive buildup of leverage in the Chinese economy following the financial crisis will force the government to accept lower growth for at least a few years. When combined with Xi's efforts to rapidly consolidate power, it is possible that top-down systems of direction and control will prevent these bold reforms from coming to fruition.

China's Potential Futures

In forming a robust and effective Alliance

strategy it is crucial to go beyond current and past trends to consider a range of future possibilities. The four quadrants represent four alternative futures for China.

Alternative Chinese Futures

A powerful and benevolent China would likely achieve economic growth rates of 5-7% over the near- and medium-term by successfully managing a transition to considerably greater consumer-led economic growth and a larger private sector. The Chinese government would feel secure enough both domestically and internationally that it could and frequently would cooperate freely with the United States, Japan and Europe on important issues. It would employ economic and political influence and negotiated compromise to advance its core interests—continued primacy of the Chinese Communist Party, reunification of Taiwan, secure administration of Tibet and Xinjiang, and major concessions on its claims in the East and South China Seas and along its border with India. would seek to solve its immediate territorial disputes by negotiated compromise and would transition from a "free-rider" foreign policy to an involved and cooperative one in which China took substantial shared leadership responsibility for solving both regional and global challenges, confident that its own interests would be advanced in line with the shared interests of other states.

If China were to take this path, then the United States and Japan could cooperate with Beijing on a broad range of important issues, reduce their military expenditures and support increased Chinese leadership positions across a full range of international economic, diplomatic and security organizations. There would still be many difficult and sometimes acrimonious negotiations among China, the United States and Japan over political, geographic, economic and other issues. However, those negotiations would take place unfettered by underlying suspicions that China was engaged in a relentless, unilateral pursuit of its own interests at the expense of others.

A powerful and aggressive China would be the most dangerous and difficult for the United States and Japan. This China would have successfully transitioned to a predominately market-based economy; it would have maintained a rate of

economic growth at least 3-4% higher than that of the more developed economies of the United States, Europe and Japan; it would further restrict the activities of foreign businesses in China in favor of domestic companies; it would pursue strongly mercantilist policies overseas; it would continue to increase its defense expenditures so that by 2030 they would approach those of the United States. With the confidence and popular support that the Communist Party would enjoy with this sort of clear economic and military advantage, China would use its power and influence to move quickly, and if necessary, aggressively to support not only what it defines as its urrent core interests-continued primacy of the Chinese Communist reunification of Taiwan, secure administration of Tibet and Xinjiang and prevailing in its claims in the East and South China—but also would, as its power increased, develop more expansive claims in its border disputes with India, and become the dominant maritime power in the Indian Ocean to protect its oil supply lanes. With clearly superior military and economic power, China would take much greater risks in asserting its claims.²

If China were to take such a path, the United States and Japan would have two fundamental choices: contain China's aggression and ambitions or concede to them, seeking some sort of division in spheres of influence or power sharing in East Asia and beyond.

A weak and inward-looking China³ would have failed in its current efforts to shift its economy toward a more market-based model with greater consumer demand-led growth. Its economic growth over the next 15 years would be 2-3% per year at most. Chinese leaders would be preoccupied with internal developments—continued tinkering with economic policies in order to increase growth; social and political controls to deal with popular dissatisfaction over stagnating incomes, diminished opportunities for individual citizens and continued increased income inequality. expenditures would be reduced as economic growth slowed and internal security needs increased—as occurred in the 1990s.4

A weak and inward looking China would have little interest in cooperation to deal with common regional and global problems. China would have

little interest or incentive to join political—much less military—efforts to relieve suffering and end the violence resulting from conflicts and crises over economic problems. The United States, Europe and Japan would have to handle these problems largely on their own, with China taking actions only to protect its narrow interests.

In dealing with this type of a China, American and Japanese positions in East Asia would not be actively threatened. However, even if China could only maintain its current level of military capability, sustained American and Japanese naval and air power in the region would be required to maintain a military balance. American and Japanese interests would be challenged elsewhere as reduced world economic growth resulted in economic and political crises and even conflict in Russia, the Middle East or the oil-producing states of West Africa. U.S. and Japanese responses to these crises would be made more difficult by China's lack of incentive to cooperate in finding and supporting solutions.

A weak and aggressive China would be characterized by lackluster growth, and the government would be faced with a daunting array of internal challenges in maintaining social order. However, as a major component of its policies to maintain its hold on power, the Party would attribute blame for its economic problems and the resentment of dissatisfied groups within China to hostility from the United States and Japan. It would encourage nationalist resentment against foreign countries in order to deflect blame from its own shortcomings. It would take harsh actions in Tibet and Xinjiang to suppress any opposition to strong central Han rule. However, it would go further and initiate actions from nationalistic rhetoric to military attacks—along its unsettled borders to gain territories for which it has made historical claims.

It is important to note that in taking these actions, the Chinese government, aware of its weakness, would not be seeking to set off a general war with Japan and the United States. Rather, it would be attempting to keep its provocations at a level below that threshold in intensity or timing, counting on foreign responses to be limited.

In dealing with this type of a China, the United States and Japan would adopt the kind of policies that NATO is currently developing toward Russia, a country with a weak economy but pursuing hostile—and domestically popular—policies towards NATO. As described in the discussion of a weak and inward-looking China, its economic weakness would be a major drag on the global economy, leading to crisis and even conflict in other parts of the world. The United States and Japan would be stretched to deal with problems in the Middle East, Africa and elsewhere, while at the same time maintaining the policy attention and military resources to deal with the aggressive Chinese actions in its immediate neighborhood. Dealing with this kind of a China would be a difficult challenge for the rest of the world.

Baseline Projection

China's actual course of development will not fall neatly into any of the four alternatives described above. However, as a starting point for developing a strategy it is useful to describe a single baseline projection for China's development and security policies for the next 15 years.

The following is a baseline projection for China over the next 15 years: The Chinese Communist Party will maintain its grip on power with a mixture of concessions to and repression of newly empowered sectors of the country. China's economy will develop at 3-4% annually, and it will not overcome the United States as the largest economy in the world during this period. It will continue to allocate resources to its armed forces with commensurate its overall economic development, meaning it will reduce the past 10% annual increases in defense spending to 3-4%. With the increasing unit costs of sophisticated systems, the People's Liberation Army will continue to grow in capability but not in numbers of platforms and weapons. However, China will not achieve levels that will displace combined American and Japanese capabilities in East Asia. China will continue to press its claims to Taiwan, in the East and South China seas, and over disputed territory with India, and it will use both paramilitary and military tactics to do so. However, China will not take actions that will lead to armed conflict with its neighbors or the United States. China will fitfully assume a more cooperative role in dealing with regional problems around the world, beginning with diplomatic and economic cooperation, and it will continue to develop Chinese-led alternatives to existing economic, diplomatic and military organizations. This baseline projection for China is graphically represented in Figure 2. Note that the current trends project a somewhat more powerful and aggressive China than the United States and Japan have dealt with in the past.

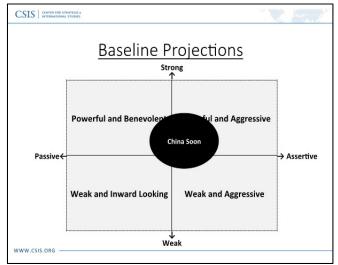


Figure 2: Baseline Projections

Future Strategies for the Alliance

With these four broad alternative paths for future Chinese developments and a likely baseline projection as background, and keeping in mind additional developments that may affect China's evolution, how is the current American-Japanese strategy working and how can it be improved?

The Current Strategy

A mixed strategy, for the most part, has been the bilateral and bipartisan consensus for both Tokyo and Washington since the April 1996 Joint Statement on Security by Prime Minister Ryutaro Hashimoto and President Bill Clinton welcoming China's positive contribution to international society and simultaneously pledging to revitalize U.S.-Japan security cooperation. Although it has been given different names, the strategy has been remarkably consistent to date. It has been a mixed strategy of cooperation in economic and some diplomatic areas and military modernization along with military deterrence on select issues, as well as efforts with like-minded states to strengthen rulemaking in the Asia Pacific in ways that shape China's choices.

Since China's decision to join the world

economy, the United States and Japan have sought to bring China into existing international economic and financial systems, culminating in China's entry into the World Trade Organization in 2001. There have been many economic disputes since then, involving trade practices, intellectual property protection and currency manipulation, but overall economic relations among the United States, China and Japan have deepened and strengthened.

Diplomatically, the United States and Japan have sought to enlist China in common international A successful example has been the initiatives. control of nuclear weapons and technology From a proliferator of nuclear proliferation. technology, notably to Pakistan in the early 1980s, and a seller of advanced missiles to states in the Persian Gulf, China has become a responsible member of the non-proliferation regime. Its own nuclear weapons programs have been restrained, and it has consistently maintained a public doctrine of no first use of nuclear weapons. China has also over time taken a small but more positive role in the management of regional crises, as it has gained a greater stake in peaceful international a environment. For example, China has joined to a limited extent in the international sanctions against Iran to encourage it to adhere to its obligations under the Non-Proliferation Treaty. China has also participated to a limited degree in many smallerscale international humanitarian operations.

Military relations between the United States and Japan on the one hand and China on the other have been more difficult. Declared American and Chinese policies have always been at odds over the issue of Taiwan's future status. China has maintained that under certain circumstances it would use force against Taiwan while the United States has maintained that it would respond to the use of force. In 1996 both countries took symbolic military actions in the vicinity of Taiwan in support of these policies. There have been dangerous encounters between American and Chinese ships and aircraft in international waters and airspace off China's coast, most notably the collision in 2001 of a Chinese fighter with an American electronic reconnaissance aircraft. More recently, China has re-asserted its claims to the Senkaku Islands and deployed military forces in their vicinity. Japan has counter-deployed military forces, and asserted publicly that it will

defend them by military force if necessary. The United States has stated that its security treaty with Japan applies to the Senkakus but take no position on their final sovereignty. Chinese and Japanese military and paramilitary forces continue to operate around the Senkakus and occasionally jostle each other.

Behind these episodic low-level military incidents in the region lies the strong and steady increase in the Chinese armed forces. Since the mid-1990s China has increased its military budget by roughly 10% each year, with a heavy concentration on naval, air and missile forces. In response, the United States has increased the size and technological level of its own forces based in the Western Pacific. Japan, after years of a gradually declining level of investment in its armed forces, showed small increases in the last two years and is on track for another small increase in the coming year.

Overall, the American and Japanese strategy of the past two decades has been largely but not completely successful. China's participation in the world economy has brought many benefits to consumers and businesses in the United States and Japan. China has become somewhat more involved in solving regional crises and problems than in the past. Although China's modernization of its armed forces has cut the margin of military superiority of the United States and Japan, China has not used its military forces to gain the territory it claims.

Shortcomings of the Current Strategy

If this strategy has been successful in the past, it is reasonable to ask why it cannot simply be continued in the future. The basic flaw in continuing the current strategy is that China has become so large and successful economically and so militarily capable that it need not and increasingly does not accept the policy choices that the United States and Japan offer. It can take advantage of opportunities for cooperation in economic areas and in dealing with common challenges from regional hotspots through climate change, but at the same time can devise and pursue independent economic and diplomatic policies that advance its interests. These range from promoting its own rules governing the Internet to starting a new international development bank. In the military and security areas China has

been deterred from direct aggression, but has adopted activist policies to advance its interests using sophisticated forms of military coercion and simple gunboat diplomacy, as well as a wide range of non-military activities including administrative declarations, coast guard and fisheries enforcement patrols and private sector development of disputed territories. China has simply outgrown the boundaries of the current American and Japanese policies of cooperation and deterrence.

On the economic front, the concept of welcoming China as a junior partner in an American and Japanese-led economic order is becoming China has developed such a large impractical. economy-now surpassing Japan's and closing on that of the United States—that it need not always follow the American and Japanese lead on international economic policies that do not meet its interests or ambitions. It has ideas and initiatives of its own, from making the renminbi an alternative international reserve currency to the dollar to signing bilateral long-term hydrocarbon agreements outside the dollar-denominated world oil market system. Whether these initiatives are possible in terms of China's capacity or the willingness of the international system to accept new rules is very much an open question, but the degree of Chinese ambition to reshape the international order is unprecedented.

In addition, China has developed policies generally staying within the WTO-defined world economic system, while supporting its own economic interests to the maximum extent possible. The most egregious example is in the area of intellectual property rights, an area in which WTO enforcement mechanisms are slow and ineffective. Using a full range of cyber espionage tools in addition to more traditional human techniques, Chinese companies, with the overall policy encouragement and sometimes the active the Chinese involvement of government, aggressively attack international companies both in China and abroad. They pilfer both intellectual property and trade secrets. In addition, China uses regulatory measures to limit the activities of international companies, from denying access to certain areas of the economy, to demanding the formation of joint ventures with domestic companies and prosecuting foreign companies more than

Chinese companies for illegal but common business practices. Many other developing countries in the world have used similar practices to attempt to reap the advantages of foreign investment, while building domestic business capability, but the scale of the Chinese economy and the aggressiveness of these measures is a unique combination. So far the United States and Japan have not developed an effective defense against these Chinese practices. Relying on WTO cases and lodging diplomatic protests has had little effect.

In the military area like the economic area, the sheer size of China's growing power is becoming more of a factor. Since its military buildup began in the 1990s with an emphasis on submarines and missiles, China has developed a substantial capability to contest American and Japanese sea and air control in areas near the Chinese coast. Its growing military force provides general coercive power and leverage on issues with its neighbors. However, China has not achieved the ability to realize its claims in sovereignty disputes with its neighbors. The future problem is that if China's military growth continues at the 10% clip it has followed in the past, and the military expenditures of the United States, Japan and other countries in the region continue to fall relative to China as they have in recent years, there will come a time when China will have maritime and air superiority at key points in East Asia that can be translated into political leverage, or, if necessary, military victory.

A new and important Chinese area of activity in support of its external geographic claims include aggressive but predominately non-military actions what Japanese observers call the "gray zone." China has deployed this set of activities most extensively in the South China Sea in support of its extensive territorial claims. It has also used the tactic in the East China Sea, most notably with the November, 2013 declaration of Aircraft an Identification Zone (ADIZ). The objective of gray zone activities is to establish faits accompli legitimacy for Chinese claims to sovereignty over some islands as well as recognition of China's ability to set regulations in areas such as fishing or mineral rights that it can physically enforce against other countries with conflicting views. China is counting on its ability to take the initiative to muster superior force at specific locations in contested

areas, and on the inability of other countries with contending claims to oppose its moves in an effective manner either individually or even collectively. So far China's gray zone strategy has been notably successful and increasingly bold. Recent major actions have included the 2012 patrols of Scarborough Shoal that turned away Philippine government vessels and fisherman, deployment of an oil rig for several months in 2014 to conduct exploratory drilling in an area in the South China Sea also claimed by Vietnam and the ongoing construction of facilities including an air strip on Fiery Cross Reef and Johnson South Reef in the Spratly Islands, claimed by the Philippines and American and Japanese responses to Malaysia. these Chinese actions have been largely rhetorical and ineffective.

In summary, the current mixed strategy of the United States and Japan to deal with China is increasingly inadequate, even to deal with the baseline projection for China outlined above. As China's economic weight grows, it is increasingly able to take advantage of selective participation in the international economic order led by the U.S., Japan and other developed countries, while simultaneously pursuing aggressive national policies at home and mercantilist policies abroad. In the military area, its steady development of capability imposes a high cost on any country, including the United States and Japan, considering the use of military force in territorial disputes. At the same time. China has been able to use measures below the level of military aggression—in the gray zone, to strengthen its claims in the South China Sea.

Improving current strategy: "Assertive Engagement"

There is no radical but practical alternative strategy by the United States and Japan that would overcome all the shortcomings of the current mixed strategy. Strategies like accelerated military buildups, on the one hand, and accommodation of some of China's demands, on the other, are uncertain in their success and in their ability to sustain public support in both the United States and Japan. However, the current strategy requires substantial reinforcement if it is to accomplish the objective of providing both positive and negative incentives for China to play a cooperative and

positive role in the region and the world.

Figure 3 gives a graphical representation of an "assertive engagement strategy," against the background of the baseline projection and the four alternative future Chinas. The black oval represents the baseline projection for Chinese development for a somewhat more prosperous and active China. The light blue area illustrates a strategy of maintaining, and selectively increasing, actions for reassurance and institutionalization, while using both internal and external balancing to contest aggressive economic and gray zone Chinese actions that are unchecked by the current strategy and over time will undermine vital American and Japanese interests.

There are five areas of improved policies that the United States and Japan can adopt that will strengthen the current strategy, reduce uncertainties and risks, and forge a strengthened version of the current Alliance strategy for the next fifteen years.

An Alliance Policy of Assertive

Engagement

Institutionalization

Strong

US-Japan Assertive
Engagement

China Soon

Passive

Reassurance

Www.csis.org

Figure 3: An Alliance Strategy of Assertive Engagement

1. Better-Integrated American and Japanese Policy Towards China

The first set of improvements that can be made in the current strategy has to do with better integration of American and Japanese strategies. While the policies and actions of the two countries have generally been closely aligned in the past, there have been fissures that have undercut their effectiveness in dealing with China. There remain suspicions on both sides. In addition, the issues of basic values underlying the relationship have unfortunately received decreasing emphasis in U.S.-Japan relations in recent years, making the

relationship seem more transactional. The 70th anniversary of the end of World War II offers the opportunity to re-emphasize the values of free people and free markets that both countries share and that China challenges.

So the first set of actions the United States and Japan must take together is to make a formal and authoritative statement of an updated common strategy towards China, updating the 1996 Clinton-Hashimoto Security Declaration and including the concept of "assertive engagement" recommended in this paper. The new declaration must include both a ringing endorsement of the common values of liberty, democracy, free markets and free trade that both countries are based upon. In addition, the declaration must include a much more specific treatment of China than the 1996 version, covering a common assessment of Chinese capabilities and describing bilateral economic, diplomatic and military policies towards that country. nations revise their national security strategies in the future (Japan's first comprehensive national security strategy was issued in December, 2013, and the latest American national security strategy in 2010), the strategy towards China must be consistent.

2. Stronger American and Japanese Economies

The second set of improvements that can be made in the current strategy is to improve the economic fundamentals in both the United States and Japan. Resumed solid American and Japanese growth, along with greatly reduced Chinese economic growth, would mean the Chinese advantage in economic power and influence will wane.

There are of course powerful domestic reasons for leaders in both countries to improve their economies through bold action. Leaders in both countries should educate their citizens that increasing Chinese influence over the global economic system threatens American and Japanese prosperity over the long run, and that only if their two economies are strong and growing can they maintain the ability to uphold the rules of fair economic competition that will allow their businesses to compete and prosper, provide jobs and increase prosperity. Explanations along these lines should help American and Japanese leaders to take more politically difficult actions that they have not

been able to justify so far.

With China no longer perceived as the country that will soon dominate the world economy, then integration of China into the current international economic structure will be easier. China can be given a greater role in international financial institutions without fear that it will be able to turn them to its mercantilist advantage. It will be easier to hold China to its obligations under the WTO, or the Transpacific Partnership (TPP) if it is concluded and China joins.

Indeed, in the economic sphere, no issue is more important than a rapid ratification of TPP. The economic benefits to both the United States and Japan are modest but positive, though they will grow substantially if China and other countries join. Bur the benefits in terms of global economic leadership are immense. A successful TPP will ensure that in the most dynamic economic region of the world, the economic principles that the United States and Japan believe in set the foundation for international business relations.

3. Realistic Economic Relations with China

While working to improve their own economic performance, the United States and Japan need to take an updated approach to economic relations with China. With China's economy larger than Japan's and its growth rate higher than that of the United States, it is unrealistic to think that the United States and Japan can force China to accept a global system developed largely without China's input. Instead the United States and Japan will have to deal on much more equal economic terms with China. Japan and the U.S. will cooperate with China in some areas, but must contest others not only using international mechanisms such as the WTO but also employing coordinated WTO-consistent actions, particularly in countering Chinese theft of intellectual property.

