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<b>14. ABSTRACT</b> A nation's economic vitality underpins its diplomatic influence and military power. The international community currently has different expectations of both China and the U.S., which informs the application of U.S. influence and the various elements of national power. The U.S. and China are in different phases of development, and fulfill different roles within the international system. China continues to develop, emphasizing the economic dimension of its national power, remaining focused on competing in global markets, setting the conditions for the success of its firms, and increasing the standard of living within its borders. The U.S. clearly maintains and exercises economic influence, but does so from a more defensive posture, attempting to preserve the stability of the current international system by utilizing its vast military apparatus. This has led to the prioritization of the military aspect of national power above the economic, and arguably the foreign above the domestic. The most important facet of the U.S. relationship with China is economic. Sound U.S. foreign policy begins with sound domestic policy, and the foundation of sound domestic policy is national productivity. To maintain its influence, the U.S. government must refocus on domestic policy, laws, and institutions; reexamining current law and pending legislative proposals, the structure of legislative branch committee structures and jurisdictions, and refining Executive branch policies.					
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MASTER OF MILITARY STUDIES

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**SUSTAINING THE U.S. POSITION IN THE INTERNATIONAL COMMUNITY:  
THE CHINA CHALLENGE**

SUBMITTED IN PARTIAL FULFILLMENT  
OF THE REQUIREMENTS FOR THE DEGREE OF  
MASTER OF MILITARY STUDIES

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## Executive Summary

**Title:** Sustaining the U.S. Position in the International Community: The China Challenge

**Author:** Major Sean Welch, United States Marine Corps

**Thesis:** Sound foreign policy begins with sound domestic policy and institutions. The United States government must reexamine these domestic issues in order to maintain American influence as China develops.

**Discussion:** The U.S. and China are in different phases of development, and fulfill different roles within the international system. The international community currently has different expectations of both China and the U.S., which informs the application of U.S. influence and the various elements of national power. China continues to develop, emphasizing the economic dimension of its national power, remaining focused on competing in global markets, setting the conditions for the success of its firms, and increasing the standard of living within its borders. The U.S. clearly maintains and exercises economic influence, but does so from a more defensive posture, attempting to preserve the stability of the *current* international system by utilizing its vast military apparatus. This has led to the prioritization of the military aspect of national power above the economic, and arguably the foreign above the domestic. Because China's plans include the development of certain military capabilities and increased capacity, the U.S. military will continue to adapt its operating concepts, refine existing capabilities, and develop new ones. Accordingly, the military-to-military relationship with China will continue to evolve and generate significant interest. But, this evolving relationship is only one facet of the complex relationship the U.S. maintains with China. A nation's economic vitality underpins its diplomatic influence and military power. The most important facet of the U.S. relationship with China is economic. Sound U.S. foreign policy begins with sound domestic policy, and the foundation of sound domestic policy is national productivity. U.S. and Chinese influence will only grow to the extent that their respective economies remain productive and competitive. Herein lays the imperative. The Chinese government is primarily focused on domestic policies which enable economic competition and growth, the underpinnings of its military growth. This has propelled China's economy forward steadily despite the global financial crisis. The U.S. government, on the other hand, remains more outwardly focused, continuing to press China to reform policies that put it at a disadvantage. China has been successful in resisting such pressures and asserting its sovereignty in establishing policy pertaining to Chinese systems. Therefore, the U.S. must compete more favorably in world markets.

**Conclusion:** The U.S. government must refocus on domestic policy, laws, and institutions; reexamining current law and pending legislative proposals, the structure of legislative branch committee structures and jurisdictions, and refining Executive branch policies. China's success and ascendancy may not necessarily result in its predominance. If the U.S. is to retain its influence it must reexamine and adjust its domestic policies and evolve its institutions, rebalancing towards achieving a level of productivity similar to that which vaulted America into global prominence following World War II.

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## **Preface**

Entering into the process of determining and refining the topic of this paper, I held the perception that the United States' (U.S.) foreign policy is overly reliant on the military. My problem was that this was not something that I could explore, develop, or capture within the course of a year or in 20-25 pages. Around the same time, the President announced that the United States, coming out of over ten years of land conflict in the Middle East, would execute a strategic pivot to the Pacific. I knew little about the Pacific so, in an effort to focus my paper, chose to learn about China. While this seemed to provide some degree of focus, I quickly discovered that exploring U.S.-China relations in any depth was unattainable without further narrowing my focus. As I continued to read, a number of items continuously reappeared as challenges within Sino-American relations. These challenges include Taiwan, the South China Sea, the U.S. trade deficit, and Chinese currency policies. Conveniently, these issues could be separated into two categories of the Diplomatic, Information, Military, and Economics, or DIME, construct of the elements of national power. The first two fit within the military piece, and the second two within the economic piece. I chose to focus on these issues to develop the paper and attempt to substantiate my initial perception.

