12 in ’12: Strategic Challenges Facing the U.S. and China as the 2012 Political Season Approaches

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Executive Summary:

Challenges Washington faces that will affect relations with China

1) Adapting to a sometimes contradictory “frenemies” type relationship with China.
2) Accepting that China’s idea of what constitutes “responsible behavior” on the world stage may be very different from what Washington wants.
3) Reassuring countries like Japan, South Korea, and Singapore, as well as other ASEAN members, that it intends to maintain—and possibly strengthen—its focus on the Asia-Pacific region while trying not to overly antagonize China.
4) Currency and trade policies, along with the hollowing out of the U.S. heavy industrial base, will almost certainly be major issues in the upcoming elections.
5) China faces more profound structural economic and human development problems such as chronic diseases that may prompt its new leadership to focus more closely on internal issues, while also adopting more muscular external policies designed to secure the resources and political support that it needs to confront internal challenges.
6) The most profound foreign policy challenges and opportunities that the U.S. faces in coming years lie in the Asia-Pacific region, not the Middle East.

Challenges Beijing faces that will affect relations with the U.S.

1) Grappling with inflation and higher labor costs that are driven as much by demographic pressures as they are by economic forces.
2) Monitoring how U.S. economic policies affect China’s massive U.S. bond holdings.
3) Deciding whether to improve market access for U.S. firms wishing to do business in China.
4) Managing the Taiwan question.
5) Deciding how to handle maritime disputes with its neighbors, particularly in the South China Sea.
6) Reign in cyber attacks on the U.S. by Chinese hackers.

As China nears its next leadership transition and the U.S. gears up for a Presidential election in 2012, it is worth highlighting the key strategic opportunities and challenges that both countries create for each other. China will almost certainly be a central foreign policy issue in the 2012 U.S.

Presidential election, particularly since one of the Republican candidates, Jon Huntsman, is a former U.S. Ambassador to China.

Already, China is an issue in Congressional races. In perhaps the most dramatic example to date, Mark Amodei (R-Nevada) is attempting to link administration spending with images of PLA soldiers marching on Washington. In the ad, a Chinese TV anchor intones: "America became its own worst enemy. When all their borrowed money ran out, they kept spending out of control. Their President Obama just kept raising the debt limit and their independence became a new dependence. As their debt grew, our fortune grew and that is how our great empire rose again."[1]

Dr. Scott Kennedy, Director, Research Center for Chinese Politics & Business at Indiana University, tells us: "In the 2010 midterm elections, there were 250 races in which ads about China were used to accuse one side of being too pro-China. From what I understand, none of those ads was effective and had no impact on the outcome of races. We should expect to see more ads, but there's no proof yet that they have political traction."

In any case, China and the U.S. are each other's single most important foreign relationship partner and probably also pose the biggest set of foreign policy challenges that each country faces. Part of the challenge factor stems from the reality that unlike the U.S. and the Soviet Union during the Cold War period, the U.S. and China need each other, but lack a clear external danger strong enough to incentivize real cooperation.

Issues like trade and currency valuation, pollution control, and even terrorism to some extent simply do not inspire the same fear, sense of urgency, and unity of action in Beijing and Washington that a belligerent Soviet Union did. Simultaneously, there are many divergent core interests about which the U.S. and China are unlikely to agree on in the foreseeable future. These include freedom of navigation in the claimed exclusive economic zones of the South China Sea, as well as the development of enduring lines of communication between the PLA and the U.S. military. China's already-limited willingness to reach accommodation with the U.S.—particularly on issues in Asia—will probably decline further as the country becomes even more powerful.

Outlining and assessing the challenges is an urgent task because the strategic framework that will shape how the next decade unfolds in Asia is being laid at this very moment through a large constellation of events whose consequences will shape the strategic landscape for years to come. One reason that frictions are heating up in the South China Sea between China, Vietnam, and the Philippines is because each party wants to establish its claims over disputed areas in the region while also preventing others from doing so.

This note provides a brief roadmap showing 12 of the key challenges that Washington and Beijing will grapple with during the upcoming political transitions and electoral contests.

Significant potential exists for Sino-U.S. cooperation, but fundamental differences in political systems, objectives, and most importantly, ways of thinking, will create friction for the foreseeable future.