There are still international economic organizations and arrangements in which it is worthwhile to encourage Chinese participation. Once the current round of TPP negotiations is complete, China should be actively encouraged to join by meeting its requirements. It is worth bringing China more closely into the Organization for Economic Cooperation and Development, if not as a full member, then in some status that would allow it, for example, to join the International

Energy Agency, where it could cooperate on the security and resilience of the worldwide energy market.

In addition, Japan and the United States can play a much more positive role towards the Asia Infrastructure Investment Bank recently announced and led by China. There is no question that Asia needs additional capital for economic development, and the United States and Japan can better work to ensure that AIIB meets international lending standards from within the organization rather than from outside. Moreover, even from the Chinese point of view, in order for the AIIB to be viewed as an international financial institution on par with existing organizations, gaining support from Japan and the United States will be imperative. Constructive support from the United States and Japan would also reassure China that when it initiates actions for the common good, it would find support, not opposition.

However, there are areas in which the United States must contest Chinese activities with far more powerful measures than WTO cases and diplomatic complaints. Most important is protecting intellectual property (IP). It has been justifiably called the greatest illegal wealth transfer in history, amounting to more than \$300 billion every year. Chinese companies have been brazenly profiting from IP pilfered from American and Japanese companies, with the encouragement of official Chinese policies of indigenous innovation, and sometimes active participation of Chinese officials, four from the People's Liberation Army who were identified and indicted by the United States last year.

The response to Chinese activities has amounted to little more than diplomatic protests. The indictments against the four PLA officers have no chance of being enforced. The United States and Japan need to take concerted action to use access to their own markets as a penalty against Chinese companies that have conducted or benefitted from intellectual property theft. Once guilty Chinese companies have been identified, their exports to the United States and Japan can be confiscated, their use of the banking systems halted, their attempts to sell equity in American and Japanese stock markets halted, and other penalties can be levied. Although these measures do not affect Chinese companies that

steal intellectual property and use it for sales in the domestic Chinese market, they would have a powerful impact on the most advanced Chinese companies seeking to become world-class international companies.

In summary, in the economic area the United States and Japan need to insist China meet its WTO commitments, but they also must take actions in areas such as IP when China violates the law.

4. Stronger Combined Military Capability of the United States and Japan

As explained elsewhere in this paper, Chinese military power has increased in recent years, but still remains modest compared to the combined military power of the United States and Japan. Japan has no competing defense priorities to offsetting China, and American defense obligations elsewhere in the world do not appear to be overwhelming. While the United States will need some ground and many special forces for contingencies in the Middle East, the numbers are not huge, and they are not forces relevant to East Asia, which is a maritime and air theater. American naval forces are already 60% deployed in the Pacific, and that weighting could be American air forces are deployable increased. within days around the world, especially to East Asia, where there are many bases available to handle them. Both the United States and Japan need to continue to modernize their forces. If acquisition budgets are not slashed as deeply as they have been in recent years, there is no objective reason that the United States and Japan cannot maintain the current relatively stable maritime and air balance in the region, denying China a high-confidence ability to take and hold Taiwan, the Senkakus or other islands in the South and East China Seas.

In this context, it should be recognized that key U.S. bases in Japan have been, and under the U.S. rebalance to the Asia Pacific will continue to be, an effective, reliable, stable and indispensable U.S. power projection platform for maintaining regional security. Greater shared use of American as well as Japanese bases would enhance that role and increase resilience and operational flexibility of forces from both countries. At the same time, the two countries should recognize and respond to the acute need for consolidation and rationalization of U.S. bases in Japan.

Related to improving its military capabilities, the United States and Japan should continue to engage China's armed forces in exercises such as the multilateral RIMPAC exercise and operations to meet common challenges, from anti-piracy patrols to the Ebola outbreak, tsunami responses, and the full range of peacekeeping operations. In addition, there is scope for an array of confidence-building measures (CBMs) such as hotlines, exercise notifications and observer exchanges, protocols for seamanship and airmanship when encountering ships and planes of the other country, and others.

5. Countering Chinese Aggression in the South China Seas

A fifth set of improvements that needs to be made to the current strategy has to do with countering Chinese actions in the maritime domain, particularly in the East and South China Seas. In the East China Sea the current deterrent posture is generally adequate, although additional sea and air patrols may be required as China increases its Coast Guard and military activity.

The South China Sea

In the South China Sea, China has been challenging international laws by unilaterally drawing the so called "Nine-dotted line" to claim most of the South China Sea as its territorial waters. As explained earlier, currently Chinese support of its territorial claims in the South China Sea is taking place primarily below the level of military confrontation. This gray area aggression has been refined and intensified in recent years, and neither the other claimant countries—Vietnam, the Philippines, Malaysia, Brunei and Indonesia—nor the United States and Japan have formulated effective responses.

Although both Japan and the United States maintain that they take no position on the territorial disputes in the South China Sea to which they are not parties, in fact, both have a strong interest in preventing China from successfully asserting its claim to virtually the entire South China Sea. China has shown clearly that its interpretation of the rights of a country within its Exclusive Economic Zones—especially the restrictions on traditional military activities — would severely limit American and Japanese access to allies and partners in the region. Japan and the United States need to formulate an

effective response to the series of Chinese actions by civil agencies, backed up by military forces that seek to establish *de facto* jurisdiction over the entire South China Sea.

American and Japanese statements about the region have been toughening since Secretary Clinton's 2010 declaration of American interests at the ASEAN regional forum and Prime Minister Abe's speech at the Shangri La Dialogue in 2014. In addition, the United States has been expanding its military contacts with Malaysia, Vietnam and the Philippines, and Japan has provided assistance to the latter two countries to improve their maritime surveillance capacity. However, both countries need a more comprehensive approach

First, the United States and Japan should encourage, even facilitate, at least the elements, if not the exact shape of a settlement for South China Sea territorial and EEZ claims, including those of China. Such an action should attract the support of all countries involved except for China, which of course would denounce it and refuse to participate. This action would further isolate China as the outlier for a reasonable solution, generally acceptable by international standards. However, it could also reassure China. China has some strong claims, and any reasonable adjudication would award to China a healthy EEZ in at least the northern part of the South China Sea. Establishing this settlement would provide a positive diplomatic vision around which all countries except China and its few subservient friendly countries could throw their support.

Second, once there is in place a general scheme for a reasonable settlement of all the conflicting claims—although one not accepted by China—then the United States and Japan should encourage all parties to take actions that are their right and responsibility on their islands, and within their territorial seas and EEZs. The United States and Japan should recognize these actions as legitimate, rather than the current policy of simply calling for restraint and moratoria by all claimants.

China would then in part lose the initiative that it now enjoys. Instead of being the only country that takes the initiative to pass laws, build up and fortify atolls and reefs, and enforce fishing laws, it would be faced with four other countries doing the same, simultaneous strengthening many of the 25 features

that Vietnam claims in the Spratleys, the seven that the Philippines claims, the four that Malaysia claims, and the one that Brunei claims. Chinese fisherman would they be challenged by the coast guards of four other countries throughout EEZs that most of the world considers reasonable.

The objective of these activities would be to demonstrate to China that it cannot necessarily win a game of unilaterally strengthening its own claims—that many can play that game, and that it does not necessarily play to China's advantage.

At worst, an initiative like this would strengthen the claims of countries other than China to their own claims, increasing the resiliency of the region.

Third, the United States and Japan should take actions to support their core interests in the South China Sea—that it not becomes a territorial sea or Exclusive Economic Zone of China. The Chinese interpretation of littoral state prerogatives in EEZs includes restrictions on the military activities of other countries that are intolerable to the United States. The United States and Japan need to conduct traditional military activities such as exercises and reconnaissance and survey air and sea operations with enough frequency and in enough strength to establish precedent and prerogative.

Fourth, in addition to these diplomatic and military actions, the United States and Japan can provide economic and other assistance to claimant countries to build their capacity to enforce maritime security in their claimed territorial waters and EEZs.

Conclusion

China's phenomenal economic growth of the past quarter century has been both enabled and welcomed by the United States and Japan. However with the economic influence and greatly increased military capability funded by that growth, China has developed the power and influence to assert its claims and interests at the expense of other countries in the region and beyond. A combination of historical grievances and authoritarian impulses has fueled China's persistent and increasingly insistent campaign to expand its current territory and influence around the world. The current American and Japanese strategy of encouraging common economic and diplomatic interests with China, while

maintaining military deterrence against direct aggression is no longer adequate to protect both country's interests against Chinese activities such as gray zone aggression and intellectual property theft. The U.S.-Japan alliance needs to adopt a more active strategy of its own—"Assertive Engagement"—to protect bilateral interests while still cooperating with China in forging common responses to common concerns, and equitable and peaceful compromises where interests conflict.

Endnotes

- 1 Today, China accounts for roughly half of all economic activity in East Asia and has become the world's largest merchandise trader. China is expected to contribute the single largest national share of global and regional growth in 2015, and more than \$1 trillion of Chinese foreign direct investment will flow abroad by 2020—much of it to China's periphery—according to consensus forecasts among leading economists and trade specialists.
- 2 There are limits to China's ability to carry out such a strategy: the more it pursues aggressive policies, the more other countries in the region and around the world would react by limiting their economic interactions with China, which would in turn slow China's economic growth. Other countries would also increase their own defense budgets, turn to the United States for support, and in perhaps the most extreme case, form an anti-China coalition, whether formal or informal, to limit China's ability to press its interests in new areas.
- This was essentially the China of roughly 1975 through 2000. During the early part of that period the Cultural Revolution convulsed China. Neither the United States nor Japan felt threatened. The United States and China cooperated against the Soviet Union; Japan sent China large amounts of overseas development assistance, and American and Japanese companies invested in China on a large scale once the country opened to foreign business in 1989. In 1995-96 when China attempted military coercion of Taiwan, the United States responded with superior military force and China had no immediate answer.
- 4 China's slowed economic growth and inward focus would have follow-in effects globally. World economic growth would slow without a growing Chinese economy. Reduced Chinese economic growth would shrink investment and export opportunities for American and Japanese companies.
- 5 Gray zone aggression uses a combination of administrative proclamations such as declarations of fishing regulations for the entire South China Sea and establishment of Chinese jurisdiction over disputed waters, physical actions by non-military units including national oil companies and construction companies, patrols by ships and aircraft of civil organizations such as the Coast Guard and fisheries enforcement departments, and certain patrols by military ships and aircraft.
- 6 Many Japanese worry about the China "perception gap," that the faraway United States does not consider China to be as powerful a threat as nearby Japan does. A related suspicion on the Japanese side is an abiding concern that the United States might choose its interests in China over its interests in Japan because of China's larger size and greater economic opportunity. While the phrase from the 2013 U.S.-China summit communiqué, "a new model of great power relations" plays well in China, in Tokyo it raises fears. On the American side, there is a concern that Japan on the one hand will never forge the internal political consensus to be an effective full partner with the United States. There is a fear that the pacifist strain in Japan will prevent it from the sort of bold, flexible security policies that are needed to deal with a rising China. There is concern on the other hand that if Japan overcomes this pacifist tendency and is successful in changing the military restrictions of its constitution and to develop its military forces, it might become too independent and pursue policies that will not coincide with American interests.

The Changing U.S.-China Balance of Power in the Western Pacific: Getting the Transition Right

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Often obscured in media reports about points of contention in Asia between China and the U.S. – such as the South China Sea maritime disputes or the exclusion of China from the U.S.-led Trans-Pacific Partnership trade agreement – is that the balance of power between the U.S., the longtime hegemon, and China is changing slowly in favor of Beijing. This need not lead to conflict.

During the Cold War and in the years immediately afterward, the U.S. held a huge advantage in its balance of power against China in the Asia Pacific region, especially with regard to military power. Since the beginning of the 21st century, the gap between them has been narrowing. The U.S. is still in the dominant position, but in East Asia and the Western Pacific, a new strategic balance of power is emerging. Neither country has adapted well to this change, leading to increased security frictions and strategic suspicions, which have had adverse effects on both the bilateral relationship and regional security and stability. Will China and the U.S. develop a new balance of power in the Western Pacific? What influence will it have on China-U.S. relations? How can the two sides develop a stable balance of power in this part of the region? These are some of the key questions for the two sides to answer.

In my view, it is an irresistible trend for the two countries to develop a new strategic balance of power in the Western Pacific in the coming decade or two; in the long term, this new balance will be conducive to better bilateral relations.

Shifting toward China

As some experts and scholars in both countries

have pointed out, after the end of the Cold War, on the basis of China having a strong land-power advantage and the U.S. having a strong sea-power advantage, the military strengths of the two countries found a certain strategic balance in the Western Pacific along the lines of China's border or territorial seas. Since the beginning of the new century, however, the original strategic balance has been broken, with China's strengthening, both economically and militarily, and its accelerated defense modernization. In the coming decade or two, if there is no fundamental change in the current trend, the balance between their military strengths and strategies may shift to the first island chain in the Western Pacific. By then, China will have the strategic advantage in its near sea and the U.S. will maintain its strategic advantage and dominance in the vast sea, outside of the first island chain.

In this process, there will be fierce games between China and the U.S.. But so long as the games do not get out of control, frictions between the two countries in the Pacific will gradually weaken as the new balance of power emerges. This will have a positive influence on their long-term relations.

As is well known, security frictions between China and the U.S. for a long time have occurred mainly within the first island chain. Chinese efforts to secure reunification across the Taiwan Straits and to safeguard its territory, sovereignty and maritime rights and interests in the East China Sea and the South China Sea face incessant U.S. interference and intervention. The American close-range military reconnaissance activities directed at China constitutes a long-term security threat.

The development of a new balance of power will be marked by China's enhanced capacity to safeguard its territory and sovereignty and maritime rights and interests and a weakened U.S. capability to intervene. That will be beneficial not only to stability across the Taiwan Strait and the development of cross-strait relations, but also to independent and peaceful resolution of territorial and maritime disputes between China and its neighbors and to the defense of China's territorial seas and offshore waters. The result will be a significant decrease in China-U.S. security frictions.

When the new China-U.S. balance of power in the Western Pacific is formed, Chinese power may still develop beyond the first island chain. However, judging from such variables as technologies, geopolitics and the reliability of military systems, the first island chain will for a long time to come be the line along which their powers balance. This will increase bilateral stability and be conducive to its future development.

Managing a broken balance

The process leading toward this new balance of power will inevitably see the original balance broken. For some time, destabilizing factors will increase. If these are not well handled, China and the U.S. may enter into vicious competition, or even confrontation, in the Western Pacific. This is worrying. In recent years, frictions in East Asia and the Western Pacific have rapidly increased. For example, the U.S. rebalancing strategy has strengthened bilateral military alliances, increasing its military presence in the Asia Pacific and intensifying efforts to guard against and tie down China, causing serious concerns in Beijing and leading to rising calls to break American "containment" or "encirclement." In another example. as the U.S. openly intervenes in maritime disputes between China and its neighbors - particularly the way it put itself into the foreground in the South China Sea in 2015 in the name of freedom of navigation with its so-called routine patrols in waters surrounding Chinese islands and reefs - the risk of a U.S.-China crisis or conflict has markedly grown. In yet another example, as China becomes more capable of opposing external military intervention close to its shores (the American iargon for this is A2-AD, or Anti-Access/Area Denial). the U.S. is deliberating such concepts and strategies as Air-Sea Battle and Offshore Control and Deterrence by Denial, in order to maintain its capability to intervene in the Western Pacific and East Asia. The concept of Air-Sea Battle appeared first, and has developed the fastest. It is now set forth in a U.S. Department of Defense document, targeting mainly China.

These new strategic concepts have caused serious concerns in China and even many American scholars believe that their implementation will pose enormous risks, with limited possibility of success. In particular, Air-Sea Battle might rapidly escalate into war, with severe consequences on China-U.S. relations. In addition, economic competition between the two countries is intensifying. China is actively promoting the Regional Comprehensive Economic Partnership (RCEP), while the U.S. is pushing the Trans-Pacific Partnership to maintain its dominant position in trade policy and economic cooperation in the Asia Pacific. Although this competition is not as tense as the one in the military and security field, bilateral relations may also be undermined if it is protracted.

Finding the steady path

How, then, can we ensure a relatively steady path toward a new balance of power and avoid vicious competition or confrontation between the two countries? This will require both sides to have an objective and accurate judgment of the situation in the Western Pacific, the changing balance of power between them and the other party's strategic intentions. On the basis of that judgment, both sides need to make far-sighted strategic decisions and adopt pragmatic policies and actions. To be specific, the two sides should make efforts in four areas outlined below.

First, Beijing and Washington need to think long term, develop a strategic dialogue on the emerging balance of power in the Western Pacific and strive to achieve at an early date a basic common understanding on how security and stability in this region will be best maintained. The content of the dialogue should include:

Trends of development and change in the strategic balance in the Western Pacific and the positions, roles and responsibilities of China and the U.S. in the Western Pacific:

How China and the U.S. will avoid conflict or confrontation and develop a relationship that is mutually adaptive and inclusive, with benign competition and active cooperation;

How to promote resolution of disputes in the region and strengthen non-traditional security cooperation; and, Interactions between regional multilateral security-cooperation mechanisms and America's bilateral military alliances.

The basic objectives of this dialogue should be for the U.S. to gradually change its long-term policy of diplomatic and military intervention in the Western Pacific and accept China's effective maintenance of state sovereignty and territorial integrity and greater say in regional affairs (including in regional multilateral dialogue and cooperation mechanisms). China, for its part, should explicitly assure the U.S. that its policy of striving for peaceful reunification with Taiwan and peaceful resolution of maritime disputes with its Asian neighbors and Japan will not change, that China does not intend to demand U.S. withdrawal from East Asia or deny the U.S. freedom of navigation in the Western Pacific so long as it's pursued in a manner consistent with international law or to challenge its global leadership. The two countries will agree that they will jointly undertake main responsibility for maintaining regional peace, security and stability.

Undoubtedly, it will not be easy for the two countries to achieve such a common understanding. But they have to make unswerving efforts in this direction, because the maintenance of security and stability in the Western Pacific serves the common interests of not only China and the U.S., but all other countries in the Asia Pacific.

Second, the two sides should endeavor to have balanced strategic-hedging policies. Since the end of the Cold War, the U.S. has implemented a hedging policy towards China, with cooperation and engagement, on the one hand, and counterbalancing and preventive measures, on the other. China has responded with a similar two-handed policy. In recent years, frictions between the two countries in the Western Pacific and East Asia have increased and started to spread to new strategic domains (such as cyber space and outer space). Both countries, their militaries in particular, have started to regard each other as potential adversaries and are preparing for worst case scenarios. Some Chinese scholars believe that current U.S. policy toward China is moving dangerously from "preventive hedging" hedging.;,2 To avoid "containment consequences for bilateral relations, the two countries and their militaries should cooperate in areas of common interest, so that their hedging policies will remain roughly balanced rather than being heavily dominated by counterbalancing and preventive measures, let alone moves toward containment. In addition to expand bilateral economic and trade operation and people-to-people communication, to promote cooperation in global governance,³ to boost the economic prosperity in East Asia and strengthen cooperation on non-traditional security in the Western Pacific (especially the de-nuclearization of the Korean Peninsula) will be important ways to contain and mitigate differences or frictions. The two sides should set their eyes on the long term and strive for more engagement and cooperation. (In academic exchanges, some American scholars and former government officials have expressed agreement on this proposal of mine.)

Third, the two sides must significantly improve management of differences and crises. increasingly prominent geopolitical between the two countries have had serious, adverse impacts on their relationship on the question of sea lines of communications (SLOCs) and in other strategic fields such as cyberspace, outer space and nuclear issues. Both China and the U.S. should regard the no-conflict, no-confrontation agreement between their leaders as the bottom line that must be protected. and place a priority on crisis avoidance and the prevention of escalation. They should be highly vigilant against any crisis or conflict caused by differences between them and those caused by thirdparty factors.

Among the many hot-spots in East Asia and the Western Pacific, the Korean Peninsula and the Taiwan Strait should always be the most important focus in crisis management between China and the U.S., while the most pressing demand of the day is to prevent a conflict in the South China Sea. To this end, the diplomatic and defense services should further improve the relevant security dialogue and crisis management mechanisms and redouble efforts to strengthen security confidence-building measures (SCBM). This includes strengthening the crisis management function of bilateral hotlines; further enriching the nascent mutualnotification mechanism for major military operations and the code of conduct on military encounters in the air and at sea (COC); establishing joint working groups in the foreign affairs or defense departments to deal with unexpected incidents; engaging in discussions on signing a bilateral no-first-use agreement on nuclear weapons; and refraining from conducting attacks on outer space assets or conducting cyber-attacks against each other.