As I developed my understanding of the facts and factors influencing the behavior of both China and the U.S., I began to consider the drivers of the U.S. focus on its military and the Chinese focus on its economy. The contrast is significant. Remaining focused on U.S. foreign policy, I considered the U.S. institutions, laws, and policies that have led to more than half of the Federal Government's discretionary budget authorities residing with the Department of Defense (DoD). Drawing on past experiences, I looked at what the Executive and Legislative branches of the U.S. government considered in determining how to engage with China. What I found is that the structure and jurisdictional lines of congressional committees determine, to a significant degree, the options available for the Executive branch to pursue. The DoD is indeed the most highly resourced Executive branch agency due to these committee structures and jurisdictional lines. This is due chiefly to the personal and parochial interests of the Members of the Congress. However, the most troubling challenges the U.S. faces in regard to China are economic, and stem largely from domestic policies and mandatory spending. Throughout the process of writing this paper I was repeatedly led back to U.S. domestic laws and policies. Specifically, those laws that now contribute to \$1.989 Trillion (T) in mandatory spending, and over \$1T in deficit spending in 2012 alone. The United States cannot effectively influence China or many other nation states from such a position of relative economic weakness.

## **Introduction**

A nation's economic vitality underpins its diplomatic influence and military power. While China continues to develop, its military growth and associated increase in assertiveness will stem from the mounting strength and resiliency of the Chinese economy.<sup>1</sup> Similarly, U.S. military strength is directly dependant on the stability and vitality of the U.S. economy. The 1991 U.S. National Security Strategy points this out: "Our national power, for example, ultimately rests on the strength and resilience of our economy, and our security would be badly served if we allowed fiscal irresponsibility at home to erode our ability to protect our interests abroad, to aid new democracies or to help find solutions to other global problems."<sup>2</sup> In the case of U.S. interaction with China, American foreign policy appears imbalanced, and overly reliant on military means. A solution to this is a reexamination of the drivers of U.S. law and policy, and the governance structure within which they are developed.

The contrast in sensitivities within the Sino-American relations is striking, as observed in American media. On one hand, the Chinese quite visibly object to U.S. military activity in the Asia-Pacific region. On the other hand, the U.S. is particularly sensitive to the Chinese government's economic policies. The U.S., exercising a visible component of national strength or "hard power," elicits sharp rebuke from the Chinese government. China, exercising a less visible aspect of its influence, or "soft power," garners criticism of similar magnitude from the U.S. government. This dynamic suggests a lack of balance in terms of how the U.S. has implemented much of its foreign policy, via the use of the military.

U.S. authorities continue to challenge Chinese monetary, industrial, and trade policies. U.S. policy-makers have repeatedly charged China with intentionally undervaluing its currency.<sup>3</sup>

These officials fear that such Chinese policies may create an unfair advantage for Chinese firms, reducing the competitiveness of American products.<sup>4</sup> Another issue for the U.S. is China's trade policy. The U.S. remains watchful of Chinese policies that give an unfair advantage to Chinese firms in the global marketplace, particularly in the form of direct or indirect subsidies, which would violate World Trade Organization (WTO) guidelines.<sup>5</sup> Finally, the U.S. trade deficit with China is a significant source of frustration for the U.S. and has risen from \$10 billion in 1990 to \$273 billion in 2010.<sup>6</sup> While Chinese goods are abundant in U.S. markets and American consumption of these goods contributes significantly to the continued growth of the Chinese economy, American goods are not as abundant in Chinese markets.

Conversely, China has challenged the legitimacy of U.S. military operations and relationships in the Pacific. China often bemoans the presence of the U.S. military close to its national borders and operating within what it claims as its exclusive economic zone and historically territorial waters.<sup>7</sup> Joint naval exercises and routine patrols in the South China Sea can trigger these outbursts.<sup>8</sup> Similarly, China objects to other U.S. bilateral interactions in the region.<sup>9</sup> U.S. foreign military sales with Taiwan can elicit sharp objections. During times of U.S. and Chinese military to military engagement, the U.S. interaction with Taiwan can result in the suspension of further engagement.<sup>10</sup>

With the Chinese economy continuing to grow, China's military capabilities and capacities will grow as well.<sup>11</sup> As this growth occurs, the U.S. will have to expend more resources simply to maintain current levels of engagement and to understand the intent of China's military actions.<sup>12</sup> However, this does not mean that additional military to military

engagement and a shift in defense policy focus is all that is required or appropriate of the U.S. government in formulating a balanced foreign policy.