The "new normal" of U.S.-China relations will increasingly be one that includes challenges which, unlike the 1990s-era debates over human rights, are often more politically charged, but which also have more direct effects on each country's national interests and thus cannot be sidestepped or finessed nearly as easily. Examples include freedom of navigation, China's continued dealings with Iran and North Korea, and mercantilistic Chinese trade and economic policies.

Challenges Washington faces that will affect relations with China

1) Chinese politicians are, by and large, much more comfortable with a contradictory "frenemies"-type relationship—one with both competition and areas of cooperation—than are most Americans. The U.S. can certainly cooperate with China on an *ad hoc* basis, but will most likely not be able to create the types of partnership it has with Asian allies such as Japan and South Korea. A more realistic goal is to achieve some form of "competitive coexistence."

2) The relatively impatient and solution-driven U.S. diplomatic style and the more plodding, process-oriented stance of Chinese negotiators will create friction points. Both governments will almost certainly continue to disagree on what constitutes "internationally responsible behavior" with respect to the Iran and North Korea nuclear issues, and other challenges as well.

3) A key challenge for the U.S. will be to reassure countries like Japan, South Korea, and Singapore, as well as other ASEAN members, that it intends to maintain—and possibly strengthen—its focus on the Asia-Pacific region while trying not to overly antagonize China. The diplomatic dance (backed by credible military power) will be a delicate one, but a more robust U.S. presence increases Washington's leverage in dealing with China—and, as such, is a force for regional peace and stability. It is also important for U.S. policymakers to consider that, unlike the U.S., China has no formal alliance partners to share security burdens. In addition, the "friends" that China chooses, including states like Pakistan, Iran, Burma, and Sudan, are useful as natural resource providers or trade partners, but are actually liabilities for security purposes overall—even if they do provide niche benefits, such as helping to contain India in the case of Pakistan. These realities help to motivate China's sense of international isolation and fears of encirclement.

4) Currency valuation and dumping accusations will likely arise during the election. As long as the U.S. economy struggles to create jobs, the valuation of the RMB relative to the dollar will be an important political issue. It will almost certainly be a hot button item in the upcoming U.S. presidential and Congressional elections. In addition, supplies of steel, drillpipe, tires, and other basic Chinese exports tend to inflame powerful industrial lobbies within the U.S., setting the stage for anti-dumping claims and potential retaliation against American goods exported to China. We also expect the hollowing-out of the U.S. heavy industrial base to be a key issue in China-focused discussions, particularly in Congressional races in industrial states including Michigan, Ohio, Indiana, and California.

5) While the U.S. faces financial challenges, China faces more profound structural economic and human development problems such as chronic diseases that may prompt the new leadership to focus more tightly on internal issues, while also adopting more muscular external policies designed to secure the resources and political support that it needs to confront internal challenges.

6) Despite ongoing military actions in Iraq and Afghanistan, the real strategic future for the U.S. is one predominantly oriented towards the Asia-Pacific region, not the Middle East. The Middle East requires attention primarily to keep the peace and ensure that energy supplies flow uninterrupted (avoiding negative outcomes), but Asia demands U.S. engagement because of its current dynamism and future potential (producing positive outcomes). The U.S. is not, and cannot ever be, a Middle Eastern nation; but it is, and must remain, an Asia-Pacific nation.

Challenges Beijing faces that will affect relations with the U.S.

1) China is grappling with inflation and higher labor costs that are driven as much by demographic pressures as they are by economic forces. This is likely to make it even less receptive to U.S. trade and economic policy requests than it would be otherwise. U.S. policy makers and citizens alike must realize that, while the U.S. plays a major role in Chinese government decision-making, it does not shape every decision definitively—"it's not always about us." For any great power with some degree of autonomy, it is natural for domestic issues to come first.