In short, the two sides should be fully aware that their relationship is in nature different from that between the U.S. and the former Soviet Union. China and the U.S. are not enemies. The extensive economic cooperation, and some major security cooperation, between them did not exist between the U.S. and the Soviet Union. Both countries should be confident of managing well their differences and crises.

Fourth, China and the U.S. should strengthen coordination and cooperation in the various multilateral security and economic dialogue and cooperation mechanisms in East Asia and the Asia Pacific. They, of course, have differences and competition within these mechanisms. However, in multilateral arenas, the common interests of countries are discussed and pursued. And, as such, the possibility of virtuous competition between China and the U.S. is greater than that of vicious competition. AT the East Asia Summit (EAS), the ASEAN Regional Forum (ARF) and other ASEAN diplomatic and security talks, the two sides should first work together to promote multilateral cooperation (including establishing confidencebuilding measures) in the region in areas they have common ground such as non-proliferation, public health, disaster management, search and rescue at sea and maritime safety. Furthermore, the two sides should create conditions for ASEAN+3 and RCEP integration and APEC and TPP co-operation to be mutually accommodating, inclusive and complementary. In the future, as regional cooperation develops, East Asian and Asian economic integration should be open to the U.S., and the TPP should welcome China's participation. In the long term, the two sides should also work together towards creating a unified multilateral security cooperation mechanism in the Asia Pacific region. Positive interaction between the two countries in multilateral dialogue and cooperation mechanisms will help mitigate frictions and turbulence caused by the changing balance of power in the Western Pacific.

In the near future, if China makes progress on properly settling territorial and maritime disputes with Japan and some Southeast Asian neighbors by agreeing on a code of conduct, a breakthrough on joint development of maritime areas and sustained bilateral negotiations, this will play an important role in facilitating a stable China-U.S. balance of power in the Western Pacific. It would also help if America's bilateral military alliances in the region – the U.S. and Japan, the U.S. and South Korea and the U.S. and Australia – would each develop a security dialogue with China.

Endnotes

- 1 Technological progress and increased complexity in operational systems will certainly strengthen the geographical advantage of China as a land power in the near sea of the Western Pacific. But the situation in distant seas is completely different. See "Zhongmei Zai Xitaipingyang De Junshi Jinzheng Yu Zhanlue Pingheng" (Military Competition and Strategic Balance between China and U.S.A in the Western Pacific). World Economy and Politics. Issue 5, 2014.
- 2 There are two types of strategic hedging policies in the world: preventive hedging and containment hedging. The former has a certain rationality and may produce hedging effects, while the latter contains huge risks and may intensify differences and lead to conflict.
- 3 China and the U.S. have significant common interests on many issues of global governance such as addressing climate change, counter terrorism, non-proliferation, nuclear security, security and stability in the Middle East, poverty reduction, financial risk management, stopping international spread of infectious diseases and cross-boundary crimes, etc.. Although the two sides do have some differences on these questions, they stand obvioU.S.ly secondary to their common interests. China-U.S. relationship in the whole world is significantly different from that in the Western Pacific.
- 4 While focused on economic development and cooperation, East Asia Summit also discusses political and security issues.
- 5 So far, ARF is the most important channel of official multilateral security dialogue and cooperation in the Asia Pacific region.

Negative Scenarios I: No Escape from Troubled Seesaw in Japan-China Relations*

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Japan's relations with China for about two years from September 2012 were the worst they had been since normalization in 1972. In late 2014 and over the first months of 2015, the impression spread that relations had turned a corner. Some saw signs of a return to the seesaw in relations observed for about two decades previously. Yet, since September 2012, China continues sending its patrol boats regularly into territorial waters around the Senkaku Islands. Evidence from Chinese commentaries on Prime Minister Abe's April visit to Washington and Japanese reports of new Chinese oil and gas exploration very close to what Japan regards as the mid-line in the East China Sea suggest that, if this is a seesaw, it is a more troubled one, sinking much lower than before. We should not be lulled by the revival of summits or President Xi Jinping's invitation to Abe to attend the September 3 seventieth anniversary commemoration into expecting stable, closer ties.

When the Japanese government decided to purchase three of the five major Senkaku Islands from a private owner, there were two different interpretations of this act in Beijing. The hardliners saw this as Japan's open provocation vis-à-vis China and a challenge to its sovereignty. In contrast, the moderates saw that the Japanese government purchased the islands to cool things down by outdoing the Tokyo governor Ishihara Shintaro, who had declared he would buy the islands and construct a port and facilities for stationing staff. After Hu Jintao and Xi Jinping decided to take a hard-line approach, the Chinese media

became fiercely confrontational against Japan and created an atmosphere that no longer allowed any one in China to express different public opinions. The backdrop to the hard-line policy taken by the Chinese leadership was the eighteenth National Congress of the Chinese Communist Party scheduled in November 2012. The purchase of the islands was made when the power struggle was at its height and, thus, no one could dare to take a soft stand against Japan.

Anti-Japanese demonstrations were allowed in a good number of cities and many of them became violent. As a result of arson, destruction, and looting, it was estimated that the damage inflicted on Japanese stores, restaurants and factories amounted to no less than JYP 10 billion. The Chinese government decided to send their patrol vessels regularly into territorial waters around the Senkaku Islands, with naval ships waiting in the vicinity for contingencies. Japan-China relations took a nosedive to the lowest level since 1972, and, in the view of some, even since the end of WWII.

However, China started seeking détente in 2014. Ministerial meetings gradually resumed from the spring, first in multilateral settings and then moving toward bilateral meetings in China. This upgrading of meetings culminated in the Abe-Xi meeting on the sidelines of the November APEC summit hosted by Xi in Beijing. Before the meeting, China demanded that Japan acknowledge that there is a territorial dispute over the Senkaku Islands and promise that Abe would not visit the controversial Yasukuni Shrine again. A

few days prior to the November 2014 Abe-Xi meeting, upon the request of the Chinese, diplomats cleverly crafted an equivocal agreement that could be interpreted in different ways and cleared the way

In April 2015, when state leaders gathered in Indonesia to celebrate the sixtieth anniversary of the Bandung Asia-Africa Conference, Abe and Xi met for the second time and exchanged smiles as well as positive views about the development in bilateral relations in a more relaxed and amicable atmosphere. In May, Xi delivered a most friendly speech in front of a group of three thousand Japanese that visited Beijing, saying: "Through you, I extend my heartfelt greetings and good wishes to the Japanese people...The Japanese people were also victims of the war."

What caused this change in Xi Jinping's attitude towards Japan? There was no basic change of position on the Japanese side. First, any change in the status quo by physical force was unacceptable, and as long as provocative China continued its maritime advancement, Japan had no choice but to adopt some hedging measures, including strengthening the alliance with the United States. Second, the two sides did not let the questions of the Senkaku Islands and the Yasukuni Shrine disrupt the entire relationship. And third, the two powers were responsible to the region and the world for improving and developing their relations, so the leaders could meet without any preconditions. In fact, Japanese political heavyweights kept visiting China in an attempt to crack an opening in the gridlock. Such visits included those by Komeito leader Yamaguchi Natsuo in January 2013 and by the former prime minister Fukuda Yasuo in July 2014. It was the Chinese side that finally changed its position and sought rapprochement.

The factors in China's policy shift seem to have included the following. First, there was increased tension in the military or security sphere. Two near miss incidents between military aircraft took place consecutively in May and June 2014. If an accident had occurred, it was highly likely that the conflict would have escalated rather badly. Xi wanted to avoid war no less than Abe. In addition to other reasons for this, he was in the midst of a serious anti-corruption campaign in the military.

Second, China's economic slowdown became a source of increasing concern for the CCP leadership. In

addition to the grave fiscal debt that had emerged in many localities, the impact of the economic slowdown on social stability was being felt. According to the Institute of Sociology of the Chinese Academy of Social Sciences, there was a resurgence of social contradictions in 2014, and "Hot Incidents of Social Contradiction/Conflict" that attracted nationwide attention amounted to around 400 cases that year. Especially, there was a large increase in labor strife. The Chinese leadership eventually recognized that the political confrontation with Japan was affecting economic exchange; the amount of Japanese investment from January to September 2014 decreased by 42.9 percent compared to the previous year. Minister of Commerce Gao Hucheng told a high-level economic delegation from Japan in September that a cooling in politics leading to a downturn in economics was something he did not want to see.

Third, internationally, China found it increasingly difficult to promote the "new model of major power relations" with the United States. This was because strategic competition with the United States was intensifying due to China's continuous maritime advancement and their different interpretation of the legality of military actions in the Exclusive Economic Zones (EEZs). In Beijing, there was also recognition that the hard-line policy against neighbors, including Japan, the Philippines, and Vietnam, had not brought any benefit to China but, rather, had promoted a united front against China such as at the ASEAN Regional Forum or the Shangri-La Dialogue. These contributed to China's emphasis on its Silk Road Initiative and neighborhood diplomacy, resulting in a "rebalancing" to Japan.

Finally, in terms of domestic politics, rapprochement with Japan proceeded while Xi Jinping consolidated his power base by making significant progress in his anti-corruption campaign. He expelled Xu Caihou, the former vice-chairman of the CMC from the party at the end of June 2014, and a month later formally announced that Zhou Yongkang, a former member of the Politburo Standing Committee, was under investigation. Zhou was eventually expelled from the CCP in early December. It was widely rumored that Xu and Zhou supported Bo Xilai, the disgraced former party secretary of Chongqing, in his challenge to Xi. In addition, there is an increasing number of Chinese tourists visiting Japan, who find the country culturally attractive and different from what they had learned through patriotic education.

Considering that these factors all remain in effect, we should be able to find good prospects for the bilateral relations to come. However, nothing is simple in Japan-China relations in recent years. Immediately after the amicable meeting with Xi, Abe made a successful visit to Washington, but the reporting on the visit by Xinhua was critical and satirical as ever. "Abe's visit to the U.S. and his laughable performance invites condemnation"; "Abe's visit to the U.S. and his laughable performance ends in voices of protest and strong criticism." Such were the headlines of Xinhua articles on the topic.

Then in mid-June, Abe gave an exclusive interview to Phoenix Television, in which he replied to Xi's May speech and sent out friendly messages to the Chinese people. "Japan inflicted sufferings to the peoples in Asia. It was on this deep remorse that Japan, to this day, has strived to contribute with all we have to the peace and development of the world, and particularly development in Asian countries...Seventy years ago, Japan made a vow that we shall never go to war again, and this vow forever will not change." Surprisingly, the mainland media ignored this interview. It was a snub to Abe, but it also looked as if the Propaganda Department did not pay much attention to Xi's signal that he wanted to improve the bilateral relationship.

While the Japanese Diet discussed the new security legislation for strengthening the Japan-US alliance, retired PLA generals lashed out at the "revival of Japanese militarism," as usual. Meanwhile, the Japanese side picked up on China's construction of new oil/gas exploration platforms near the middle line that Japan regards as the dividing line for the EEZs in the East China Sea. The Japanese government criticized such unilateral action as against the spirit of the 2008 agreement on joint development. The defense division of the Liberal Democratic Party (LDP) rejected the initial draft of the annual Defense White Paper and made the Ministry of Defense add information on this move by China. The timing

suggested that, faced with strong opposition, the LDP needed China's mischief as ammunition in passing the controversial legislation.

Thus, despite the bases for resilience such as economic interdependence and cultural affinity, we easily can identify some structural factors that impede the smooth recovery in Japan-China relations. The leftist, hardliners in China are adamant on sticking to the "Japan threat theory." Especially, the image of Abe as a "militarist" and "historical revisionist" is a convenient target for arousing nationalistic sentiments and justifying China's strategic advancement and assertiveness. Xi Jinping is, arguably, torn between these and the reformist moderates who are more inclined towards mending ties with Japan for peace and development. It seems the gap between them is so wide that Xi has difficulties finding a middle ground. The "China threat theory" can also be handy for Abe, who faces societal opposition to his security legislation. At the same time, he knows the Japanese public understands the importance of China and that he would be criticized if he failed to improve bilateral relations.

The two governments are now negotiating over Xi's invitation to Abe to attend the September ceremony to commemorate the war. Nowadays, no issue between Japan and China is simple, as it involves people's emotions, economic and strategic interests, the international environment, and domestic politics. There are various factors that could drive the bilateral relations either way. But if the economic slowdown in China results in more labor strife and other signs of social instability, the leaders in Beijing would be tempted to tilt towards the hardliners and reactivate the "Japan threat theory" in an even bigger way. Japan and China have entered an era of both cooperation and conflict, and the seesaw in relations most likely will continue for some time. Yet, with China's maritime advancement and heightened nationalism, this is a more troubled state than existed prior to the 2012 slide in relations. Recovery to that state seems very unlikely in the near future.

^{*}Originally published in The Asan Forum, an online publication for in-depth interpretation of rapid changes across the Asia-Pacific region.

Negative Scenario II: Problems Are Structural

On September 3, 2015, Beijing's sky was "parade blue." It was a rare day when the U.S. embassy index indicated that the air quality was "good." Following the "APEC blue" last November, the Chinese government once again displayed its power to achieve what seems hardly possible. Yes, the parade was a display of power, indeed, with the brandishing of modern weapons and the disruption and restriction on citizens' work and livelihood. President Xi Jinping, in his dark Mao-suit, announced on the Gate of Heaven that the Chinese people fought gallantly in the past and that the Chinese nation, having created a splendid civilization of over 5000 years, would certainly usher in an even brighter future.

Well, an even brighter future for whom, people abroad are asking, including Japanese who have been following the September 3 events with close attention. On the day of the parade, a goodly number of citizens were denied access to hospitals near Chang'an Avenue because of security control. Internally, people have recently been made even more aware that the Communist Party relies on the naked exercise of power to achieve its interests and maintain order. There is no rule of law, and state interests stand above human rights. That is, people are resigned to live under Pax Communista, an order supported by the outstanding power of the Party. Trying to channel their discontent, the leadership seized the opportunity of the 70th anniversary of war's end to combine claims of a glorious victory (however misleading some of the assertions) with the bombast of a militaristic display meant both to inspire pride at home and to awe the outside world, not least Japan—the historical focus and an obvious target of China's strength.

Prime Minister Abe Shinzo could have shown up in Beijing under the blue sky, although it was a remote possibility that he would have attended the military parade itself. Abe had indicated on Japanese television that he might visit China if the ceremonies were "not anti-Japan but reconciling" in character. However, Abe's remorseful statement issued on the eve of the 70th anniversary was received with skepticism in China, while Xi's remarks in the commemorative

events did not mention the postwar efforts for cooperation and reconciliation between the two nations. To this, Cabinet Secretary Suga Yoshihide expressed his big regret that the Chinese side did not accept Japan's request and failed to include the element of reconciliation in Xi's speech.

Another fact that annoyed the Japanese side was the attendance of President Park Geun-hye of South Korea at the military parade. Her acceptance of the invitation to the ceremonies was understandable, considering her country's economic dependence on China, and she did gain a point in Beijing by extracting China's agreement to a Japan-South Korea-China trilateral summit in the autumn. However, her attendance at the parade gave the appearance in Japan of symbolizing her inclination to lean towards China in the strategic competition in the Western Pacific and revived talk of her close alliance with Xi Jinping in the contemporary "anti-Japanese resistance" over history.

Neighbors including South Korea are aware that China relies on power to achieve its interests, and they do not accept that. A good example is the attempt to change the status quo around the Senkaku Islands by physical force, i.e., by sending coast guard vessels into the territorial waters and claiming that they are patrolling. Needless to say, such forceful actions occur more frequently, intensively, and extensively in the South China Sea. If the "brighter future" of China implies the "revival" of Pax Sinica, as of now it is likely to become an extension of Pax Communista. That is, the order will be supported by the outstanding

power of China, and there will be no rule of law. No neighbor would want that, and they are all scratching their heads over the dilemma that economic cooperation with China increases the potential threat to their security. Many Japanese were reminded of this reality by the military parade.

It is strange and interesting that the Chinese themselves often do not realize such concerns of their neighbors. Nationalism can be mesmerizing. Xi Jinping has remarked many times that there is no DNA of invading others in the blood of the Chinese. Admiral Zheng He of the fifteenth century, who is often extolled in China as the symbol of its peaceful maritime advancement, is considered an invader in a number of regions in South and Southeast Asia. Whenever I tell my Chinese friends that they should not call their neighborhood diplomacy "peripheral diplomacy" since it implies that you are the center or the "middle kingdom", they awaken to this and acknowledge that I am right.

For Japan-China relations, there is a case for cautious optimism as long as Xi Jinping stands firmly at the helm, given structural issues. First, there is a contradiction between development and nationalism, the two pillars that support the legitimacy of Communist Party rule. For peaceful development, China needs to improve ties with Japan. However, the way the Party arouses nationalistic sentiments damages its relationship with Japan. For example, in celebrating the seventieth anniversary, there was no mention whatsoever of the history of the past 70 years in which China mended ties and cooperated with Japan, receiving enormous contributions from Japan toward its development.

Second, since the Party has made Japan a safe target of criticism through its patriotic education, opposition to the leadership can take the form of anonymous attacks on Japan. In August, a Xinhua commentary demanded that the Japanese emperor apologize for the war, which provoked a sharp protest from Suga, the cabinet secretary. If, for example, further economic downturn or the approaching Party Congress intensifies political infighting, opposition to Xi may increase such provocations. In the failed negotiations over Abe's September visit to Beijing, the Chinese side reportedly insisted that Abe should come and take part in the ceremonies on September 3rd. One wonders if such a tall order stemmed from increased internal pressure resenting Xi's rapprochement with Japan. Of course, as I mentioned in the first statement, it would be tempting for Xi himself to resort to arousing nationalistic sentiments if social and/or Party unity grows even more unstable.

The need to reduce the heat of exclusive nationalism exists on both sides. However, the problem is much more serious among the Chinese not only because of "patriotic education," but also since amid modernization they tend to be fixated on the "rich nation, strong military" paradigm. It is true that although politics in China has not changed or has even been retrogressive, the Chinese people and the Chinese society are changing rapidly due to marketization and what comes with it. Nevertheless, it most likely will take some time for the majority of the Chinese to liberate their thoughts and free themselves from Party propaganda on the "splendid civilization of over 5000 years" and its modern humiliation.

Beijing's Taiwan Dilemma

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As Beijing continues to pursue its goal of securing the unification of Taiwan with the rest of China, it faces a serious dilemma—a dilemma as difficult to manage as the dilemmas faced by Taipei in managing its complex and controversial relationship with China.*

Peaceful unification seemed possible—at least over the very long term—when the governments on both sides of the Taiwan Strait shared that objective, when China seemed embarked on the same road of gradual political liberalization as Taiwan, and when Taiwanese largely regarded themselves, either partly or entirely, as "Chinese." The "one country, two systems" formula advanced by Beijing for both Hong Kong and Taiwan in the early 1980s appeared to be a feasible way of achieving unification while granting both territories a high degree of autonomy on domestic issues.

Today, none of these conditions continues to hold. Most Taiwanese have adopted a Taiwanese identity and many no longer regard themselves as Chinese at all, except perhaps in a very abstract ethnic or cultural sense. As a result, the overwhelming majority of Taiwanese desire continued autonomy, rather than favoring unification. The process of political liberalization in China appears to have stalled and even reversed, whereas Taiwan's democracy has become more and more consolidated and institutionalized. The perception that China is tightening its control over Hong Kong, is imposing increasing limits on its autonomy, and is unsympathetic to public demands for a more democratic electoral system, is making the "one-country, two systems" formula less appealing to Taiwan as well as to many Hong Kongers.