The America's relationship with China is dynamic and American foreign policy must continuously adjust to account for this. On May 15, 2008 Senator Richard Lugar remarked "The U.S. must come to grips with the incredibly complex set of problems, choices, and opportunities that China represents. Clearly we have sharp differences with the Beijing government on many issues... Though progress has been made in some areas, most of these issues are unlikely to be resolved in the short run."<sup>13</sup> There are many issues within a number of broad categories that are high priorities. The security and economic environments are included within these categories.

First, this paper will look at U.S. foreign policy with China. Next, this paper will discuss the economic dimension of U.S. – People's Republic of China (PRC) relations, focusing on trade and currency. These are areas of intense diplomatic consultations. Finally, the paper will offer an analysis and provide recommendations intended to refocus the application of U.S. national power in light of the increasingly competitive international system.

## **Security**

A facet of the U.S. – China relationship is the security environment. Even during the Cold War, the U.S. and China maintained significant diplomatic relations in this area. Thirty years ago, cooperation in this area was largely intended to manage the threat of the Soviet Union. Now, with the Soviet threat gone, diplomatic relations typically highlight cooperation in achieving mutually beneficial outcomes in areas of regional security and the development of military-to-military relationships.<sup>14</sup> However, Sino-American security and military relations have

remained strained since the Tiananmen Square incident in 1989.<sup>15</sup> Since that time, and in light of China's increasing economic, political, and military influence, the U.S. has viewed Chinese intentions with increasing skepticism. Today, Chinese security concerns include continued American arms sales to Taiwan and U.S. operations in the South China Sea, which China continues to claim as territorial waters or, at least, its 200-mile Exclusive Economic Zone (EEZ).<sup>16</sup>

## **Taiwan**

The issue of Taiwan is among the most sensitive issues in U.S. - China relations. The U.S. continues to sell Taiwan military articles through Foreign Military Sales and, consistent with the Taiwan Relations Act, the U.S. Pacific Command "maintain[s] the capacity... to resist any resort to force or other forms of coercion that would jeopardize the security, or social or economic system, of the people of Taiwan."<sup>17</sup> On September 21, 2011, the U.S. Defense Security Cooperation Agency issued three notifications to Congress that it would sell a package of weapons to Taiwan under the Foreign Military Sales program.<sup>18</sup> Following these notifications, the Chinese government suspended a series of military-to-military engagements.<sup>19</sup> Meanwhile, China is increasing its military capability, modernizing its Air Force and increasing its short-range ballistic missile force to over 1,000 missiles.<sup>20</sup>

There are positive non-military developments taking place in China – Taiwan relations which may, over time, contribute to the resolution of the Taiwan issue. Ma Ying-jeou, the leader of the Nationalist party, or Kuomintang (KMT), was first elected in 2008 and in January of 2012 won a second term. This election was won on a platform of increased engagement with China and based on the belief that Taiwan's interests were better served by engaging China rather than

provoking it. His "three-point China policy" is "no independence," "no unification," and "no war."<sup>21</sup> Since then, considerable progress has been made between China and Taiwan economically. Over 40% of Taiwan's exports go to China, where Taiwanese businesses have invested more than US\$90 billion and over 800,000 Taiwanese live.<sup>22</sup> In 2008 regular passenger flights between China and Taiwan began, and in 2010 more than 1.6 million Chinese visited Taiwan.<sup>23</sup> Economically, Taiwan's economy grew by more than 10% in 2010, and saw more than a US\$70 billion surplus in bilateral trade with China and Hong Kong.<sup>24</sup>

In the meantime, despite these positive economic developments, peace and stability will continue to rest on the U.S. military. Resolution of this issue will require China to set aside the use of force as a means of reabsorbing Taiwan into what it calls "One China." Until Taiwan and China can come to a diplomatic resolution regarding Taiwanese sovereignty or reunification, or until the U.S. government is compelled to walk away from the Taiwan Relations Act, tensions will remain.

### **The South China Sea**

Taiwan is located at the North of the South China Sea, which is as critical to the continued economic development of China as it is for the rest of the world's economies. This region is, arguably, the epicenter of future global economic development, production, and consumption. Taiwan, China, Vietnam, Malaysia, Indonesia, Brunei, and the Philippines all ring the South China Sea. All of these states rank among the world's top 100 economies, which include major cities and corporations.<sup>25</sup> Similarly, most of these countries are listed among the world's most populous, with their vast markets under development.<sup>26</sup>

China's perspective on this region comes, in part, from a historically rooted sense of what constitutes its historical boundaries. This perspective places Chinese nationalism and a desire to restore China to its former boundaries at odds with the interests of the other sovereign states in the region. However, China can claim some portion as its coastal waters. Control of coastal waters is necessary for China to maintain its national sovereignty as it exists today. The sensitivity of the numerous competing claims of sovereignty over the South China Sea among the nations that ring this body of water is clear. Even with the United Nations Convention on the Law of the Sea (UNCLOS) agreement in place, these competing claims pose significant economic and security challenges within the region.