China is aware of these trends and is attempting to reverse them. So far, however, its efforts have been unsuccessful at best and counterproductive at worst. Increasing the level of economic integration, intended to demonstrate the benefits of a closer relationship with China, is instead perceived as increasing inequality on Taiwan, reducing opportunities for Taiwanese youth at home, and granting Beijing undue influence over the island in the service of a political agenda that Taiwanese no longer accept. Attempts to put pressure on Taiwan by restricting its international space, conducting periodic military exercises and increasing its missile deployments directed at Taiwan, and threatening to cut back on economic relations are viewed as signs of continued hostility, making Beijing an even less attractive partner. The efforts to invoke a common Chinese identity appear anachronistic and fall on deaf ears, despite the undeniable historical and cultural connections between Taiwan and mainland China.

In retrospect, it appears that China may have missed an important opportunity in the late 1980s, when cross-Strait relations began to unfreeze and economic interaction began rapidly to increase. That was a time when some anticipated that China might engage in a gradual policy of political liberalization and reform that would parallel what had occurred on Taiwan sometime earlier, up to and including the tolerance of an informal opposition (what in Taiwan were called the dangwai) that could contest elections to local executive and legislative positions. This would have made unification a more plausible alternative for Taiwan, and would have built upon what was still a

widespread Chinese identity on the island. Such was not to be. Instead, the gap in political systems widened, rather than narrowing. The growing interaction across the Taiwan Strait, intended to bolster a common identity, instead made Taiwanese aware of the growing differences in political institutions and political values between Taiwan and the mainland. The democratization of Taiwan made those values and institutions central to their identity and their way of life. If China has now in some sense "lost" Taiwan, that can be traced to decisions it made in the late 1980s.

Given this, Beijing now faces a dilemma. While it can almost certainly dissuade Taiwan from a formal declaration of independence—and indeed few in Taiwan support de jure independence—its strategies for promoting a common identity and a renewed commitment to eventual unification are unlikely to succeed. Increasing pressure on Taiwan through the threat or use of economic sanctions or military force will either be risky, counter-productive, or both. Attempts to narrow the gap in political institutions and values through domestic political reform would pose major risks to the stability of China and the continued dominance of the Chinese Communist Party. The issue for China is therefore: how can it promote its goal of

unification when trends on Taiwan are heading toward continued political separation, when its efforts to reverse those trends through either economic carrots or military and diplomatic sticks have failed, and when political reform appears to be off the agenda? If a solution to that dilemma cannot be found soon, the separation of the two sides will become more and more entrenched, and the dilemma will become even more difficult. Beijing's only hope appears to be to put pressure on the U.S. to reduce its commitments to the security of Taiwan and to accept or even promote peaceful—if involuntary—unification. But given the strains in U.S.-China relations and the shared political values between the U.S. and Taiwan, that strategy holds little hope either.

In short, Beijing's relations with Taiwan reflect a missed opportunity and embody a true dilemma—a choice among options whose blend of costs and benefits make all of them unappealing. Given the consolidation of a Taiwanese identity, even the most enlightened option—renewed political liberalization and reform at home—may prove to be too late.

^{*} Syaru Shirley Lin, Taiwan's China Dilemma: Contested Identities and Multiple Interests in Taiwan's Cross-Strait Economic Policy (Stanford: Stanford University Press, forthcoming 2016).

Heading towards Troubled Waters? The Impact of Taiwan's 2016 Elections on Cross-Strait Relations

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I. A Bird's Eye View of the Trajectory

Cross Taiwan Strait relations play an important role in defining Taiwan's politics. The national identity of the Taiwan people is torn between exclusively Taiwanese that treats China as another nation, and Chinese-Taiwanese that views the Chinese across the Taiwan Strait as kinsmen. Two historiographies compete for dominance in Taiwan: one adopts a jus soli approach and views Taiwan's history as a process of melting immigrants from different origins into Taiwanese, and the other takes a jus sanguinis view that treats Taiwan as a frontier province of the Chinese nation. Economically, mainland China has become Taiwan's largest trading partner and the main destination of the island's outbound investment, hence Beijing is in a position to influence Taiwan politics. Foreign relations of Taiwan have been hampered by Beijing which insists that there is only one China, and Taiwan is an integral part of it, thus denying the island of representation in the United Nations and most other important international organizations. The main goal of Taiwan's defense policy is to thwart a possible invasion by the People's Liberation Army from across the Strait. In all, Taiwan is overshadowed by its relationship with mainland China.

The impact of Taiwan politics on cross-Strait relations is equally pronounced. As mainland China has been governed by the Chinese Communist Party since 1949, and the CCP regime has always held a staunch position on unifying the mainland and Taiwan, the goal of Beijing's Taiwan policy is a constant. The same cannot be said of Taiwan. The Blue camp and the Green camp hold quite different ideas on Taiwan's

national identity, and on the appropriate relation with the Chinese mainland. The Blues see Taiwanese and mainland Chinese as compatriots. The traditional view of the Kuomintang (KMT) is that Taiwan is a frontier province of the Republic of China (ROC), and the bastion for national reunification. As the prospects of the ROC recovering the mainland become dimmer, and the mainland successfully transforms itself into an economic powerhouse with its open-door policy, the Blues work for closer cross-Strait relations. They do not rule out the possibility of eventual unification with the mainland, if the conditions are ripe. On the other hand, the Greens see Taiwanese and mainland Chinese as two different nations, living in two different countries. With Beijing committed to unifying Taiwan, its policy is viewed with great suspicion, and cross-Strait relations are meticulously scrutinized. The Greens' goal is to build a new and independent nation, devoid of any legal tangling with China. Naturally political competition between the Blues and Greens in Taiwan's electoral politics cast a long shadow on cross-Strait relations.

There have been wild ups and downs in the cross-Strait relations. Long-term stalemate was thawed by the breakthrough in the early 1990s, encapsulated as the "1992 Consensus" that made it possible to for the two sides to affirm their commitment to "one China" but with different interpretations. The thaw euphoria was swiftly replaced by antagonism, as Taiwan seemed to gain diplomatic ground in the aftermath of the 1989 Tiananmen crisis and President Lee Teng-hui was able to visit the U.S., albeit in a private capacity. The missile scare of 1995-96 that followed pitted the sablerattling PLA against the American carrier combat

group that came to Taiwan's rescue after the mainland threatened to punish Taiwan for its diplomatic breakthrough and for holding its first direct presidential election, a sign towards an independent national entity. Lee's "two-state theory" (liangguo lun) fueled tension as it was the first time when a ROC president would conceptualize cross-Strait relations as between two countries. The election of Chen Shui-bian as president from the pro-independence Democratic Progressive Party further galvanized the situation. Throughout the Chen Shui-bian era (2000-2008), despite continued growth of trade and investment, the strategic "hawks" on each side advocated hardline positions and thus reinforced each other's intransigence. The rise of "national identity" polarized cross-Strait relations, making compromise politically suicidal. Chen's calls for "one country on each side," rewriting the constitution, and joining the UN under the name of Taiwan, all geared to mobilizing electoral support, bordered dangerously on declaring "independence." They were reciprocated by the passage of the Anti-Secession Law in 2005 by the National People's Congress in Beijing. The Taiwan Strait became a world-noticed flashpoint of military confrontation.

The KMT's political comeback in 2008 was a watershed. Well before that date China had courted the anti-independence KMT and Taiwan businesses with mainland links in a united front against Chen's DPP government. Hu Jingtao, the CCP's general secretary, was eager to reciprocate Ma Ying-jeou, the newly elected KMT president, for the latter's endorsement of the 1992 Consensus. Taiwan's Straits Exchange Foundation (SEF) and the mainland's Association for Relations across the Taiwan Straits (ARATS), the two semi-official agencies in charge of cross-Strait negotiations, was reconnected. The thaw resulted in the resumption of direct air and shipping links, a diplomatic "truce," booming tourism, financial liberalization, quarantine and medical cooperation, judicial assistance, investment protection, particularly an overall Economic Cooperation Framework Agreement (ECFA).

Ma's rapprochement with the mainland has been carefully circumscribed, concentrating on the economic front, while conspicuously evasive of political negotiations that may lead to unification (even a peace accord that may have such implications) which is the mainland's ultimate goal. The National Unification Guidelines remain "frozen" and Ma has precluded any discussion of reunification during his term by his "three no's" (no unification, no

independence, and no use of force). The fact that Hu and then his successor Xi Jinping have been willing to play along with Ma testifies the mainland's intense annoyance with the pursuit of formal independence by Ma's predecessor, relief at having found a negotiating partner willing to render at least nominal acceptance of the "one China" formula, and the difficulty they have encountered in reaching a compromise with the new DPP politicians who planned a political comeback in 2016.

A political comeback was indeed achieved by the DPP through a landslide victory in the January 2016 presidential-cum-parliamentary elections. The DPP's presidential candidate Tsai Ing-wen beat her KMT rival Eric Chu by an astonishing 25 percent of popular vote (56.1 percent vs. 31 percent), and the DPP captured majority of seats (68 of 113, compared with the KMT's 35) in the Legislative Yuan for the first time. The result was well-anticipated, and the CCP and the DPP had attempted to explore the possibility of reaching a compromise on the thorny issue of national identity before the elections. Conciliatory gestures were made, but the gap remained unbridgeable. Would turbulence govern cross-Strait relations again, like in 2000-2008 when the first DPP president Chen Shuibian ruled?

II. Tsai's Choice: A Repeat of Chen Scenario?

There are striking similarities between Chen in 2000 and Tsai in 2016, the first and second DPP president. Do they foretell what is in store for Taiwan? Before this question can be answered, we should recap Chen's trajectory, or the Chen Scenario. It goes as follows. Initially a moderated position was taken to gain middle voter's support in winning the presidency. This was followed by orchestrated moves to court Beijing in order to further reduce tension (reciprocated). Then came an abrupt shift to ideological mobilization of the president's political base in economic malaise as the next presidential election approached (also reciprocated). Finally came a toning down of rhetoric after the president's successful reelection. Chen's flip-flops were caused by the needs to seek electoral victory and manage cross-Strait and Taiwan-U.S. relations. The domestic concern pushed for a radicalization of position when the government's economic performance was poor. The cross-Strait and international relations on the other hand demand moderation. When the two requirements collided, Chen opted for domestic victory first, then swiftly shifted to assure the mainland and international audience. In short, there was a wide gap between the domestic and

cross-Strait/international equilibria for Chen, hence the fluctuations of his ideological position. In comparison, the convergence of Ma's domestic and cross-Strait/international equilibria foretold the consistency of his position. The question now is to whether the Chen Scenario would repeat itself in 2016-2020 under Tsai.

Committed and Flexible Leadership

Firstly, both Chen and Tsai are committed to Taiwan independence. Neither has shown any willingness to accept the "one China" principle, however interpreted. On this core commitment, Chen's record is for everyone to see, including his drive for defensive referenda, call for rewriting the constitution, initiative to join the UN under the name of Taiwan, order to remove "China" from the names of a host of state-owned enterprises and postal stamps, amongst a plethora of high-profile symbolic gestures. Tsai's credential in this regard is less conspicuous, but still robust. Foremost is her critical role in the advisory group on strengthening the ROC's sovereignty (qianghua Zhonghuaminguo zhuquan diwei xiaozu) that Lee commissioned in 1998 which came up with the proposal of "two-state theory." That theory was used by Lee to torpedo the visit to Taiwan by Wang Daohan, the mainland's chief negotiator, at a time when Lee considered Taiwan vulnerable to pressure from Beijing and Washington. Tsai was much closer to Lee than to the DPP at that early time. She was recommended by Lee for the job of the minister of mainland affairs in Chen's first cabinet. Throughout her political career, Tsai was aided by Lee, who after being excommunicated by the KMT became a most ardent supporter of Taiwan independence, and the spiritual leader of Taiwan Solidarity Union, the most pro-independence political party in Taiwan. Tsai's close link with Lee added to her political color.

Although ideologically committed, both Chen and Tsai are realists, and are capable of adjusting their positions to the needs of the time. Such tendency brought about the image of political moderation that contributed to their respective elections in 2000 and 2016. For Chen, the passage of the Resolution on the Future of Taiwan by the DPP in 1999 under his influence was a landmark that shifted the party's ideological position from Taiwan independence to two Chinas, though grudgingly. His "new middle line" and "third way" rhetoric mimicked that of Tony Blair and Bill Clinton, and positioned himself closer to mainstream public opinion than diehard Green politicians. For Tsai, her equation of the ROC and

Taiwan in 2011 was an early sign of her two Chinas position. Her "Taiwan Consensus" was raised as an alternative to the 1992 Consensus. Although it showed her resistance to the KMT-CCP formula, the Taiwan Consensus nevertheless was a catch-all term that did not tilt towards Taiwan independence or two Chinas. In her second bid for the presidency, Tsai pledged to maintain the status quo, and "push for the peaceful and stable development of cross-Strait relations in accordance with the will of the Taiwanese people and the existing ROC constitutional order." A natural extension of that position is Tsai would uphold the one-China principle inherent in the ROC Constitution, and so should not disagree with the 1992 Consensus. However, Tsai maintains that the 1992 Consensus is but one of the options for the Taiwanese people, suggesting her resistance to that political formula. In all, Tsai stepped up her "moderation offensive" during the presidential campaign, which contributed greatly to her winning support from the middle voters, and American acquiescence to her candidacy. In all, the fact that Chen and Tsai are both committed to Taiwan independence, and are capable of adjustments as the situation requires suggests the possibility of position shifts on the ideological spectrum, specifically between "one China one Taiwan" and "two Chinas."

Economic Malaise

In the Chen scenario, the most important catalyst of ideological radicalization is economic malaise. When voters rebel against the incumbent because of dismal economic performance by government, the surest way to regain popular support is to mobilize nationalism and create a "rally around the flag" effect. Chen's shift to blatant espousal of Taiwan independence since 2002 coincided with a dramatic downturn of Taiwan's economy and the approach of the next presidential election. The whole 2000-2008 period witnessed a gradual decline of growth, increase of unemployment, and worsening of distribution. The triple trends continued into the Ma period, reflecting the global financial crisis and weak recovery, as well as Taiwan's own structural problems (see Table 1). In 2015, Taiwan's growth further dipped to a mere 0.75 percent. After registering two negative growth periods for the third and fourth quarters of the year, Taiwan's economy has entered a recessionary period. The economic forecast for the years ahead remains bleak.

The great dissatisfaction with Ma's administration which greatly contributed to the dismal performance of the KMT candidates in the presidential-cumparliamentary elections on January 16, 2016 is rooted

in economic plight, including low growth and dispersed income distribution. The young generation who are most vulnerable to economic malaise demanded "distributional justice" and became the champion for regime change. A strong suspicion of Ma's China policy also contributed to the KMT's electoral fiasco, as the DPP had been successful in linking Taiwan's economic plight to too close ties with the mainland, embodied in the Economic Cooperation Framework Agreement (ECFA) between Taiwan and mainland China and the various planned agreements under this semi-Free Trade Agreement structure. During 2018-2012, Ma was able to "freeze" the ideological debate and direct popular attention to the economy, promising significant improvement as the dividends from cross-Strait détente flowed in. This approach helped him win the 2008 and 2012 presidential elections, but backfired when it was clear that the government could not deliver on its economic promise, and ECFA was not a panacea. Taiwan voters have become more conscious of economic issues and voted accordingly. By seizing this popular mood, Tsai and the DPP were able to reap electoral benefits and routed the KMT.

Taiwan's economy, however, is difficult to turn around. The long-term trend is towards slower growth and greater income disparity. The global trend is not encouraging and China, the most powerful growth engine for Taiwan and the world for decades, is losing economic steam. Furthermore, Beijing has no reason to grant Taiwan economic concessions with a proindependence government in power. ECFA related negotiations on trade liberalization and insurance were originally stalled on Taiwan's side after the Sunflower Movement that saw student protesters occupied the parliament for three weeks, but now may be also stalled on the mainland's side. Beijing will have no incentive to give green light to Taiwan's entry to any international economic organization, including those created and dominated by Beijing, such as Asian Infrastructure Investment Bank launched in January 2016. Given that a sizable support for Tsai and the DPP was based on dissatisfaction with Ma and the KMT on economic issues, the new government is bound to lose that support if it also fails to deliver as its predecessor. Thus when the next electoral duel comes, Tsai and her DPP government will be hard pressed to show their economic record. Failing to satisfy the voters, something else needs to be offered in lieu of material benefits. That is when the temptation of ethnic politics and nationalist mobilization kick in.

Beijing's Position

The third element in the Chen Scenario was a staunchly pro-unification CCP regime that reacted strongly against Taiwan's tilts towards independence. As such it both constrained Taiwan leaders in choosing positions on the ideological spectrum and provided incentives for the pro-independence politicians to push the envelope for the electoral benefits that they might reap. In this tug-of-war, the net effect of Beijing's staunch position is determined by Taiwan's election schedule and the ruling party's electoral prospects. If the election draws near and the government's performance is poor, then Beijing "pushes" the proindependence party away towards the latter's ideological goal. If the election is still far away and the government enjoys popularity for its performance, then Beijing "pulls" the pro-independence party closer to itself. The Early Chen years show the first trend, and the Late Chen the second. Beijing can amplify its effect on Taiwan politics by reacting strongly to signs of Taiwan slipping away. However, it does not enjoy the flexibility of changing its own basic stance.

Beijing has always been concerned with whether Taiwan remains in the "one China" framework, to the extent of its willingness to tolerate Taipei interpreting the principle in ways that deny the very legitimacy of the PRC, i.e. the ROC is the one China. That is how the 1992 Consensus was reached. Prior to Chen's inauguration in 2000, Beijing's attention focused on whether Chen would accept the 1992 Consensus, and determined its Taiwan policy accordingly. When Chen tinkered with two Chinas/conditional independence as embodied in the "five no's" (no declaration of independence, no change of the country's name, no inclusion of two-state theory in constitution, no referendum on independence, and no abrogation of Unification Guidelines as long as mainland China does not attack Taiwan), ostensibly a conciliatory gesture from a staunchly pro-independence politician, Beijing was willing to play along and even came up with the "new one-China syllogism" that gave Taiwan equal status with the mainland under the one-China roof. However, when Chen clearly broke away from China and espoused "one China, one Taiwan," Beijing's response was stormy, culminating in the Anti-Secession Law that made a military attack on Taiwan obligatory if Taiwan embraced independence. The warm welcome extended to Ma's election in 2008 and the economic concessions that followed were all signs of Beijing's eagerness to award Taiwan for treading the "right course." Prior to Tsai's electoral victory, Beijing

expressed deep concern over the possibility of the DPP turning the clock back to Chen's time. Xi made a stern warning that the 1992 Consensus is the irreplaceable cornerstone of cross-Strait relations, and that if such foundation is undermined, then "the ground will move and mountain will be shaken" (*jichu bulao*, *didong shanyao*). Such remarks were regurgitated by other prominent party leaders. In short, the insistence on one-China is Beijing's bottom line, a minimum condition for the mainland to keep a warm relationship with Taiwan.

U.S. Factor

The fourth element in the Chen Scenario is a U.S. that has incentive to rein in an aggressive Taiwanese president. In 2000-2008, except for the initial several months of President Bush's rule when he showed unrestricted commitment to Taiwan's security, the U.S. president was preoccupied with his war on terror, and considered Beijing a valuable ally in that enterprise. After the failed mission of James Moriarty, the presidential envoy sent by Bush to Chen to thwart the latter's plan of holding a defensive referenda that smacked of a tilt towards independence, Bush publicly chastised Chen for his willingness "to make decisions unilaterally, to change the status quo, which we oppose." Not unlike the collaboration between the U.S. and the PRC in the aftermath of Lee's "two-state theory" to defuse the crisis, Washington and Beijing "co-managed" the 2003-04 crisis and others that followed, and constrained Chen's aggressive acts. It is clear that even though the U.S. is committed to Taiwan's security, as stipulated in the Taiwan Relations Act of 1979, Washington has never given Taipei a blank check. For fear of being dragged into a war with China by Taiwan's provocations, Washington has shown no reluctance in pressuring Taipei to toe the party line set by the U.S.

Would the U.S. still be interested in reining in a pro-independent Taiwanese president? In 2000-2008 the U.S. was preoccupied with its war on terror in Afghanistan and Iraq. It did not perceive the PRC as a major threat. However, with the balance of power rapidly shifting in favor of China, the strategic picture has changed, and President Obama has been advocating "rebalancing" and "pivot to Asia," with China the obvious target. Since 2008, tension has being rising in both the East China Sea and the South China Sea between China and Japan, and between China and Vietnam and the Philippines. The U.S. is standing behind Japan, the Philippines, and Vietnam. As the major naval power, it is also defending freedom of

navigation. Taiwan is in an awkward position, as its own territorial claims coincided with those of Beijing, but it certainly does not want to be perceived as siding with Beijing in those territorial disputes. The core issue is the validity of the 11 dashed lines (for Beijing the nine dashed lines) that define the ROC's territorial waters in the South China Sea. As Beijing bases its own territorial claims on those dashed lines drawn in 1947 by the ROC government, Beijing and Taipei are natural allies, and the mainland has been asking Taiwan to jointly defend the sacred territories of the Chinese nation against foreign incursion. Under those circumstances, it seems that Washington's major concern is Taipei getting too close to Beijing, instead of taking an ideological stance that alienates Beijing and pulls the two apart. It seems that a proindependence DPP president has more maneuvering space under those circumstances.

This may be more apparent than real. Even though Washington does not want to see an "inter-Chinese alliance" in the territorial disputes in the East and South China Sea between China and Taiwan, it has even greater reason to worry about a conflict between the two caused by Taiwan flirting with independence. One of the primary reasons for the territorial disputes to flare up in those waters is the rising military power of the PRC. With the gap between the U.S. and Chinese militaries narrowing, it has become more and more difficult for Washington to defend Taiwan in waters adjacent to China. A Taiwan Strait crisis à la 1995-1996 in the 2010s may end in a way quite different from in the past. Under those circumstances, there is greater incentive for Washington to prevent Taiwan from initiating a crisis by changing its ideological position and crossing Beijing's red line. Washington may not be intrinsically opposed to Tsai's stance on the "one China" principle, but is quite aware of what Beijing's response will be if its red line is crossed, and thus wants to set limits to the DPP president's maneuvering space. In this sense, the second DPP president is facing basically the same international situation as her predecessor was.

Taiwan in 2016 is not that different from Taiwan in 2000. There is a high possibility that the Chen Scenario will repeat itself. Of course, what happened in the past certainly cannot predetermine what will happen in the future. People learn from past experiences. However, things happened in the past because of the forces behind them. If those forces are still in place and the structure of action remains the same, then it is likely that a chain of events that

happened in the past will be repeated in the future. Based on the above analysis, there is a high probability that the Chen Scenario of "moderation-economic plight-electoral pressure-radicalization-external pressure-climbing down" will repeat itself under Tsai, although the different phases may be lengthened or

shortened. On the other hand, it may also become a self-defeating prophecy, as policy makers are aware of the troubled waters they navigate into and thus capable of taking actions to evade the pitfalls. That remains to be seen.

An Apprehensive Hong Kong Faces Its Future

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Although still one of the world's most dynamic cities and most important international financial centers, Hong Kong is gripped by increasing pessimism about what lies ahead. A public opinion poll conducted by the University of Hong Kong showed that net confidence in Hong Kong's future has fallen from 69.7% shortly after the handover to China in 1997 to negative 1.0% in July 2015. In casual conversation, more and more Hong Kongers worry that "it's over" for their city, or soon will be.

Hong Kong's growing nervousness about its future is understandable. The city's legislature is deadlocked pro-government and anti-government legislators. Beijing's proposals for implementing direct popular elections for of Hong Kong's Chief Executive (CE) in 2017 were rejected, as have been a number of proposed bills and budget allocations since then. Large-scale demonstrations are increasingly frequent. In 2014 the "Occupy Central" and "Umbrella Movement" protests shut down major parts of the city's central business district for weeks until they were forcibly broken up by the police. A sudden and particularly violent riot occurred in Mongkok (a more working class area) on the eve of the Lunar New Year holiday in 2016, with more than seventy alleged organizers and participants arrested since then. Students have disrupted meetings of the governing body of the University of Hong. Hong Kong's society is increasingly divided between those who support the local government and those who oppose it, those who remain sympathetic to Beijing and those who are critical, and those who regard themselves as Chinese and a growing number who identify themselves exclusively as "Hong Kongers"—a term so new that it was introduced into the Oxford English Dictionary only in 2014.² A very small but increasingly vocal minority, described as "localists" or "nativists," actively demand a higher degree of local autonomy or even formal independence from China.

All this is happening as sands are starting to run through yet another hourglass, counting down the time left before a second major turning point in Hong Kong history. The first was Hong Kong's transfer from British colonial rule to Chinese sovereignty in 1997, a deadline that passed relatively smoothly. Now, a second deadline is beginning to loom: the end of China's subsequent agreement to preserve Hong Kong's political and economic institutions for fifty years, until 2047. The outlook as that second deadline approaches is not at all clear.

The Immediate Grounds for Pessimism

What is happening to Hong Kong? When Hong Kong returned to Chinese sovereignty a bit less than twenty years ago, the mood of the city was quite optimistic. Under Deng Xiaoping's concept of "one country, two systems," both the Joint Declaration between China and Britain governing the future of Hong Kong after British rule, and then the Basic Law enacted by China's national legislature to formalize Hong Kong's future relationship with the central government in Beijing (often termed Hong Kong's "mini-constitution"), assured the city that there would be little change in its economic system, legal structure, political system or "way of life," except for the welcome promise that the ultimate aim" would be that both the CE and all members of the Legislative Council would be directly elected. Hong Kong was

guaranteed that "the people of Hong Kong will govern Hong Kong" and that it would enjoy a "high degree of autonomy, except in defense and foreign affairs." Both the Sino-British Joint Declaration and the Basic Law provided that these arrangements would remain in effect until 2047.

The transfer of sovereignty at midnight on June 30, 1997, was therefore the cause for genuine celebration in the city, by both many local Chinese and many expatriates. Optimism about Hong Kong's future ran quite high—remarkable given that so many Hong Kongers were either the children of refugees from the mainland or refugees themselves. So why the growing pessimism after that promising start?

The most fundamental problem has been growing socio-economic woes. Like many other advanced economies in a globalized world, Hong Kong is experiencing what might be called the "upper income trap," comparable to the "middle income trap" faced by emerging markets at lower levels of development. It is becoming increasingly difficult, if not impossible, to sustain the rates of economic growth to which Hong Kongers have become accustomed. In many areas of economic activity, including Hong Kong's roles as a regional entrepot, an international financial center, and a major destination for shopping and tourism, Hong Kong faces increasing competition and a declining comparative advantage. At the same time, the economic growth that is still occurring is disproportionately benefitting a relatively small percentage of extremely well-educated and well-placed workers and executives, while a new generation of younger Hong Kongers are despairing of their ability to get good jobs, purchase apartments, and raise their families. It is not surprising that members of this younger generation have been at the forefront of the recent demonstrations and protests. At the same time as this new generation enters the political arena, an aging population will place increasing demands on government—and thus on taxpayers—for retirement benefits and eldercare.

Second, again like some other advanced economies facing the upper-income trap, Hong Kong faces the problems created by immigration, but the character and causes of immigration are distinctive. There has been an increasing flow of mainland Chinese into Hong Kong since 1997, mainly as short-term tourists and students, but also as eventual permanent residents, whether as the spouses of Hong Kong residents or as job seekers under various employment schemes. These new immigrants amount to 150 per

day, or around 55,000 per year, not counting the mainland students who are able to find work after graduation from college. Although seemingly a small number on a daily basis, this inflow of 150 new residents per day has added up to more than a million new residents from mainland China in the nineteen years since the handover in a city of whose population numbered 5.5 million in 1997. This flow has produced the widespread public perception that the city is becoming over-crowded, with increasing competition for employment and apartments, let alone spaces on narrow sidewalks and in packed subways. changing attitudes toward the flood of mainland visitors and immigrants is reflected in the changing language commonly used to describe them: first as "country bumpkins" due to their unsophisticated and largely rural backgrounds, then as "smugglers," crossing the border to buy consumer goods unavailable in the mainland to resell back home at a profit, then as "locusts," sweeping down on the city in droves to snatch up jobs and apartments away from local residents. and now simply as agents "mainlandization," whose purpose, or at least whose impact, will be to gradually reduce the differences in language, culture, and way of life between China and the mainland in preparation for the possible end of Hong Kong's special status under in 2047.

A third set of problems has to do with Hong Kong's political system, which is still based on a British colonial structure that, despite the substantial localization of the police and civil service and the introduction of limited popular elections to the Legislative Council in the years running up to 1997, does not provide adequate channels of representation or responsiveness for a rapidly mobilizing society. The present system features a chief executive selected by an election committee largely controlled by Beijing and a legislature with a large (although shrinking) number of seats elected by functional constituencies, many of which represent business and professional interests sympathetic to Beijing, rather than the more common geographic constituencies. In addition, the CE is constitutionally prohibited from forming or joining a political party, meaning that he has no firm base of organized support in the legislature. Conversely, members of the Legislative Council are prohibited from introducing significant legislation involving public expenditures or political structure, and even proposals on policy questions require the approval of the CE before they can be considered. These structural characteristics have contributed to the growing confrontation between the executive and legislative branches. To make matters worse, with no history of truly democratic politics or even of effectively functioning political parties, Hong Kong's chief executives have been drawn from either the business community or the professional civil service. All have been well intentioned and some have been more effective than others, but none has been skilled at engaging in political leadership in a quasi-democratic society. (Paradoxically, Hong Kong's most successful leader in that regard was arguably the last British governor, Chris Patten, precisely because he had been a skilled elected politician back in the UK who brought those skills with him to his post in Hong Kong.)

Adding to the city's growing pessimism, the future of this troubled political system has been clouded by the failure to reach agreement on the method for selecting the next CE in 2017. As already noted, the Basic Law provided that this would ultimately occur through popular election, but that candidates would be nominated by a "broadly representative nominating committee in accordance with democratic procedures." One of the major causes of the Umbrella Movement was public frustration at Beijing's restrictions on the size and composition of the nominating committee, and its refusal to allow additional candidates to be put forward through "civic nomination." Not only would this nomination process ensure that Beijing would have a strong voice in the selection of the candidates for CE, but the Basic Law also provides that the CE must be formally appointed by Beijing, and Beijing has strongly suggested that this power of appointment is a substantive power rather than a mere formality. This procedure guarantees that no candidate unacceptable to Beijing can ever become CE, and moreover gives Beijing a high degree of influence over the selection of the nominees. Because the legislation embodying this new election procedure was defeated by the Legislative Council, unless new legislation can be put forward and passed in time, the next CE will be chosen by the same kind of Election Committee that has selected the previous ones, with no popular election at all.

Finally, many Hong Kongers are concerned about the increasingly clear limits on their autonomy vis-àvis Beijing.³ It is a common misperception, even in Hong Kong, that the Basic Law granted the city virtually complete autonomy except in defense and foreign affairs. In fact, the promise was only for a "high degree of autonomy" in those purely internal matters, and Beijing has made it clear that Hong Kong's domestic autonomy will be limited on matters

that Beijing regards as affecting national security or Chinese domestic stability. Several unresolved issues have stemmed from this tug-of-war over Hong Kong's autonomy. The first was the successful popular resistance to the adoption of national security legislation for the city, even though that is required by Article 23 of the Basic Law, on the grounds that it would potentially limit the exercise of political rights in the city. But now, the derogatory way in which Beijing has described the Mongkok protests has increased concerns that Beijing will insist that such legislation now be introduced and adopted, always with the implicit threat that what cannot be obtained through ordinary legislative processes can be imposed by Beijing as Hong Kong's sovereign authority.

A more recent issue stems from the still mysterious disappearances of five employees of a Hong Kong bookstore well-known for selling books, banned on the Mainland, that are critical of China's political system and even individual Chinese leaders. Many believe that the booksellers were abducted without any proper legal proceedings, some from Hong Kong but others from Thailand, despite the fact that at least two held foreign passports, suggesting that mainland security agents are operating inside Hong Kong despite assurances to the contrary. In addition, of course, the tightening of political controls on the mainland in recent years has simply increased the apprehension in Hong Kong about the future of its own political system.

Longer-term concerns

These recent developments are rapidly focusing attention on the most difficult issue of all: what will happen in 2047 when the guarantees provided in the Sino-British Joint Declaration and the Basic Law expire. While there is some hope that the Basic Law can continue in effect and that Hong Kong will remain a Special Administrative Region under the principle of "one country, two systems," there is as yet no reason to believe that this will be the case, despite the common but inaccurate belief that the arrangements were promised to Hong Kong for "at least" fifty years with an eye to their eventual extension.

While there remain a little more than thirty years before this deadline, this question of Hong Kong's fate after 2047 is becoming an increasing matter of concern. This time, what is forcing the issue is not so much the question of the future of government land leases, which was the question that forced Britain and China to come to a clear decision on the future of Hong

Kong fifteen years before the 1997 deadline. Instead, it is the future prospects for Hong Kong's rising generation of young people, many of whom will still be in their prime in 2047 and are already beginning to think about how to spend the rest of their lives. Will they plan to stay in Hong Kong or emigrate abroad?

Moreover, if Beijing intends to end the current arrangements governing Hong Kong after fifty years, pessimistic observers worry that it will start to take active measures to narrow the gap between Hong Kong's values and way of life and those on the mainland, so that it will have virtually disappeared by 2047. This might involve attempts not only to impose national security legislation on Hong Kong, but also to promote a Chinese identity through continued immigration, the adoption of "national education" in the city's schools, policies to promote the use of Mandarin and the simplified Chinese characters used on the mainland at the expense of Cantonese and the standard Chinese characters now common in Hong Kong, and increased efforts to control the Hong Kong news media by purchasing some outlets and increasing economic pressure on others.⁴ Moreover, there will be slow if any progress toward the further democratization of Hong Kong's increasingly dysfunctional political system, but rather efforts to increase the power of the CE who is accountable to Beijing, relative to the members of the legislature who are popularly elected.

Conclusion

In short, Hong Kong today is increasingly apprehensive about both its immediate and longer-term future. It faces mounting socio-economic problems, growing political polarization, the mobilization of a new generation of anxious and dissatisfied youth, increasingly frequent and occasionally violent protests, and growing concern about the future of the city after 2047. Even if Beijing agrees to extend the validity of the Basic Law beyond 2047 and continue the formula of "one country, two systems," that move may encounter a skeptical response given the high levels of

mistrust that the central government presently faces in Hong Kong: For fully 60.6% of the population, the level of trust in Beijing ranges from "so-so" to "no trust at all." And if it decides to end the present system, it will need to reduce the differences in political structure, political rights, and economic system between now and then in order to have any hope of a smooth transition. It would then face two choices: It can reduce the differences by undertaking greater economic and political reform on the mainland to make the mainland more similar to Hong Kong or it can tighten its control over Hong Kong to make Hong Kong more similar to the mainland. Either strategy will carry great costs and risks—for Beijing, for Hong Kong, or for both.

Endnotes

- 1 "Net confidence" is defined as the difference between the percentage of respondents expressing confidence in Hong Kong's future and those expressing a lack of confidence. "People's Confidence in HK's Future," poll conducted by the Public Opinion Programme, Hong Kong University, at hkupop.hku.hk, accessed February 27, 2015. A similar poll conducted by the Chinese University of Hong Kong in July 2015 showed that only 24.1% of respondents expressed any degree of optimism about Hong Kong's prospects. "Hong Kong Public Opinion and Political Development' Opinion Survey: Comparison of Survey Results" (Hong Kong: Centre for Communication and Public Opinion Survey, Chinese University of Hong Kong, July 2015), Table 12.
- 2 For an analysis of the rise of a local identity in Hong Kong and a comparison with similar developments in Taiwan, see Syaru Shirley Lin, "Bridging the Chinese National Identity Gap: Alternative Identities in Hong Kong and Taiwan." in Gilbert Rozman (ed.), *Joint U.S.-Korea Academic Studies*, no. 25(Washington, DC: Korea Economic Institute, 2014).
- 3 In July 2015, 10.4% of respondents in a University of Hong Kong poll believed that Hong Kong had "absolutely no autonomy" from Beijing, and another 26.6% said that its autonomy was limited. "'Hong Kong Public Opinion and Political Development' Opinion Survey: Comparison of Survey Results" (Hong Kong: Centre for Communication and Public Opinion Survey, Chinese University of Hong Kong, July 2015), Table 8.
- 4 Several of these possibilities, projected into the future, are depicted in the controversial but popular local film, Ten Years," depicting a dystopian vision of Hong Kong between 2015 and 2025, which has been condemned by one prominent mainland newspaper, the *Global Times*, as "overly pessimistic and absurd."
- 5 "'Hong Kong Public Opinion and Political Development' Opinion Survey: Comparison of Survey Results" (Hong Kong: Centre for Communication and Public Opinion Survey, Chinese University of Hong Kong, July 2015), Table 10.

For China, a Plunge and a Reckoning

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Anyone trying to design an event to bring Xi Jinping's China back to Earth couldn't have engineered something much more elegant than the turmoil in China's financial markets and the resulting global aftershocks. The upheaval is traumatic for China's leaders but not life-threatening to China's system. Yet the jolt may have been just large enough to change the country's underlying bargain between ruler and ruled—and by doing so, to temper Beijing's current tendency toward arrogance, rigidity, belligerence and diplomatic hectoring.

If the week's tumult has reminded Americans nervously eyeing their retirement funds of the interconnectedness of the global economy, it may also serve to remind today's proud Chinese leaders that they too exist in a larger context—that they need their neighbors, that they need the U.S. and that they might need to become a little more accommodating.

As president, Mr. Xi has seemed pleased by his ability to seize and use power—to have China's weaker neighbors genuflect and have the world respond more compliantly. But he has just had a particularly jarring wake-up call.

A society that had grown accustomed to dismissing anyone it didn't like—including the U.S.—has been rattled by a marketplace that doesn't know what obedience is. Much of China's growth in recent decades has depended on the cultivation of capitalism, but having implanted the quintessentially capitalist institution of stock markets in its midst, the Chinese Communist Party's leaders have now been forced to confront a creature of their own making as it rises up and goes its own way, immune to their attempts to

bend it to their will.

All this touches not just on issues of economics and politics but those of psychology and authority. The free fall in the stock markets has been especially unnerving in a society over which the party has long pretended to ride herd—and has heretofore done well enough at creating economic growth that it had come to seem invincible and omnipotent.

Mr. Xi and his predecessors have bragged that they have created a new model superior to the West's brand of liberal democratic capitalism. They have had considerable evidence. Over the past 2½ decades, the "Chinese economic miracle" had sped upward in ways that appeared gravity-defying.

Enjoying torrid two-figure growth rates, China boasted urban skylines bristling with cranes and towering high-rise buildings while its countryside became laced with freeways, high-speed rail systems and wireless telecom networks. A year and a half ago, the composite index of China's once-placid stock markets—one in Shanghai where 831 companies are listed and one in Shenzhen listing some 1,700—started its rapid and stratospheric climb, as if it had suddenly grown embarrassed by its relative languor.

By June, the Shenzhen market had risen by some 135% and Shanghai by about 150%, with a combined market capitalization of more than \$9.5 trillion. Too few party leaders were concerned by how rapidly share prices had risen or by the fact that the Shenzhen market's average price-to-earnings ratio was about 70:1 (compared with the S&P 500, which trades at about 17 times trailing price-to-earnings). Millions of new punters bought on margin—sometimes using their

houses as collateral. The party's own mouthpiece, the People's Daily, exhorted "the broad masses" to join the feeding frenzy, claiming that China's bull market was just beginning.

Mr. Xi and his Politburo had good reason to be confident, even cocky. After 2½ decades of Deng Xiaoping's "reform and opening up," or gaige kaifang, China had become the fastest-growing economy in the world. When China's stock markets finally started their hyperactive rise, one more cog in this well-oiled juggernaut of progress just seemed to be kicking into gear.

Call it "the China dream" (as Mr. Xi does) or "socialism with Chinese characteristics" (as the party likes), but many Chinese were only too glad to proudly embrace this new vision of rejuvenation and prowess. It was enough to make any foreigner envious, especially when so many Western economies lay like St. Catherine, bound to a wheel of endlessly depressing cycles of capitalist boom and bust.