UNCLOS, signed in 1982, plays a significant role in the geopolitical dynamics of this region. Competition over sovereignty of portions of the South China Sea centers on access to and control of natural resources, and the flow of commerce through the various shipping lanes. According to the UNCLOS, the South China Sea can be categorized as an "enclosed or semi-enclosed sea" surrounded by two or more States and connected to another sea or the ocean by a narrow outlet or consisting entirely or primarily of the territorial seas and exclusive economic zones of two or more coastal States.<sup>27</sup> This document specifies that a coastal state may claim no more than 200 nautical miles as that state's exclusive economic zone.<sup>28</sup> Within this zone, a state has "sovereign rights for the purpose of exploring and exploiting, conserving and managing the natural resources, whether living or non-living, of the waters superjacent to the seabed and of the seabed and its subsoil, and with regard to other activities for the economic exploitation and exploration of the zone, such as the production of energy from the water, currents and winds."<sup>29</sup> However, the agreement also specifies "States bordering an enclosed or semi-enclosed sea

should cooperate with each other in the exercise of their rights and in the performance of their duties under this Convention.”<sup>30</sup> Painting a 200 nautical mile circle around any given state within the South China Sea, each state overlaps others. Resolving these overlaps requires constant coordination, cooperation, and a degree of trust. While both China and the U.S. have signed this agreement the U.S. Congress has not ratified it. This leaves room for political negotiations relative to what role the U.S. chooses to play at any given point in time, but also leaves the U.S. open to accusations of hypocrisy. This provides some advantage in the form of flexibility to U.S. policy-makers in dealing with Chinese territorial claims. America’s current role is ensuring that freedom of navigation remains open to all countries transiting the South China Sea. This focus preserves the unencumbered flow of commerce.

The 2006 Chinese National Defense White Paper points out the “policy of coordinated development of national defense and economy.” While China maintains that Taiwan poses the most significant security concern, a significant component of its “active defense” strategy is the defense and preservation of continued economic ascendance. The 2006 White Paper outlines the significance of national security interests in Chinese coastal waters and regional maritime areas.<sup>31</sup> It explains that China’s national defense policy “includes guarding against and resisting aggression, defending against violation of China’s territorial sea and air space, and borders; opposing and containing the separatist forces for ‘Taiwan independence’ and their activities, taking precautions against and cracking down on terrorism, separatism and extremism in all forms.”<sup>32</sup> As China pursues its policy of “active defense” many People’s Liberation Army Navy (PLAN) strategists see American presence in the Philippines, Taiwan, and Japan as forming a barricade around Chinese maritime interests.<sup>33</sup> This perspective points to continued military

tensions as China's economy continues to expand and suggests that China's continued economic growth and development may lead to a more modern and "active" military organ, with naval capabilities oriented toward the South China Sea and beyond.

As China continues to assert itself, the U.S. continues to refine its security posture, plans, and operational concepts. The addendum to the U.S. National Defense Strategy articulates a military "rebalancing" towards the Asia-Pacific.<sup>34</sup> Similarly, the Chairman of the Joint Chiefs of Staff signed the 2012 Joint Operational Access concept "focus[ing] on anti-access and area-denial threats designed to keep forces away and limit freedom of action... often use[d] in connection with China."<sup>35</sup> The Departments of the Navy and Air Force have also continued to develop Air-Sea Battle, "a limited operational concept designed to address an adversary's Anti-Access and Area-Denial capabilities..., to ensure our Joint force maintains the ability to project power and protect U.S. national interests."<sup>36</sup> The DoD will continue to refine these, and other concepts, and develop new ones as China's military capability evolves.

Elsewhere, the Center for a New American Security (CNAS), an American national security policy think-tank, asserts that many regional states and members of the Association of South East Asian Nations want continued U.S. engagement, military presence in particular, in order to maintain a maritime balance of power in the region. That balance of power, however, requires sufficient U.S. warships, fighter jets, and personnel to ensure the U.S. maintains access to and a sufficient deterrent effect within the region. Without the military capabilities and capacity to maintain credibility, the U.S. could cede considerable influence to the Chinese. This would certainly affect U.S. economic interests negatively.<sup>37</sup>

None the less, China continues to declare its intentions peaceful, focused on the development of the Chinese economy and the sustainment of a peaceful international system in which it can pursue continued economic successes.<sup>38</sup> The U.S. has also repeatedly declared its intentions of “...fostering a peaceful global system comprised of interdependent networks of trade, finance, information, law, people and governance.”<sup>39</sup> However benign these statements may sound, they necessarily allow for increased militarism in areas where the U.S. and China’s interests diverge. While the United States seeks to preserve the stability of the existing global system, China is increasingly unwilling to accept the status quo in the South China Sea. In order to fulfill its obligations under the Taiwan Relations Act and maintain the current global system the U.S. naval fleet ensures freedom of navigation. This requires the maintenance of a significant U.S. military presence to preserve the stability of this particular portion of the global commons.