Meanwhile, here was China, a country that President Bill Clinton once consigned to "the wrong side of history," making a glorious end run around the verities of all the vaunted Western development theorists. After the 1997 Asian financial crisis, when the Dow Jones Industrial Average fell 7.2% in a single day and the New York Stock Exchange briefly suspended trading, China sailed through without even devaluing its currency, the renminbi. In 2008-09, as the collapse of Lehman Brothers sent the U.S. into the worst financial crisis since the Depression, China again glided through unscathed.

After years of experimenting with what Deng once called "crossing the river by feeling the way over the stones," China had seemingly arrived safely on the other side—and built not just a Chinese model but an economic perpetual-motion machine that had the added virtue of being patented in China rather than abroad. Some wondered if the blush wasn't off the American rose—if the future might soon be claimed not by U.S. entrepreneurs but by Leninist capitalists.

"The Chinese model has transcended the dichotomy between socialism and capitalism," proclaimed Li Xiguang, a professor of media at Beijing's Tsinghua University. "It has broken down the universe of discourse of the old market style of economy and proven that there is no singe narrative that is suitable for the whole world."

Mr. Xi himself has sounded similar notes. "One part of the now long-standing Chinese leadership

critique of Western-style democracy is that it is prone to paralysis and gridlock and ultimately governmental weakness," he said in Sept. 2014 in Beijing's Great Hall of the People. When he met President Barack Obama in June 2013 at the Sunnylands Retreat in Palm Springs, Calif., Mr. Xi proposed a "new model of bigpower relations," suggesting that Chinese success had bought it a seat at any geopolitical table.

This confidence in the strength of the China model—and the supposed weakness of its Western competitors—has reshaped the way Beijing relates to the world. Its new confidence in its wealth and power has been matched by an increasingly unyielding and aggressive posture abroad that has been on most vivid display in its maritime disputes in the South and East China seas.

China has claimed a protrusion hanging down from Hainan Island into the South China Sea like a giant cow's udder, along the Vietnamese and Philippine coastlines all the way to Indonesia. The audacity of insisting that all the contested atolls and islands in the region are sovereign Chinese territory—and the uncompromising attitude with which Chinese officials pressed the claim—marked a more aggressive phase in Chinese foreign policy. This bullying new posture not only injected unnecessary tensions into its relations with its neighbors but soured relations with the U.S. and Japan.

Not everyone has been impressed. A few analysts—mostly notably David Shambaugh, a George Washington University professor, in these pages in March—have warned that the center of this new Chinese proposition cannot hold. Despite its apparent economic success, Prof. Shambaugh argued, China was plagued by unresolved contradictions and headed for "a breaking point." Other China specialists strenuously disagreed. But now China has experienced a major jolt—far short of a collapse but still tectonic enough to cause alarm about its stability.

Perhaps the most important question is: How will China's leadership digest what has happened? Will they reflect on it in an open-minded way, learn from it and adjust the way they view themselves and their place in the world? Or will they batten down the hatches and persist on the same course?

As China's stock markets started nose-diving, the government almost immediately intervened, forbidding state-owned enterprises to sell shares, buying hundreds of billions of dollars worth of stocks and lowering interest rates to stimulate buying. It was a fatal

decision: Their interventions immediately turned the markets into an institution they owned. Henceforth, the party's reputation would rise or fall with those markets. And as the markets roil, as they undoubtedly will, the way that ordinary Chinese citizens see their leaders is likely to change significantly.

The plunge was all the more unnerving because it belied the party leadership's conceit that their superior formula of governance could safely guide the economy through just such cyclical shocks. This pretension had not only helped create a mythology of can-do omnipotence and invincibility around party leaders but also helped silence foreign critics of the slow pace of economic reform and the complete absence of political reform.

Worse, the market crash came alongside a rash of other unsettling news. Earlier this month, a key gauge of China's nationwide manufacturing activity showed the lowest level in 77 months. Steel production and consumption are both notably off. Exports slid sharply in July. The renminbi has been devalued. And on Aug. 12, a chemical warehouse serving the port city of Tianjin blew up in a devastating explosion that incinerated whole lots full of export vehicles, demolished thousands of apartments, killed some 140 people and spewed untold quantities of toxic chemicals into densely populated neighborhoods. The party suddenly no longer seemed infallible.

For China's leaders, the most profound problem with this string of events isn't simply the monetary loss or the body count but the overall psychological effect. Because Mr. Xi's China is such a brittle, tightly wound society, it is especially vulnerable to such shocks.

Moreover, because the party leadership and central government purport to control so many aspects of Chinese life—from economics and financial markets to culture and politics—they get blamed first whenever anything goes awry. Since China today already has a serious trust deficit, blame can be instant and uncompromising.

And China's leaders have been laid low by their own venture, not Western gunboats. The debacle was nothing that could be convincingly blamed on the outside world; it was made in China.

The party would have been better off to have just left the stock markets alone. Party leaders could not have tangled with a more free-willed and insubordinate jousting partner. Markets answer to their own value-driven drummers. Unlike dissident Nobel Peace Prize laureates, who can always be silenced or jailed, there is

no obvious way to bring a market to heel—something the party evidently remains ill-equipped to understand.

China's markets are now scarred by a serious distortion. And if these markets ever collapse again, as they may well, it will be very difficult for party leaders to dissociate themselves from the debacle.

Thus China's rulers have acquired a serious and unnecessary new liability. And in a society and culture like theirs—which has for millennia harbored a deep sensitivity to any phenomenon that smacks of end-of-dynasty symbolism, such as floods, rebellions, droughts, earthquakes and now explosions and stockmarket crashes—the party has a new albatross around its neck.

Of course, even in full crash mode, these markets do not equate with China's overall economy. Despite the recent financial turmoil, China remains a global economic powerhouse. Yet the most important fallout may not be financial but psychological. In the China equation, a crack in the edifice of trust can corrode confidence in party rule and threaten the legitimacy of the state—one of the leadership's biggest fears.

After all, the party has long had an unwritten compact with its people: You stay out of politics, and we'll deliver economic benefits. And for the past quarter-century, with the turn toward market-based reform, it has done an impressive job on delivering its end of the bargain.

This grand bargain's latest leader is Mr. Xi, who has acquired far more power than any other recent leader—and, in the process, gained a reputation as an implacable, no-nonsense, if enigmatic ruler. Renowned for his ubiquitous, Mao-like visage, frozen into just a hint of a smile as unreadable as the Mona Lisa's, Mr. Xi has boosted his own importance in ways that can seem modeled on Mao himself. But the recent stumbles have hurt his ruling mystique and ability to maintain a pose of aloof, invincible indestructibility.

If the crash is a danger for Mr. Xi, it also presents him with a paradoxical opportunity. Sometimes a crisis that shocks, even humbles, but doesn't completely upend can catalyze a crucial moment of reflection that leads to reappraisal and even change.

One clear message of this turbulent week is how interconnected everything actually has become in our 21st-century world. Financial markets, trade flows, pandemics and climate change all ineluctably tie us together.

Of late, China has been acting in an ever more unilateral way, perhaps at last enjoying the prerogatives of its long-sought wealth and power. Mao imagined a China rooted in the idea of "self-reliance," zili gengsheng. The most encouraging news out of this week would be for Mr. Xi and his comrades to recognize that China can no longer be such an island—that China cannot succeed in isolation, much less by antagonizing most of its neighbors and the U.S.

As large, dynamic and successful as China has become, it still exists in a global context—and remains vulnerable to myriad forces beyond the party's control. It must take the chip off its shoulder, recognize that it is already a great power and begin to put its people, its Pacific neighbors and the U.S. at ease. Any truly great nation must learn that the art of compromise lies at the heart of diplomacy, that it is almost always better to negotiate before resorting to war and that compromise is neither a sign of weakness nor surrender.

If the alarms over the past few months presage such a revelation in Beijing, it would not only enhance China's stability but its soft power and historic quest for global respect. Given Mr. Xi's track record, one dare not be too optimistic.

A perfect place to begin such a course correction is just weeks away: the September summit in Washington with Presidents Obama and Xi. With all the disagreements that divide the two countries, the summit could be frigid and fraught. But it also offers both countries a chance to work together on one of the greatest challenges of the century: forming a more effective partnership to tackle global climate change.

Will it happen? The past shows that such a turnaround won't come easily. But if China should take any larger message away from its near-death tangle with its own financial markets, it is that neither country—nor the world at large—has much hope of dealing with the century's shared problems if Washington and Beijing cannot find more common cause.

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Xi Jinping: Core Leader of a Great Nation

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Xi Takes Command

Xi Jinping became General Secretary of China's Communist Party on November 15, 2012. From the outset of his ten-year term, he has been active on domestic and diplomatic fronts. It is clear that he sees himself as a transformational leader.

In light of the scale of China's challenges and the long period over which Xi expects his policies to take effect, it has seemed prudent until recently to withhold judgement on Xi's ideology, intentions, and prospects. After three years, however, the evidence is in. The high stakes of Xi's leadership, moreover—high for China, for the rest of the world, and for the U.S.—demand that American policymakers have an assessment of Xi's thinking that can guide U.S. strategy.

Xi's Torches

The Chinese say that when a new leader comes to power he carries three torches. The phrase means that new leaders define their tenures with three initiatives. It also implies that the torches will soon burn out and life will return to normal.

Xi breaks the mold in two ways. First, he bears at least four torches, although the number of major initiatives he has announced would justify a higher count. Second, he doesn't let torches burn out. He adds fuel to the fires. He doubles down.

Xi's first torch is the anti-corruption campaign. His punishment of "tigers and flies" is the hallmark of his leadership and seems to be the source of his popularity among ordinary Chinese. His second torch is the program he laid out in 2013 and 2014 to restructure China's economy and administrative organs to achieve

slower, more sustainable, higher quality growth so that China can become moderately well-off by 2021 and draw even with developed nations by 2049.

Xi's third torch is an ideology campaign which combines (a) a crackdown on rights advocates and the influence of Western thought and (b) a nationalistic exhortation to all Chinese to achieve the Dream of the Rejuvenation of the Great Chinese Nation. Xi is punishing individuals whose beliefs differ from his own, but he is also calling for spiritual and cultural renewal—a Chinese Great Awakening—under the unquestioned leadership of the CCP.

His fourth torch is an activist foreign policy which views the U.S. as the primary obstacle to China's pursuit of greatness.

Xi as Cultural High Priest

Xi's crackdown is the harshest seen in China since 1989. The tones in which he describes his goals to his countrymen are not harsh, however. He is fatherly, almost pastoral, in calling for self-examination and the rooting out of evil influences, many of which are Western. Recovery of a Chinese essence, he says, will set the nation right after its Century of Humiliation.

To bolster Xi's authority, government propaganda organs depict Xi as an exemplar of traditional Chinese and socialist virtues. By grounding his authority in virtue—and in the support of China's military and security organs—Xi is operating in the tradition of imperial China. In the Confucian prescription, leaders must be (or appear to be) morally perfect. They must be junzi—sage/saints who enjoy the "Mandate of Heaven" because they can lead by virtuous example

(德治天下). Confucius put it this way: "To govern is to rectify. If the Ruler is virtuous, who would dare be otherwise? (Analects 12:17). One fruit of this tradition, as described by Kenneth Lieberthal in Governing China, is that "There is an assumption in China, to this day, that the government's influence can and should pervade all aspects of life because the government sets the moral framework for the whole society."

Xi has been tireless in building this framework. He signals virtuous stewardship by visiting poor villages and commoners' restaurants, by salting his speeches with classical allusions, by standing up to less virtuous foreigners, especially the Japanese, championing Chinese culture. In presenting himself as protector and connoisseur of Chinese arts, Xi is again drawing on China's ancient traditions. Before adopting Westphalian notions of sovereignty, China was not so much a nation-state as a cultural collective. Leaders earned legitimacy by public demonstrations of their love for Chinese arts and artifacts. That is why an early Chinese emperor, upon hearing that an ancient bronze tripod had been unearthed, walked out of the city gates in the sight of his subjects to welcome the ceremonial vessel to the capital. Even rulers of conquering dynasties, like the Manchu Qing (1644-1911), could strengthen their political bona fides through expertise in calligraphy and painting. When Mao led the People's Republic of China (1949 to 1976), Chinese hailed him as the most accomplished calligrapher and poet in the land. (The sinologist, Arthur Waley, said Mao's poetry was "not as bad as Hitler's painting, but not as good at Churchill's.") Several years into the tenure of General Secretary Jiang Zemin (1993-2003), it was revealed that he, too, was a fine calligrapher. Factories, universities, and government agencies carved his calligraphy in stone at the entrances to their compounds. Xi Jinping is not (yet) known as a calligrapher or poet. He asserts cultural authority through his love for classic literature and for his wife, a famous singer of patriotic ballads.

Xi now has the moral, cultural, and political authority to preach rejuvenation to the masses and to punish transgressors. His ideology campaign extends to every sector of Chinese society.

The Ideology Campaign

Education

 In January, 2015, Xi's Minister of Education met in Beijing with university leaders responsible for "Higher Education Propaganda and Thought Work Under the New Conditions (meaning: under the

- leadership of Xi Jinping)." He said that universities must:
- "Not permit teaching materials that disseminate Western values in our classrooms;"
- "Never allow teachers to ... pass on their unhealthy emotions to students;" and
- Make sure the ideas of Chairman Xi, "enter teaching materials, enter classrooms, and enter the minds" of students.

A few academics struck back. The President of Nankai University, Gong Ke, wrote that, "Recently, I've read people on the Internet saying that the ranks of academics must be cleansed, purified, and rectified. I can't agree with this. This was the mentality of 1957 or 1966." 1957 was the first year of violent persecution of intellectuals under the Anti-Rightist Campaign. 1966 saw the launch of the Cultural Revolution.

Gong and other outspoken academics were rebutted by leaders at Peking University and the Chinese Academy of Social Sciences. A CASS Party Secretary wrote that "Of course China's socialist universities absolutely cannot allow (unhealthy emotions and speech) to appear in university classrooms and we cannot allow it to appear in any form anywhere on our campuses." The Party-run Global Times added that, "young students and teachers are the major groups used by enemy forces to penetrate and divide China."

Few Chinese academics have been ordered to revise syllabi and Western texts are still widely used. But Xi Jinping continues to insist that education serve the Party. This principle was recently extended to Chinese students overseas. In February, the Ministry of Education called for Chinese students in foreign universities to receive "patriotic education" through a "multidimensional contact network linking home and abroad."

Culture

Xi Jinping held a widely publicized meeting with China's leading cultural lights—writers, film directors, bloggers—in Beijing in October, 2014. He used the occasion to strike out at vulgarity, commercialism, and Western influence, claiming that: "Some works ridicule the sublime, warp the classics, subvert history, or defile the masses and heroic characters. In others, good and evil cannot be distinguished, ugliness replaces beauty, and the dark side of society is overemphasized ... Contemporary arts must ... take patriotism as a theme, leading the people to establish and maintain correct views of history, nationality,

statehood, and culture ... To realize the Chinese Dream of the great rejuvenation of the Chinese nation, the role of literature and art is irreplaceable...Chinese art will further develop only when we make foreign things serve China."

Xi's demand that culture serve the people was staged to remind artists and intellectuals of Mao Zedong's 1942 Talks at Yan'an Forum on Literature and Art. Donning Mao's mantle, Xi cast himself as patron and protector of the arts and as pastor to China's creative class. He made explicit the link between culture and politics—between the ideology and anti-corruption campaigns: "Fine art works should be like sunshine from blue skies and breeze in spring that will inspire minds, warm hearts, cultivate taste, and clean up undesirable work styles."

Media

The CCP has always controlled Chinese media but, as in the educational and cultural spheres, Xi's hand has been particularly heavy. Media that conduct independent investigations have been shut down or neutered. Journalists have been arrested for reporting facts. In the most startling case, Wang Xiaolu, who wrote for Caijing magazine, was arrested after the Shanghai stock exchange plummeted in August, 2015. He was forced to make a confession on national television, in which he said, "I shouldn't have published the report at such a sensitive time, especially when it could have great adverse impact on the market ... I shouldn't have caused our country and shareholders such great losses just for the sake of sensationalism and eye-catchiness." The Party newswire, Xinhua, wrote that Wang had admitted to basing his report on "hearsay and his own subjective guesses without conducting due verifications." In most nations, Wang would have been viewed as writing an accurate analytical piece. He is now undergoing "criminal compulsory measures" and is suspected of "colluding with others and fabricating and spreading fake information on securities and futures markets."

In February 2016, Xi Jinping visited the headquarters of the CCP's top news organizations and received ecstatic nationwide coverage. Journalists and editors gathered around him like teenyboppers at a Beatles concert. Xi's message, delivered with genuine warmth, was that, "All news media run by the Party must work to speak for the Party's will and its propositions, and protect the Party's authority and unity." Like academics and artists, it is time for

journalists to fall in line (this martial metaphor—看齐—is Xi's latest catch phrase).

Civil Society and "Rights Defenders"

Like Moscow and New Delhi, Beijing is deeply suspicious of foreign and foreign-funded NGOs. For the CCP, the Arab Spring and the Maidan uprising in Ukraine demonstrated that NGOs function as fifth columns for hostile outside forces, especially the United States. Beijing published the second draft of a new law governing foreign NGOs in China in 2015 for a period of domestic and international comment. The draft caused a global outcry and has been tabled for now, perhaps because Beijing feared it would pay a high reputational cost for implementation. The most striking feature of the draft was its proposal to transfer "management" of foreign NGOs from the Ministry of Civil Affairs to the Ministry of Public Security. Most of the draft's provisions spelled out how NGOs would be punished for various infractions. In effect, the draft treats NGOs as criminal suspects.

The final status of the law is unknown, but the future of Chinese and foreign NGOs seems tenuous. NGO workers, like journalists, have been detained in recent months and forced to make televised confessions. Activists can be arrested even if they are active in causes the Chinese government supports. In the spring of 2015, five young feminists were detained and later released on bail for planning a nationwide campaign to fight sexual harassment on buses and subways. The CCP prides itself on promotion of sexual equality, but the young activists were arrested anyway because they sought to drive a social agenda without the leadership of the Party. Later in 2015, Beijing closed down the Beijing Zhongze Women's Legal Counseling and Service Center, a renowned legal aid institution that had received foreign funding. Again, this wasn't an attack on women's rights; it was an attack on an organization the Party couldn't control.

The shuttering of Beijing Zhongze probably had less to do with Beijing's fear of crusading feminists than with its dislike of lawyers who champion rights guaranteed by China's constitution. In 2015, over 200 "rights-defending" (维权) lawyers were detained. Some have been released. Others have been found guilty of subversion or "picking quarrels and provoking trouble," a catch-all crime used to punish any behavior the Party disapproves of.

Battling Western Influence

Opposition to Western influence pervades Xi's political platform. The CCP's definition of Western Values was spelled out in Document Number 9, the Communiqué on the Current State of the Ideological Sphere, which was authorized by Xi and published in document April, 2013. The lists "Seven Unmentionables" (七不讲)—topics that college professors and journalists are forbidden to discuss in classrooms and reports. The document prohibits:

- 1. Promoting Western constitutional democracy
- 2. Promoting the idea that there is such a thing as "universal values"
- 3. Promoting civil society
- 4. Promoting neoliberal economic ideas
- 5. Promoting the West's idea of free media
- 6. Questioning the Party's official interpretation of its history
- 7. Questioning "Reform and Opening" and the socialist nature of socialism with Chinese characteristics.

Western analysts have asked what impulse inspired the CCP to issue Document 9. As is often the case, the Chinese government is frank about its motivations. Western Values is a non-traditional, existential threat to Chinese security that will be countered by a new National Security Commission, which Xi himself chairs. The commission lists Western Values on a par with terrorism and sedition. Beijing's claim, then, is that unfettered discussion of the banned topics would undermine the leadership of the CCP. This fear is probably well-founded.

Party Purity

Under the cloud of Xi Jinping's ideology campaign, Chinese academics, artists and entertainers, reporters, NGO leaders, activists and lawyers have fallen silent. They are more reticent now than they've been in any period since 1989. Education, art, and journalism have always been political in the People's Republic, but China's relative openness over the past 25 years, the advent of the Internet, the influx of foreign academic and cultural institutions, and the ease of foreign travel for ordinary Chinese (over 100 million per year) have made it possible for free thinkers to forget the primacy of politics.