## **Economy**

Since the end of the Cold-War, economic relations have replaced security as the emphasis of U.S. and Chinese relations. Now, the Chinese and U.S. economies are linked and dependant on one another as never before. The mere suggestion of any serious economic dispute between the two states can have profound effects on world markets and, in turn, ripple through each country’s domestic markets creating significant political repercussions.<sup>40</sup> Today, bilateral trade relations have become increasingly strained due to a number of issues, including a large and growing U.S. trade deficit with China, the effects of Chinese currency policies, and human rights concerns.<sup>41</sup> One American economist asserts that trade deficits with China and the Chinese government’s currency management policies “caused 2.4 million U.S. jobs to be lost or displaced in manufacturing and other trade-related industries between 2001 and 2008 alone, and 100

million workers experienced lower wages due to competition with imports from low-wage countries.”<sup>42</sup> The results of both Chinese and American policies have contributed to the erosion of American economic competitiveness.

A significant component of any country’s ability to materially modernize its military is economic growth. The sustained growth and integration of the Chinese economy into the global economic system, even through a significant global economic recession, has garnered the Chinese Communist Party (CCP) significant international credibility and domestic legitimacy. However, this economic ascendance is not without complication. Chinese government officials see continued economic growth as critical to sustaining political stability, but the Chinese people are demanding their share of the growing prosperity. Striking a balance between increasing the living standard of the vast Chinese populace and sustaining economic growth has proven difficult. Continued worker unrest over perceived wage inequities contributes to the Chinese government’s policy adjustments and an increasing minimum wage. This is a delicate balance however; increasing labor costs have already resulted in companies shifting production to Indonesia and Vietnam.<sup>43</sup> Chinese officials appear reluctant to implement further policies with any potential of disrupting the economy, causing additional unemployment, or increasing worker unrest.<sup>44</sup>

## **Trade**

Over the last thirty years, Sino-American trade has increased from \$2 billion in 1979 to \$457 billion in 2010, but the U.S. trade deficit has also surged, rising from \$10 billion in 1990 to \$273 billion in 2010. In 2011, the \$273.1 billion U.S. trade deficit with China accounted for over 43% of the \$634.6 billion global U.S. trade deficit.<sup>45</sup> The growth of China’s economy, among

others, continues to illustrate a clear opportunity and incentive for the U.S. to increase manufacturing productivity and exports. In 2009, China had 148 million “middle class and affluent” consumers, projected to rise to 415 million by 2020,<sup>46</sup> and 1.1 million millionaires.<sup>47</sup> Although Chinese private consumption as a percentage of GDP is much lower than that of most other major economies, growth in Chinese private consumption rates is rising rapidly. In 2010 Private consumption as a percentage of GDP in China was 35%, compared to 71% in the U.S. This is a significant difference, more so when considering the sheer size of the Chinese population. Similarly, the annual rate of growth in Chinese private consumption from 2001 to 2010 averaged 8.2%, while the U.S. annual average was 2.1%.<sup>48</sup> However, the current high level of private consumption in the U.S. explains much of the slower growth rate. In China, the growth rate in private consumption will continue to grow as the objectives of the 12<sup>th</sup> Five-Year Plan are pursued and the Chinese government seeks to shift from an export driven economic model to a domestic demand driven model.

The CPC Central Committee approved China’s 12th Five-Year Plan for National Economic and Social Development (2011-2015) in October of 2010. This plan includes: “economic rebalancing and a notional GDP growth rate target of seven percent, promoting consumption over investments and exports, and closing the income gap through minimum wage hikes and increased social safety nets, and a range of energy efficiency targets.”<sup>49</sup> Chinese decision-makers acknowledge large global trade and foreign exchange imbalances that have led to tensions between China and its major trading partners. While the Chinese economy continues to grow largely due to exports, the intent of Chinese policy makers is to reduce China’s dependency on exports, which they hope will reduce Chinese current account surpluses and the

need to maintain an “artificially weak currency.”<sup>50</sup> Estimates of a Chinese domestic consumption increase range from a current level of 35.1 percent to around 50-55 percent of Chinese GDP by 2015. The shifts outlined within China’s 12th Five-Year Plan may address some persistent Sino-American trade issues; however, other trade issues will likely arise.