Until Xi. His purification of culture and media is of a piece with his rectification of the Communist Party. His use of the Maoist playbook is even clearer in his management of the CCP than in his crackdown on intellectuals. Xi's neo-Maoist methods include:

- Resurrection of the Mass Line (studying the masses and Marxism-Leninism)
- Self-criticisms
- Public confessions
- Lei Feng campaigns (encouraging civic virtue through emulation of a selfless soldier)
- Building a cult of personality, and, most recently;
- Liberal use of biao-tai, a requirement that Party leaders, media, etc., publically pledge fealty to Xi Jinping.

Xi isn't merely out to rectify behavior; in true Maoist fashion, he wants to change hearts. The guiding slogan of his anti-corruption strategy is "Bu ken, Bu neng, Bu xiang." The phrase means that, in the first phase of the campaign, cadres will not dare be corrupt because punishment is certain. In the second phase they won't be able to be corrupt even if they want to, because institutional improvements will preclude it. In the third phase, cadre won't want to be corrupt because their hearts and minds will have been transformed through purification of the culture.

There are two more planks in Xi's program for China's political/cultural/spiritual rejuvenation. The first is the absolute authority of the Party, which "leads all affairs—Party, political, military, civil, and academic—east, west, south, north, and center (党政军 民学,东西南北中,党是领导一切的). The final plank is the unquestionable authority of Xi himself. Since January 2016, CCP propaganda organs have been reporting the biao-tai speeches of provincial leaders who declare that "Xi Jinping is the Core of the Party," and that he must be resolutely protected (坚决 维护习近平这个核心). The phrase hearkens back to Red Guard pledges to defend Chairman Mao during the Cultural Revolution. Neither Deng Xiaoping, nor Jiang Zemin, nor Hu Jintao required officials to biao-tai in this manner. For Xi, L'état, c'est moi.

Xi as the Core

The declaration that Xi is the Core is the defining step in his accrual of power. It is the end to which his campaigns have been leading. It is therefore time to form a judgement about the nature of Xi's governance and its implications for China and the United States. He personally directs all major Chinese policies; without a theory of his personality, the U.S. cannot

respond effectively to the challenges and opportunities posed by Xi's China.

How, then, is China led?

The most populous nation on earth; the world's top trading nation; the nation that will have the largest economy for the most of this century; a country with great military power and equally great territorial, historical, and cultural grievances—is led by an intelligent, experienced man who is genuinely concerned for the material well-being of his people, as he understands it, and whose ambition is to improve their welfare and China's standing in the world.

But Xi is also a leader who believes the Party is China's only possible savior and that he is the essential Core of the Party, to whom and from whom all power should flow. He rules, in the Chinese tradition, as an authoritarian whose power derives from his unassailable wisdom; his fatherly love of country and people; his protection and promotion of the sacred culture, and his moral rectitude. All Party members must "fall in line" and "speak responsibly," as must all journalists, bloggers, artists, academics, and lawyers. It is Xi's vision, Xi's discourse, Xi's country.

Implications of Xi's Leadership for China

- Over the past 20 years, Chinese have come to see collective, technocratic leadership as the norm. They are now asked to accept the concentration of power in the hands of a single, charismatic leader who serves as savior and high priest. This is occurring even as globalization and the Internet have increased China's awareness of alternate modes of governance. It is not clear that the Party and People can make this retrograde transition.
- There is a disconnect between Xi's image and his political performance. He has raised expectations and projected strength, but his record is thin and his actions suggest he is fearful. He blamed foreign agitators for the stock market and RMB exchange rate fiascos and for the Hong Kong Umbrella Movement. He blames the U.S. for friction in the South China Sea. He made no statement for one month after North Korea tested a nuclear weapon—a long silence for a strongman. The pattern suggests Xi is worried that any doubts about his competence could threaten his power.
- This kind of systemic fragility has always plagued Chinese leaders: when authority is based on alleged perfect virtue and unfailing wisdom, the least moral blemish or policy misstep can bring down the whole house of cards. Xi certainly knows

- this. It accounts for much of his leadership style, which is secretive and, perhaps, paranoid, even by CCP standards.
- Should Xi waver, his anti-corruption campaign has doubtless made him many enemies in the Party and PLA who would be glad to knock him down. The zeal with which he has prosecuted the campaign could prove his undoing.
- According to the Pew Research Center's 2015 survey of global attitudes and trends, 96% of Chinese say they are better off than their parents and 77% are wealthier than they were five years ago. Yet under Xi there has been an accelerating outflow of talent and capital from China. Those who can leave, leave.
- Xi's ideology campaign undermines his own agenda. His constraints on academic freedom are at odds with his call for universities to train innovative students. His shackling of the creative class dooms his drive to build soft power. His silencing of media hurts his efforts to build the global credibility of China's discourse.
- Not only is Xi chair of all "leading small groups" that shape policy, he has surrounded himself with a small group of advisors who have scant interaction with CCP bureaucracies. Chinese analysts wonder if Xi has placed himself in a bubble that no unwelcome information can penetrate. They worry that he makes policy based on poor advice.
- With the handover of power from Hu Jintao to Xi Jinping in 2012, the CCP seemed to have solved the succession problem that plagues authoritarian states. By calling himself the Core, Xi has called the succession mechanism into question. He is scheduled to step down in 2022. It is unlikely that the successor he chooses will be the Core from day one. That means that either Xi will remain the power behind the throne, sans title, in the manner of Deng Xiaoping, or his successor will have to spend the first half of his tenure clearing out the Xi patronage networks, just as Xi has used the anticorruption campaign to eliminate Jiang's and Hu's appointees. Both scenarios are destabilizing.

Implications of Xi's Leadership for the United States

 U.S. policymakers should assume Xi will remain the dominant force in China until at least 2027, when his successor reaches his halfway mark. Barring a major political disruption, Xi's centralization of power, ideology crackdown, opposition to Western influence, nationalism, and

- active foreign policy, as well as the destabilizing effects of his leadership, will characterize the PRC for a minimum of eleven more years.
- As Xi's assertive foreign policy unfolds, it has become clear that China is treating individuals, information, and institutions in the international sphere as it treats them domestically. External projection of internal PRC practices can be seen in China's attitude toward international law in the South China Sea: in its failed effort to prevent the UN from publishing information on which nations oppose UN certification of NGOs; in its intimidation of overseas critics scheduled to appear before the UN human rights council; and in its rendition of Hong Kong booksellers. China is seeking to have the CCP's standards for information management and its ideas about individual and social rights accepted as legitimate alternatives to existing international norms, which China views as dominated by the U.S.
- Lastly, the U.S. has grown accustomed to dealing with sophisticated Chinese diplomats and analysts with whom we cooperate on a range of mutually beneficial initiatives. If they are all required to parrot Xi Jinping's dicta and pet phrases, it will be harder to cooperate with them effectively, or even to carry on a coherent conversation. We already see this trend in China's insistence on promoting

"a new type of major power relations" with the U.S. despite the American side's rejection of the phrase. Xi has continued to use the slogan and the Chinese press has continued to amplify it, so China's diplomats continue to use it, American disinterest be damned.

Conclusion

The last time China had a strongman and culture hero at its helm, China was weak and closed off from the world. The pain was largely confined within China's borders. The PRC is now once again led in the Maoist style, but it is powerful, wealthy, and globally ambitious. We don't yet know what this portends for the U.S. and the rest of the world, but the signs are bad and uncertainties are proliferating.

Many observers ask why Xi hasn't used his power to focus on development, as his predecessors did, without the ideological crackdown and assertive foreign policies which fan suspicions of China and may undermine its stability. The answer is that, for Xi, China's economic, moral, cultural, and international greatness are One. China was humiliated in the 19th century because it failed in all of these realms. If its rejuvenation is not comprehensive, it will remain vulnerable. Eliminating every possible source of vulnerability is Xi's historic and sacred mission.

Beijing and Washington--Structure, Perception and Destiny

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In the world today there are three major conflicts – conflicts that can quickly envelope much of the globe: first, the crumbling of the Middle East or West Asia order (see the Tête à Tête interview with Prince El Hassan bin Talal at p. 42); second, the sudden new Cold War between Russia and Ukraine and the West (see the Query article by Vyacheslav Tolkovanov at p. 18); and third, all potential confrontations and shocks relating to the strategic rise of China. I have no remedies in mind for the first two conflicts – even if other writers in GB have treated them with considerable skill – but I am optimistic that the third conflict should not necessarily be bloody, if and only if all parties are far wiser about each other.

If most analysts – including those in Beijing, Washington and New York City - are in agreement that the trajectory of China-US relations will be decisive in shaping the global order in this early new century, they still often remain worlds apart in their interpretation of the behaviour of the country opposite. Consider the notion, mooted just as often by Chinese as by American analysts, that the various problems and frictions in China-US relations are actually caused by so-called 'structural factors.' These structural factors include differences in national ideology and political system, as well as the changing strategic power balance between China and the US. Structural analysis leads these observers to everywhere see evidence of continuous competition or rivalry between the US and China.

Western analysts who subscribe to the structural arguments, including the University of Chicago's John Mearsheimer, tend to argue that a rising power like China will be a revisionist power. It will, on this logic,

for the purpose of power or security maximization, inevitably challenge the predominant position of the established power, the US. The policy prescription for Washington, from the structural perspective, must be to contain Beijing.

For their part, Chinese analysts who subscribe to the structural view like to stress the structural contradictions' (jiegouxing maodun) in China-US relations, only to then argue that ideological prejudices and the desire to maintain hegemonic position will (predictably) drive the US to seek to contain or otherwise keep China down.

And yet these structural arguments might well be misleading – as overly deterministic and therefore possibly self-fulfilling. Importantly, the structural approach fails to appreciate or give weight to the role that perceptions (indeed, misperceptions) play in China-US relations – the implication being that identifying the sources of misperceptions could help to mitigate problems and therefore improve the overall bilateral relationship, if not even save us from unnecessary confrontation or war (see the Feature article by Barthélémy Courmont in the Fall/ Winter 2015 issue of GB).

First and foremost, misperceptions may be conceptual in nature. One representative erroneous conceptual assumption a given state player is fact a unitary actor. Of course, the personification of state actors is a common practice in scholarly and policy analyses. But the unitary actor assumption often causes policy-makers and strategic analysts to misperceive (or misapprehend) another country's intentions and behaviour. For example, g the 1995-1996 Taiwan

crisis, one of the causes of the escalation of the crisis was the misperception by Chinese leaders that the Clinton administration's decision to issue an entry visa to the pro-independence Taiwan leader Lee Teng-hui – a reversal of the previous US policy position – was a manifestation of US encouragement, if not outright support, of Taiwan independence. The Chinese reading of American behaviour, however, ignored the fact that the Clinton administration made the visa decision under enormous pressure from the US Congress. Indeed, the Clinton ad- ministration's implicit forewarning that it might be unable to uphold its preferred position under mounting Congressional pressure – a forewarning issued by Secretary of State Warren Christopher in his meeting with Chinese Vice Premier and Foreign Minister Qian Qichen - was unfortunately discounted by the Chinese.

US policy makers, too, may suffer from similar misperceptions caused by a unitary actor assumption. Consider so-called Impeccable Incident. In March 2009, the US reconnaissance vessel the USNS Impeccable was intercepted by Chinese ships in China's Exclusive Economic Zone (EEZ) off the coast of Hainan province. The Impeccable Incident reflected, at least in part, Beijing's and Washington's differing interpretations of the UN Convention on the Law of Sea (UNCLOS) - particularly in respect of coastal states' rights in their EEZs. Nevertheless, US officials and analysts viewed the incident as evidence of China increasingly flexing its muscles, and indeed of Beijing's growing military assertiveness. But this conclusion was surely based on a unitary actor presumption by US analysts. For much like in the US, China's vast bureaucracy also frequently falls prey to the curse of 'the right hand not knowing what the left hand is doing.' As the former US Secretary of Defense Robert Gates observes in his memoirs, China's civilian leadership might not always be in full control of the nuts and bolts of what is happening on the military side of the ship of state. One could, therefore, advance the alternative hypothesis that the Impeccable Incident resulted from initiatives taken at the lower end of the military chain of command. To be sure, however, after the standoff began, all Chinese leaders naturally came to the defence of their own boys.

Misperceptions may also be cultural in nature. As they surely have different cultural heritages and starting points (and, evidently, very different mentalities), Chinese and American policy-makers sometimes find themselves talking past each other when it comes to understanding some important policy discourses or concepts. For instance, US officials and analysts like to talk about shared responsibilities and leadership, and to urge China to assume greater responsibilities and play a greater leadership role in regional and international affairs. With the aim of moving China to play a more active role in resolving the North Korean nuclear crisis, top officials in the George W. Bush administration had, for a while, been endorsing the idea that China should lead the region in developing a Northeast Asia Security Mechanism, building on the success of the Six Party Talks.

Another example was the concept of the Group of Two (G2), an idea recognizing the centrality of the China-US dyad in the stewardship of global affairs. The G2 idea was floated by US strategic thinkers like Zbigniew Brzezinski – then a top foreign policy adviser to Barack Obama's 2008 presidential campaign. Although the Obama administration never publicly embraced the G2 construct, Washington, in the wake of the 2008 global financial crisis, vigorously courted China to participate guns blazing in international efforts to fight the global economic downturn. Top US officials such as Secretary of State Hillary Clinton confessed that the US and China were "in the same boat" during her visit to Beijing in February 2009. President Obama himself stated repeatedly that no global challenge - from climate change to nuclear proliferation - could be resolved without China and the US joining forces and collaborating. And despite the ups and downs in China-US relations over the course of the Obama presidency. and notwithstanding continued mutual grievances and suspicions, Obama and his foreign policy team have generally been keen to encourage China to play a growing leadership role befitting the country's growing strategic footprint. Secretary of State John Kerry himself even recently acknowledged that China would soon become a global leading power and that he therefore expected China to assume a greater share of global responsibility for solving major international problems.

However, shared leadership is a patently foreign concept to Chinese ears. Unlike in American or Western culture, leadership (lindao) in the Chinese culture is understood as something hierarchical – something that cannot, as a logical proposition, be shared. Indeed, as the Chinese saying goes, "How can an outsider be allowed to sleep beside one's bed?" (wota zhice qirong taren hanshui); or, in other words, a king will not allow any potential threat to his authority and power. As such, repeated US calls for Beijing to

share leadership with Washington and other important capitals tend to be viewed with suspicion, distrust and incredulity in China. Worse still, such Chinese distrust of American logic, coupled with the bitter memory of the Century of Humiliation at the hands of the Western imperialist powers, predisposes Chinese elites and the public to brush aside any suggestion that China and the US should share in any leadership. Such deep-rooted suspicion helps to explain Chinese leaders' and strategic analysts' wary reaction to the G2 idea; indeed, these leaders and analysts may even believe such American proposals for shared leadership and responsibility to be a trap set by Washington – one betrayed by what must be the overriding objective of the US, which is to contain China (as discussed above).

Another example of culture-based misperception is the concept of a 'new model of major-country relations' (xinxing daguo guanxin) between China and the US - proposed by the Chinese leadership and described by President Xi Jinping as an intellectual framework for resolving the dilemma of seemingly inevitable historical conflict between rising and established powers (call it the 'Thucydides Trap'). By committing to building a 'new model of major-country relations' between China and the US, Beijing argues, the two countries can transcend the old pattern of hegemonic conflict and war and develop a new type of interface that is characterized by "no conflict, no confrontation, mutual respect, and mutual benefit" (buchongtu, buduikang, xianghu zunzhong, Alas. despite official huligongving). Chinese enthusiasm for the construct, the US has to date shown far less interest in it, and seems to even view it with skepticism.

Cultural difference matters here. In the Chinese culture people define the nature of a relationship before entering into formal or 'legitimate' interactions. The Rectification of Names (zhengming) is a very important doctrine in Confucianism. According to Confucianism, the rectification of names – the proper designation of things in the web of relationships creates meaning and legitimacy for social behaviour and social order. As Confucius famously puts it, "If names be not correct, language is not in accordance with the truth of things. If language be not in accordance with the truth of things, affairs cannot be carried on to success" (mingbuzheng ze yanbushun, yanbushun ze shibucheng). The doctrine of zhengming is encrypted into the Chinese psyche, including among China's political and strategic classes. In terms of the Chinese social behaviour, then, relational trust comes

only after a relationship is positively defined. Typically, Chinese business culture requires that people dine and drink until they feel that they have become well acquainted and comfortable with each other – only after which do they get down to business, as it were. In other words, unless the nature of the relationship is properly defined, the trust that is requisite to practical cooperation will not materialize.

The American way of doing business, of course, is almost a reversal of the Chinese approach. For Americans, the name (ming) of a thing or person is not critical. Substance precedes name or form. And this, then, is the US disposition in respect of the 'new model of major-country relations.' "Let's forget about the label, and focus on cooperation," US officials would tell their Chinese counterparts. US analysts, for their part, may suspect that China is setting up a rhetorical trap by insisting on US acceptance of a 'new model of relations' before major-country any deliverables are agreed. These analysts would point to the principles that China proposes for the new model of China-US relations – first and foremost, mutual respect - as setting Washington up to effectively affirm Beijing's 'core interests' - a position that Washington would presumably never take. On the US logic, Washington should never unilaterally accommodate China's core interests - not least because the boundaries and definition of these core interests may be highly elastic. And yet these US policy analysts and their political audience or masters seem to have again misperceived China's intentions. Accommodation, by definition, is mutual. And no Chinese leaders would be so naïve as to believe that they could coax US officials into endorsing China's core interests. But the US fundamentally misreads the proposed new model of major-country relations because it fails to appreciate the import of rectifying the name (zhengming) in China's way of thinking.

The third source of misperception is perhaps the simplest of the three majors: media misrepresentation. Media in China and the US alike today have strong commercial and cultural incentives to dramatize, exaggerate and sometimes even distort stories. Open the ages of any major US or Western newspaper, and one rarely finds much positive reporting about China. That may not be particularly surprising, as American newspapers hardly report any positive stories at all about anything, including the US.

Chinese media have, for better or ill, become increasingly like their Western counterparts since market reforms were enacted in the more than two

decades ago. Indeed, Western observers would be surprised to learn that the Chinese media sector has become even more commercialized than its equivalents in Western countries. Moreover, Chinese media, as with their counterparts in East Asia and some other parts of the world (consider the present euphoric nationalism in Russia driven by that country's media in the aftermath of the Crimean annexation), have also contributed to, and prospered by dint of, the rising tide of nationalism in China. Brief, commercialism and nationalism have together conspired to have the Chinese media often misrepresent the true picture or state of China-US relations.

GB readers will recall that after attending the Asia Pacific Economic Cooperation (APEC) summit meetings in Beijing in November 2014, President Obama made a visit to Australia for the G20 summit and gave a speech at Queensland University. In his speech, Obama revealed his lingering suspicion of China's intentions. He said: "China will inevitably play a critical role in the future of this region. And the question is, what kind of role will it play?" Unfortunately, by the time the story had made it to Chinese online news portals – through the mediation of some other foreign commentary on Obama's choice of words - the dominant headline was as follows: "Obama: China is not a Responsible Country." Many in China today still believe that this was what Obama had actually said about their country.

What's to be done about these misperceptions in order to keep the bilateral relations between Beijing and Washington peaceable and productive? First, drop the unitary actor assumption or presumption on both sides. Both capitals must develop far better understanding and more nuanced appreciation of the black box of the decision-making processes on the other side – primarily to better understand that side's intentions.

Second, both sides must develop greater cultural awareness and sensitivity in order to avoid foolish misunderstandings driven by deeply rooted codes of behaviour. Broadly speaking, promoting cultural and educational exchanges will help to improve the understanding of the other country by elites and publics alike. To this end, the Obama administration's 100,000 Strong Initiative, which aims to send more than 100,000 American students to study in China over a period of five years – a goal already achieved by 2014 – should be applauded. Training the next generations of China specialists in the US, and America watchers in China – specialists who not only speak the languages, but also have deep insights into the culture and history of the opposite country – will be crucial.