There is a significant difference between U.S. Foreign Direct Investment (FDI) in China and Chinese FDI in the U.S. The U.S. Treasury defines FDI as “the ownership or control, directly or indirectly, by one foreign resident of 10 percent or more of the voting securities of an incorporated U.S. business enterprise or the equivalent interest in an unincorporated U.S. business enterprise, including a branch.”<sup>51</sup> China’s foreign investment in the U.S. consists of U.S. securities, FDI, and investment in capital markets via a sovereign wealth fund. The preponderance of this investment is in U.S. securities. The U.S. invests in China principally via FDI. As of 2009, China’s holdings of U.S. securities totaled \$1.6 trillion, and cumulative FDI was \$2.3 billion.<sup>52</sup> In contrast, in 2009 alone, U.S. FDI in China was \$49.4 billion.<sup>53</sup> In addition to FDI and U.S. securities holdings, in 2007 the Chinese government established the China Investment Corporation (CIC), a sovereign wealth fund to help better manage China’s foreign exchange reserves. As of June 2010, China held \$127 billion in U.S. equities and \$360 billion in U.S. asset backed agency securities, such as Fannie Mae and Freddie Mac.<sup>54</sup> Since its establishment, the CIC has been one of the largest Chinese purchasers of U.S. equities and other U.S. assets.<sup>55</sup>

Critics of Chinese economic policies assert that these policies are intended to boost the competitiveness of Chinese businesses and tend to focus on mergers and acquisitions in order to create access to foreign technology and training for Chinese firms.<sup>56</sup> Similarly, these critics point

out that these firms are selected by the Chinese government for development, and that they receive government subsidies. China's stated focus on fostering the continued growth and competitiveness of its economy confirms their charges and makes apparent the logic behind such Chinese investment policies. As discussed within China's 12th Five-Year Plan, some of these "Strategic Emerging Industries" include: "biotechnology, new energy, high-end equipment manufacturing, energy conservation and environmental protection, clean-energy vehicles, new materials, and next-generation IT."<sup>57</sup> China plans to invest over Renminbi (RMB) 4 trillion in these industries over the course of the 12th Five-Year Plan with hopes of increasing the contribution of these strategic emerging industries from 5 percent of China's Gross Domestic Product (GDP) to 15 percent in 2020.<sup>58</sup> Accumulating over \$US3.2 trillion in foreign exchange reserves as of September 2011, this level of investment is attainable but will only continue to place pressure on competing American firms.<sup>59</sup>

In order to remain competitive, American firms are leveraging the abundance of inexpensive labor available in China and have moved the production of labor intensive goods there. As American companies move production of their goods to China, attempting to drive down costs, American jobs are lost. This further reduces U.S. economic productivity in the manufacturing sector, while increasing the statistical significance of the U.S. – China trade deficit. According to the Bureau of Economic Analysis (BEA), American majority-owned nonbank affiliates in China employed 774,000 workers in China in 2008.<sup>60</sup> Continued erosion of the U.S. economy, and American competitiveness in the global market, are greater threats to U.S interests than today's Chinese military. If allowed to continue, the decline of the U.S will become a reality.

## Currency

The U.S. remains watchful and critical of Chinese valuation of the Renminbi, the official currency of mainland China. China maintains a policy of intervening in currency markets to influence the appreciation or depreciation of the Renminbi against the U.S. Dollar and other currencies. It manages the value of its currency so that Chinese products remain highly competitive in domestic and international markets. These policies ultimately result in employment for Chinese workers, supporting the legitimacy of the PRC, but also put pressure on other Asian states to manage the value of their currencies to remain competitive, further reducing U.S. exports throughout Asia.<sup>61</sup> C. Fred Bergsten from the Peterson Institute for International Economics estimates that a Chinese shift to a market-based currency would cause Asian currencies, including the Renminbi, to appreciate significantly against the Dollar and result in an increase in U.S. exports generating 600,000 to 1.2 million U.S. jobs.<sup>62</sup>

From 1994 – 2005, China maintained a currency policy of “pegging” the Renminbi to the Dollar at roughly 8.28 Yuan to the Dollar.<sup>63</sup> This peg was maintained by the buying and selling of Dollar denominated assets in exchange for Yuan, the primary unit of Renminbi, in order to displace excess demand for the Yuan.<sup>64</sup> The Chinese government allowed the Renminbi to appreciate 21% against the Dollar from July 2005 to July 2008.<sup>65</sup> While the Chinese government announced a shift to a floating exchange rate in 2005, fluctuation of the Renminbi was managed and only allowed to appreciate .3 - .5% daily.<sup>66</sup> In 2008, demand for Chinese products dropped as a result of the global financial crisis. This caused the Chinese government to move back toward the currency peg, keeping the exchange rate constant at 6.83 Renminbi / Dollar until June

2010. Since then, China has again moved to a managed floating currency valuation system. The difference between the Renminbi and the Dollar fell 7.6%, from 6.83 to 6.35 Renminbi / Dollar, between then and November 30, 2011.<sup>67</sup>