Finally, rich and substantive exchanges and educational programmes between media representatives from all levels in both countries can help to alleviate media misrepresentation – an important aspect of socially-based misperceptions between the two countries. Equally important will be the role of policy-makers and analysts in shaping media discourses - rationally and reasonably, with tempered nationalism in place of dogma - in their home country (this, of course, sounds more Chinese than American, but both countries will need to improve in this area) and in communicating through media to colleagues and audiences in the country opposite.

If much of this happens, we cannot guarantee that war will be impossible at some point this century, but we can minimize the probability of misapprehension being its fundamental cause. War, instead, would happen in full knowledge of realities on the ground and of what would happen as a result of hostilities – hopefully enough information, in the aggregate, to keep decision-makers from flirting with such scenarios.

Global Brief Spring/Summer 2015

Addressing Strategic Domain Issues in U.S.-China Relations

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Peking University

with Roy Kamphausen and Travis Tanner

On September 22, Chinese President Xi Jinping arrived in Seattle and began a state visit to the U.S. that will culminate in a summit meeting between U.S. President Barack Obama and Mr. Xi in the White House. Mr. Xi came at a critical moment, especially as recently there have been signs of emerging strategic rivalry in U.S.-China relations.

For a bilateral relationship that is becoming increasingly more complex and interdependent, issue areas such as cyber, maritime, nuclear, space, military to military relations, and people to people exchange—what can be defined as "strategic domain issues"—are among the most consequential ones.

In a major project run jointly by The National Bureau of Asian Research and the Institute for China-U.S. People to People Exchange at Peking University, leading Chinese and U.S. scholars are studying these strategic domain issues. Based on the joint study our team has done, we believe it is of crucial importance for the leaders of our two countries to face squarely these strategic domain issues, which are among the most sensitive and thorny issues in U.S.-China relations. Below we recommend initial steps toward bilateral progress in each of these strategic-domain areas.

China and the U.S. are highly interdependent in cyberspace, notwithstanding cyberespionage concerns. Our two countries have shared interests in countering cybercrimes and cyberterrorism. These areas can become the first steppingstones toward building mutual trust and expanding cooperation in the cyber domain. The two countries should also seek common ground on cyberattacks, Internet governance, and cyber

infrastructure. Essential to this will be a return to a dialogue mechanism to reach agreement on how to protect key information infrastructure and establish a code of conduct in cyberspace.

Maritime security is the strategic domain that China and the U.S. have perhaps the greatest potential for cooperation and mutual benefits—though also great potential for conflict. Put simply, the South China Sea is not and should not be the whole picture of U.S.-China relations. The two sides should clarify their strategic intentions and avoid misunderstanding or misperception. Both sides have shared interests and responsibilities in ensuring freedom of navigation as well as maintaining regional peace and stability. We should put in place crisis prevention and management mechanisms and other confidence-building measures (CBMs). The U.S. and China should sign the air-to-air the U.S.-China Memorandum Understanding (MOU) On the Rules of Behavior for the Safety of Air and Maritime Encounters signed last November. The two coast guards should expand cooperation in law-enforcement missions, and the two navies in humanitarian assistance and disaster relief.

Nuclear weapons are a critical dimension in U.S.-China strategic relations. On the basis of changing understandings of a credible Chinese second-strike capability, the two sides should begin a nuclear strategic stability dialogue. The two presidents should reaffirm their commitment to denuclearization, particularly as North Korea has restarted its nuclear facilities and is posed for a missile launch. They should impress upon Pyongyang that a nuclear North Korea will never be accepted by the international community,

take measures to actively head off the looming crisis, and try to break the impasse by resuming the Six Party Talks.

Space is a strategic domain characterized by high risk of strategic competition with relatively fewer common interests. In order to control strategic risks, China and the U.S. should actively seek to expand cooperation. For instance, the two sides should consider establishing a periodic notification mechanism and regularly exchange information regarding space debris. The two sides should also consider promoting CBMs in the space domain, such as reciprocal commitment to not to disrupt or destroy the other side's space assets.

A mature and stable U.S.-China military-to-military relationship is crucial for fostering a new model of relations between the two countries. The two militaries should consider bilateral or multilateral military cooperation in non-traditional security arenas. For instance, the two sides might begin with exchanges on peace-keeping operations. The two militaries should deepen their cooperation in maintaining regional security and stability, including in Afghanistan.

People-to-people exchange has become one of the solid pillars of U.S.-China relations. Using people-to-people exchange as a strategic mechanism will help to reverse negative trends and address the trust deficit in the bilateral relationship. The two sides should invest in more opportunities for student exchange and language learning, ensuring these future leaders are equipped with the skills to collaborate with each other.

When the two presidents meet for a summit in Washington, D.C. on September 25, it is imperative that they engage in a real conversation on these strategic-domain issues. Fully addressing those areas head-on will help mitigate the signs of budding strategic rivalry between China and the U.S., chart the roadmap for the new type of great-power relationship between the two, and anchor U.S.-China relations on a more stable and durable basis in the years and decades to come.

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Resetting U.S.-China Relations

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President Obama arrived in Beijing on Monday for a meeting of the AsiaPacific Economic Cooperation forum. He will meet with China's president, Xi Jinping, at length on Wednesday. The occasion is a vital opportunity for the two presidents to reset the relationship between the nations.

Since Mr. Obama and Mr. Xi last met, at the Sunnylands estate in Rancho Mirage, Calif., in June 2013, many analysts have been pessimistic about that relationship. China's announcement of an "air defense identification zone" in the East China Sea last November, and ongoing disagreements in areas like computer crime, climate change and trade, have contributed to a climate of mistrust.

The two presidents should use their meeting on Wednesday to reassure each other about their nations' strategic intentions and to ease suspicions that each government harbors toward the other. This will require candor on the part of both leaders.

Mr. Obama should reiterate that America welcomes the continuing, peaceful emergence of China as a world power and that its strategy is not — as many Chinese analysts claim — to "contain" it. Mr. Xi should reassure Mr. Obama that China is not interested in (much less capable of) pursuing, in Asia, a Chinese version of the Monroe Doctrine, and that it recognizes the constructive role that the American presence can continue to play in East Asia. Above all, they should articulate a vision of global affairs in which cooperation between the United States and China is indispensable to the pursuit of peace and stability.

The two presidents will have the opportunity to cover many areas in the United States-China

relationship. They should renew their commitments to reducing greenhouse-gas emissions and cooperating on energy-efficiency technologies. They should discuss ways to align their responses to the Ebola crisis in West Africa.

Both countries have an interest in promoting reconciliation and reconstruction in Afghanistan, and in collaborating on a vision for peace, stability and prosperity there.

The rise of the self-proclaimed Islamic State poses serious threats to the stability of the Middle East and, potentially, the global community. China and the United States, which are both victims of terrorist threats and declared enemies of the Islamic State, should spare no effort in bolstering their cooperation in combating this, including possible cooperation on intelligence sharing, through the United Nations and other multilateral forums.

On North Korea, the two presidents should reaffirm their commitment to denuclearization. They should leave no doubts in the minds of North Korean leaders that a nuclear North Korea will never be accepted by the international community. The only way for North Korea to achieve the goals it holds dear, including security, economic development and normalization of relations with the United States, is for Pyongyang to return to the denuclearization process. The two presidents should work together to revive the stalled six-party talks.

Economic ties — long considered the ballast of the United States-China relations — have become less cordial in recent years, in spite of the massive expansion of bilateral trade and investment since China

entered the World Trade Organization in 2001. Last month, 51 top American business leaders, led by the U.S.-China Business Council, urged Mr. Obama to make the conclusion of a bilateral investment treaty by 2016 a priority in his meetings with Mr. Xi. Such a treaty would have tremendous benefits for both countries.

Military-to-military relations, long regarded as the weakest spot in United States-China relations, have in fact grown considerably in recent years. There are now regular visits and exchanges involving military officers of both nations, from all levels. The two militaries have cooperated in counter-piracy operations in the Gulf of Aden, and in joint exercises of humanitarian assistance and disaster relief. Recently, the Chinese Navy participated for the first time in the biennial international maritime exercise led by the United States Pacific Fleet.

Broadly put, the two presidents must act to arrest and reverse the emergence and deepening of a dynamic in which efforts by either nation to bolster its own security causes the other to feel less secure. The relationship between the United States and China must not become a strategic rivalry, spiraling downward. The two militaries should continue to build mutual understanding and trust, and promote pragmatic cooperation in areas such as United Nations peacekeeping operations and counterterrorism.

As China's economic and military strength continues to grow, and its weight in the Asia-Pacific

region increases, Beijing and Washington will have to not only negotiate and renegotiate the boundaries of their power and influence, but also develop a shared understanding of their global roles and responsibilities.

Chinese leaders have put forward a new model of "major-country relationship" between China and the United States, an intellectual framework for resolving one of the greatest puzzles in international history — how to avoid falling into the so-called Thucydides trap, the often-cited cycle of struggle between rising and established powers.

To build such a new model, the two presidents will need to not only demonstrate to the public in both countries their ability to rise above pessimism and cynicism and to deliver tangible benefits, but also to chart a trajectory for a relationship that benefits both nations and that is positive-sum, not zero-sum. This week, they should renew and sustain the momentum from their meeting last year, and lay the foundation for a mature, cooperative and robust United States-China relationship in the years and decades to come.

Wang Dong is an associate professor in the School of International Studies at Peking University. Robert A. Kapp, a former president of the U.S.-China Business Council, is a senior adviser to the China program at the Carter Center. Bernard Loeffke is a retired major general of the United States Army.

Published in The New York Times on November 10, 2014.

Co-Existing with a Rising China: U.S. Economic, Security, and Environmental Challenges

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March 28-April 4, 2016 Beijing and Nanjing, China

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Co-Existing with a Rising China: U.S. Economic, Security, and Environmental Challenges

AGENDA

March 28-April 4, 2016 Beijing and Nanjing, China

MONDAY, MARCH 28:

American participants travel to China

TUESDAY, MARCH 29

Working Dinner

WEDNESDAY, MARCH 30

FINANCIAL ENGAGEMENT, TRADE, ECONOMY

China is the world's second largest economy. China and the U.S. together account for nearly 35 percent of global Gross Domestic Product. Economic interdependence is the underlying stable framework of U.S.-China relations, with China dependent on exports to the U.S. and the U.S. reliant on China's purchase of its debt. Bilateral trade is now at a level of \$600 billion annually. China is the largest foreign debt holder for the U.S., at \$1 trillion. This economic foundation of engagement between countries with fundamentally different political systems is a stabilizing force, albeit one with some uneasiness. The change in valuation of China's currency triggered a sell-off in global stock markets last August.

- How does China's economy affect the U.S. and the world?
- What are the links between U.S.-China economic engagement and security issues?
- What are China's prospects for economic growth and why does it matter?
- What are the policy implications of the continued U.S.-China trade deficit?
- What are the implications of China not being part of the Trans-Pacific Partnership?
- Do cybersecurity and copyright protection concerns jeopardize U.S.-China economic engagement?
- Does China's increasing wealth carry commensurate global responsibilities?
- How will the continued growth of China's middle class change China, and why does it matter to the U.S.?
- What are the prospects for China's currency to become convertible and what would be the global economic consequences?

Arthur Kroeber, Managing Director, GaveKal Dragonomics, Editor, China Economic Quarterly

David Daokui Li, Director, Center for China in the World Economy, Tsinghua University,

Monetary Policy Committee, People's Bank of China

He Fan, Chief Economist, Caixin Insight Group

THE ROLE OF CHINA'S NEW ASIAN INFRASTRUCTURE INVESTMENT BANK

Jin Ligun, President, Asian Infrastructure Investment Bank

Pre-Dinner Remarks

CINEMA AS AN INSIGHT INTO CONTEMPORARY CHINA

Representatives of China's film industry will discuss how contemporary cinema reflects the social, economic and cultural ties between the U.S. and China.

Working Dinner

THURSDAY, MARCH 31

ENERGY AND ENVIRONMENT RESOURCES

China and the U.S., the two largest emitters of carbon, recently announced an agreement to reduce emissions. China gets two-thirds of its electricity from burning coal. Coal burning for home heating purposes in northern China reportedly takes an average of 5.5 years off a person's life, and over 1.2 million Chinese die prematurely annually from air pollution. In an effort to lessen its coal dependency, in addition to massive expansion of solar and wind energy, China plans to nearly double its nuclear energy capacity with 24 new plants under construction, mostly utilizing American technology and suppliers, with a goal of nuclear energy providing 20 percent of its electrical needs by 2030. China is also expected to increase its consumption of natural gas to offset coal production and become a major importer of liquefied natural gas, which could provide a huge opportunity for a new U.S. export commodity. Meanwhile, China's global thirst for energy, water, metals, food products, and strategic minerals to support the rising living standards of its immense population—one-fifth of the world—positions it as a resource competitor globally.

- How severe are China's environmental challenges and what are their global implications?
- How will China and the U.S. implement their commitments to reduce emissions?
- Does China's "Cap and Trade" system on carbon emissions have relevance for the U.S.?
- How serious is China's commitment to renewable energy sources?
- Will China's water crisis have a global impact?
- Is China's appetite for resources a motivation for its development strategy in Africa?
- What is the future food security profile for China and its global impact?

Hal Harvey, Director, Energy Innovation Jiang Lin, Senior Vice President, China Strategy, Energy Foundation

Working Lunch

MEETING WITH CHINA'S PREMIER

Li Keqiang

Pre-Dinner Discussion with Beijing-based non-governmental organizations

A CHANGING STATUS FOR FOREIGN ENTITIES IN CHINA

A new draft law could significantly change the terms for foreign entities operating in China. Non-governmental organizations (NGOs) will have to find a government sponsor and register with the state public security apparatus,

which could lead to close monitoring by the state. We will hear from a panel of representatives of NGOs active in China about the impact of the proposed new regulations and how these regulations would affect their activities.

Moderator: Paul Haenle, Director, Carnegie-Tsinghua Center for Global Policy

Elizabeth Knup, China Representative, Ford Foundation

Ji Hongbo, Representative for China, The Asia Foundation

Jeremy Daum, Senior Fellow, The China Center, Yale Law School

Lester Ross, Past Vice Chair, Board of Governors of the American Chamber of Commerce

Working Dinner

FRIDAY, APRIL 1

MORNING DISCUSSION WITH THE U.S. EMBASSY SENIOR STAFF

Participants travel to Nanjing

Afternoon Educational Site Visits in Nanjing

FORD MOTOR RESEARCH AND ENGINEERING CENTER

China has the world's largest car market and the Ford Motor Company is making significant investments here to meet those demands, with the introduction of energy-saving and innovative systems to address the needs of the growing car market while lessening emissions and improving energy efficiency. Research is also being done at this new Nanjing facility on new models of hybrids and electric cars. With a staff of nearly 2,000 engineers, Ford also sees this Nanjing center as playing a major role in its global strategy. We will discuss with Ford management why they have made this investment in Nanjing and its implications for the U.S. and China.

Dave Schoch, Group Vice President, Ford Motor Company; President, Ford Asia Pacific

NANJING AMITY PRINTING COMPANY

This visit will provide an opportunity to explore the juxtaposition of a private business and religious freedom. Amity is a joint venture between the Amity Foundation and the United Bible Societies and has been producing Bibles for domestic and international markets in several languages, employing 400 Chinese in this plant on the outskirts of Nanjing since 1988. A total of 70 million Bibles have been printed for distribution in China over the last 28 years. The plant has continued to expand with modern printing presses and is equipped to produce 20 million hardbound books annually.

John Zhang, Nanjing Amity Printing Company

HOPKINS NANJING CENTER

We will visit the Hopkins-Nanjing Center for Chinese and American Studies (HNC) a partnership between Johns Hopkins University and Nanjing University now in its 30th year of operation, where we will have a colloquy with students and faculty. The concept is to provide graduate-level studies for an equal number of American and Chinese graduate students, and all must be bilingual. The center also has received direct support from the U.S. government and currently is the recipient of a USAID grant to support its only "open stacks" library in China. Many students from the HNC center go on to careers in business and government that utilize their immersion in U.S.-China studies. We will hear an explanation of this unique arrangement and have an opportunity to discuss directly with students and American and Chinese faculty.

Dr. He Chengzhou, Deputy Chinese Co-Director, Hopkins-Nanjing Center

Dinner with Hopkins-Nanjing Center Students and Faculty

SATURDAY, APRIL 2

SECURITY/GLOBAL RESPONSIBILITY

Ongoing military and security concerns exist in the western Pacific, exacerbated by China's island reclamation project in the South China Sea. Regional relationships, including with American ally Japan, play a key role in these considerations. Cybersecurity has become a major area of concern. Beijing and Washington collaborate on stability on the Korean peninsula, antiterrorism and nonproliferation. However, a lack of trust underlies the security dimension of U.S.-China relations.

- Is China a security concern for the U.S. and the Pacific region?
- As China grows in global stature, is it fulfilling its role as a "responsible stakeholder" in addressing shared global challenges?
- How does China's pursuit of its regional and global aspirations fit with America's goals?
- How can maritime security issues best be addressed?
- What is the nature of the changing relationship between China and Russia and its relevance to the U.S.?
- How will the recent cybersecurity agreement be enforced?
- How can China and the U.S. cooperate on combatting terrorism and policy challenges in the Middle East?

Admiral Dennis Blair, former U.S. Pacific Fleet Commander

Zhu Feng, Executive Director, China Center for Collaborative Studies of the South China Sea, Nanjing University

Akio Takahara, Professor, University of Tokyo

Zhang Tousheng, Director of Research, China Foundation for International Strategic Studies

Working Lunch

Educational Site Visit

MEMORIAL TO THE VICTIMS OF THE NANJING MASSACRE

Participants will be joined by Chinese and Americans students from the Hopkins-Nanjing Center for a visit to the Memorial for the Victims of the Nanjing Massacre. The students will provide additional commentary about the historical and contemporary interpretations at the memorial, which provides insight into the relationship between China and Japan.

Working Dinner

SUNDAY, APRIL 3

GOVERNANCE/CIVIL SOCIETY

Human rights concerns and issues of equity and fairness continue to be irritants in the relationship, as does China's clamp-down on Internet freedom, cybersecurity concerns, and efforts to limit Hong Kong's democratic aspirations. President Xi Jinping's anti-corruption campaign has consolidated power and taken a more assertive stance on key issues. Is Xi "China's most authoritative leader since Mao" and if so, what relevance does that have for U.S. policymakers?

- How is the "one country, two systems" arrangement working for Hong Kong?
- What are the prospects for Taiwan's governance and its relevance to the U.S.?
- What relevance is the outcome of the recent Taiwan elections for U.S.-China relations?

Harry Harding, Visiting Professor of Social Science,
Hong Kong University of Science and Technology;
University Professor and Professor of Public Policy, University of Virginia
Yu-Shan Wu, Professor of Political Science, National Taiwan University

- What do China's leadership trends portend for U.S.-China relations?
- Is China's authoritarian capitalism viable and durable?
 - How will the Fall 2016 U.S. elections affect U.S.-China relations?

Orville Schell, Director, Center on U.S.-China Relations, Asia Society

Robert Daly, Director, Kissinger Institute, Wilson Center

Wang Dong, Director, Center for Northeast

Asian Strategic Studies, Peking University

Educational Site Visits

CHINA MODERN HISTORY MUSEUM

This is the presidential palace of Chiang Kai-Shek's nationalist government, which ruled China from 1927 until he was ousted in 1949 when communist forces captured Nanjing and his government fled to Taiwan. In the late 1980s it was transformed into the museum about 20th century China, including the history of the Republic of China and the history of the People's Republic of China. Historical and contemporary commentary will be provided.

Orville Schell, Director, Center on U.S.-China Relations, Asia Society

NANJING CITY WALL

This 600-year old brick wall, built in the early Ming Dynasty, demarcated the ancient city of Nanjing, which was formerly the capital of China. Its total length was 35 kilometers and 25 kilometers of the wall still remains today. It is the most ancient city wall still standing in China and in the world as a whole today. It is witness to the achievements of ancient China in the planning of urban defense facilities, craftsmanship of city wall construction, and overall development of feudal capitals. Historical and contemporary commentary will be provided.

Robert Daly, Director, Kissinger Institute, Wilson Center

Working Dinner

MONDAY, APRIL 4

All participants depart Nanjing in the morning; Americans continue on transpacific travel