China acknowledges the “large global trade and foreign exchange imbalances that have led to tensions between China and its major trading partners”<sup>68</sup> and expects that shifting to consumption-driven growth will reduce dependency on exports, reducing the current account surplus needed “to maintain an artificially weak currency.”<sup>69</sup> If the goals of the Chinese government are realized, with an appreciation of the Renminbi, some U.S. experts foresee a significant reduction in the bilateral trade imbalance between the U.S. and China. Bloomberg Government has estimated that the U.S. trade deficit with China could be cut in half by 2014 by a 7% annual real appreciation of the Renminbi to the Dollar.<sup>22</sup> In that study Bloomberg Government assumes that Renminbi appreciation would cause the appreciation of other Asian currencies as well, resulting in a reduction in the U.S. trade deficit from \$368 billion in 2011 to \$59 billion in 2014.<sup>70</sup>

The U.S. maintains an ongoing formal dialogue with the Chinese wherein issues such as this can be discussed. One such forum is the annual U.S.-China Strategic and Economic Dialogue established in April 2009. This forum is perhaps the most in-depth and frank bilateral forum for discussion of the most pressing issues related to U.S.-China relations. The most recent meeting was held in May of 2011. In support of the objectives discussed at that session, both the U.S. and China agreed to further cooperation and initiatives. One such initiative is the U.S.-China Investment Forum. In this forum, the U.S and China can discuss and resolve issues related to investment experiences and policies, mergers and acquisitions, services, and emerging

industries with the objective of bilateral investment cooperation and relative parity.<sup>71</sup> While this forum may have provided an opportunity to work towards resolution of a significantly sensitive issue, Chinese currency valuation practices were not discussed directly.<sup>72</sup>

An indication of the sensitivity associated with the U.S. and Chinese economic relationship and world markets is Treasury Secretary Timothy Geithner's delay in submitting the semi-annual Report to Congress on International Economic and Exchange Rate Policies in 2011.<sup>73</sup> This report requires the Secretary to report on the international economic and exchange rate policies of the major trading partners of the U.S.<sup>74</sup> Within this report, the Secretary must also consider "whether countries manipulate the rate of exchange between their currency and the U.S. Dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade."<sup>75</sup> The U.S. government has stopped short of identifying China publically and formally as a "currency manipulator."

## **Conclusion**

The U.S. and China are in different phases of development, and fulfill different roles within the global system. China continues to rise in economic, political, and military power and influence whereas U.S. power and influence is more established. The international community currently has different expectations of both China and the U.S., which informs the application of U.S. influence and the various elements of national power. China continues to develop, emphasizing the economic dimension of its national power, remaining focused on competing in global markets, setting the conditions for the success of its firms, and increasing the standard of living within its borders. This focus will enable not only sustained Chinese competitiveness, if

not outright dominance in world markets, but also continued development of both capability and capacity within China's military.

The U.S. has an established role within the international system. While it clearly maintains and exercises economic influence, it does so from a more defensive posture relative to China, attempting to preserve the stability of the *current* international system. Instead, the U.S. government utilizes its vast military apparatus in pursuit of U.S. national interests around the world. This has led to the prioritization of the military aspect of national power above the economic, and arguably the foreign above the domestic. The DoD and the military services clearly have a role within U.S. foreign policy, providing a means of actualizing the policies pursued by the nation's leaders, and fulfilling the obligations prescribed by international agreements, treaties, and expectations. These obligations include: providing for a means of enforcing the provisions of the Taiwan Relations Act, upholding and preserving freedom of navigation in the South China Sea, and have resulted in increased operations. Each obligation carries with it particular equipment and capacity requirements, which the Legislative branch provides for authorizing and appropriating resources yearly. The military element of national power should be used sparingly, however. Because China's plans include the development of certain military capabilities and increased capacity, the U.S. military will continue to adapt its operating concepts, refine existing capabilities, and develop new ones. Accordingly, the military-to-military relationship with China will continue to evolve and generate significant interest. But, this evolving relationship is only one facet of the complex relationship the U.S. maintains with China.

The most important facet of the U.S. relationship with China is economic. As described within this paper, U.S. and Chinese influence will only grow to the extent that their respective economies remain competitive. Herein lays the imperative. The Chinese government is primarily focused on domestic policies which enable economic competition and growth, the underpinnings of its military growth. This has propelled China's economy forward steadily despite the global financial crisis. The U.S. government, on the other hand, remains more outwardly focused, continuing to press China to reform policies that put it at a disadvantage. China has been successful in resisting such pressures and asserting its sovereignty in establishing policy pertaining to Chinese systems. Therefore, the U.S. must compete more favorably in world markets.

The U.S. government must refocus on domestic policy, laws, and institutions; reexamining current law and pending legislative proposals, and refining Executive branch policies. The U.S. government is focused on government structures, the military, and the military industrial complex as a means of not only providing for American security, but also minimizing fluctuations in the U.S. economy. When the U.S. economy experiences turbulence, the Federal government invests in government institutions, and grows the capacity and enhances the capabilities of the military. This growth and enhancement is typically justified by a perceived threat to U.S. interests by a foreign competitor. However, that threat to U.S. national interests is not always hostile, or of a military nature. It is sometimes economic. This is currently the case with China.

## **Recommendations**

Sound U.S. foreign policy begins with sound domestic policy, and the foundation of sound domestic policy is national productivity. Mandatory and discretionary spending are two spending categories used within the federal budget. Mandatory spending is spending that is written into permanent law. Some examples include Social Security, Medicare and Medicaid, and retirement and disability programs for federal workers and military personnel. Discretionary spending is periodic. This money is authorized and appropriated by the Legislative branch after the vetting of a budget request by the Executive branch. The funding of Executive branch agencies is managed through this process. The classical economic view is that each case results in a net consumption of resources which may have otherwise been utilized for more productive purposes. The government and the military, however necessary, consume more than they produce and place drag on the economy.

The U.S. federal government must therefore refocus on domestic issues: adjusting fiscal, macroeconomic, monetary, and regulatory policies; reducing spending; and encouraging productivity and trade. The Congressional Budget Office (CBO) projects the 2012 U.S. gross domestic product (GDP) to be \$15.73 Trillion (T).<sup>76</sup> Government revenue in that year is projected at approximately \$2.6T, but the Federal government will spend about \$3.6T, leaving \$1T as deficit spending and added economic liability.<sup>77</sup> These numbers illustrate that the DoD currently accounts for more than half of all 2012 discretionary spending, and 4.4% of the U.S. gross domestic product (GDP). The CBO also highlights that 2012 mandatory spending is at \$1.989T, and discretionary spending at \$1.344T.<sup>78</sup> Within this discretionary funding, defense related spending is \$696B and non-defense related spending is \$649B.<sup>79</sup> This means that the DoD is resourced at with over half of all discretionary resources provided to the Executive

branch, but is responsible for only 19.3% of overall federal spending. Significantly, on August 26, 2010, Admiral Mike Mullen, the Chairman of the Joint Chiefs of Staff acknowledged this in sharing his perspective that the U.S. debt is the single greatest threat to U.S. national security. He illustrated his statement by identifying that the U.S. will pay approximately \$600 billion in debt service in 2012, amounting to roughly one year of the national defense budget.<sup>80</sup> America's fiscal posture suggests that a more mercantilist and less Keynesian economic approach may be appropriate.<sup>81</sup>

Evolving American institutions will also contribute to renewed American competitiveness. The U.S. government, at least the Executive and Legislative branches, must view the evolving competitive environment such that every element of national power factors into deliberations substantively. Current Congressional committee structures and statutory jurisdictions predispose members of Congress to defense spending and do not enable coherent foreign or domestic policy. U.S. Defense Secretary Robert M. Gates advocates for the Congress to carry out its constitutional oversight responsibilities, ensuring that federal funds are spent wisely and enable unity of effort across executive branch agencies. He asserts that “enhancing cooperation across the jurisdictional boundaries of Congressional committees could strengthen Congressional oversight in matters of national security.”<sup>82</sup> If the Congress were to reexamine and restructure its various committees and jurisdictional boundaries, more coherent and effective foreign and domestic policies may emerge.

There is no deliberate integration of the foreign affairs, intelligence, defense, and economic related committee perspectives; for example, in the formulation of coherent national security legislation, there are only “defense” bills. Coordination and coherence is generated

largely via members who happen to hold seats on more than one of these committees and the due diligence of their personal staff members and the committee professional staff members.

However, parliamentary procedure does allow both chambers of the Congress to consider amendments from outside of the committee of jurisdiction when a bill is brought to the floor of that chamber. So, amendments can be “bolted on” to a bill, but, without a deliberate or contemplative process, often resulting in programmatic focused defense legislation not necessarily tied to any particular national security strategy or coherent foreign policy. Since personal and parochial interests factor into the jurisdictions of each committee, statutory adjustments based on national interest are most likely to purposely refocus the Legislative branch. A step such as this would enable the more holistic perspective of the Congress, and from this perspective a more coherent U.S. foreign policy with China can emerge, and increase American competitiveness into the future.

China’s success and ascendancy may not necessarily result in its predominance. If the U.S. is to retain its influence it must reexamine and adjust its domestic policies and evolve its institutions, rebalancing towards achieving a level of productivity similar to that which vaulted America into global prominence following World War II. The Chinese are among those who have benefitted from U.S. preoccupation with its government and war machine. While personally politically challenging, like George Washington, U.S. government officials will have to make decisions with a bias toward domestic American integrity and international economic competitiveness in the long run, rather than political preservation in the short run.

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