2) How will U.S. economic policies affect China's massive U.S. bond holdings? Will China substantively diversify its foreign exchange holdings to reduce its exposure to the U.S. dollar? If continuing financial problems in Greece and Spain or other factors trigger a

new economic slowdown in the U.S., Beijing could move to diversify more substantially its foreign reserve holdings away from the dollar. This might be hard to gauge with precision, as the Chinese government has purchased and continues to purchase significant amounts of treasuries and other economic instruments through a range of beneficiary holders to mask the true ownership.[2] While these actions reflect confidence in holding U.S. financial assets, there also exists the potential for selling through front companies, possibly leading to market shocks if other traders belatedly realized that China had been reducing its U.S. debt holdings. Nevertheless, such a move could be blood in the water that leads other holders to trim their stakes, thus causing significant problems for the value of U.S. debt and the dollar.

The U.S. Treasury Department reports that at the end of April 2011, China held US$1.1 trillion in Treasury securities, meaning that China holds one fourth of the Treasury securities owned by foreign entities. China's Treasury holdings account for a major part of its foreign exchange reserves and the last thing Beijing wants is a destabilizing event or chain of events that jeopardizes the value of its T-Bills. At the same time, China has leverage due to its ability to put money to work in other ways, such as backing purchases of natural resources and economic assets worldwide or engaging in additional "loans for resources" deals, which may effectively yield higher returns than U.S. financial assets. In short, Beijing's massive T-Bill holdings will give it an influential seat at the table as Washington struggles to find ways to bring the Federal budget deficit and rising national debt under control.

3) Market access for U.S. firms wishing to do business in China. A major sore point in the past three years has been China's move toward "local content" procurement requirements and measures that effectively shut out many foreign companies from previously robust markets. Many Chinese domestic companies would likely able to exploit their superior understanding of the local market and outcompete foreign firms in China on a head-to-head basis. Against this backdrop, loosening restrictions would send a positive diplomatic signal without actually ceding substantial Chinese market share to outside companies.

4) Managing the Taiwan question. The twin forces of time and development on the Mainland as well as the Mainland's gravitational economic pull on Taiwan can promote a peaceful, mutually-beneficial resolution—but this could take considerable time. In the meantime, it is essential to avoid having the issue become more of a centerpiece than it already is during political contests in China and the U.S. over the next 18 months.

5) How will China handle maritime disputes with its neighbors, particularly in the South China Sea? Continuing to press claims aggressively and interfere with neighboring countries' resource survey efforts will likely catalyze the formation of a more explicitly anti-China security architecture in East and Southeast Asia. Bullying smaller neighbors over areas that in many cases do not have substantial proven energy or mineral reserves contradicts Beijing's official portrayal of China as a benign re-rising power concerned primarily with "peaceful development." While outright war is unlikely, even with Vietnam, we expect China to apply substantial pressure in less visible ways, including economic sanctions/trade penalties and using non-navy vessels to harass foreign ships and arrest fishermen. This might be described as "kicking under the table" even as both parties appear to be engaged in diplomatic niceties while sitting across from each other in formal settings.

6) Will Beijing move to reign in cyber attacks on the U.S. by Chinese hackers? China's remarkably thorough "Great Wall" of Internet censorship, online monitoring, and control of all relevant routers make it implausible for Beijing to credibly deny having the ability to track and identify hackers operating on Chinese soil. Also, the fact that hacking attacks have targeted oil and gas companies and major defense contractors—types of data that hold relatively little value for private cybercriminals, who prefer banking and credit card information—further raises the standard of deniability as China tries to assure other countries that the hackers are not affiliated with elements in the Chinese government. The current U.S. Defense Department debate on whether certain cyber attacks should be treated as acts of war sends a strong signal on how seriously Washington is thinking about cybersecurity and we hope China gets the message.

In short, Beijing and Washington have full plates of foreign policy challenges simply dealing with each other, not to mention their other important foreign relationships. Rather than focus on bridges that will be difficult to cross soon—such as greatly improving military-to-military relations—we suggest focusing on functional areas that rise to the level of national interests for each country, but are less subject to being politicized.

Potential New Areas for Cooperation

- **Infrastructure**. The antiquated and often overloaded U.S. transport infrastructure system currently gets a "D" grade from The American Society of Civil Engineers. China, by contrast, has been rapidly upgrading and expanding its road, rail, port, and airport infrastructure over the past decade. While questions remain about the economic wisdom of such large fixed asset investments in China, this is not the case in the U.S., where collapsing bridges in Minneapolis and massive traffic jams in most major U.S.

metro areas attest to the dire need for infrastructure upgrades. Chinese investment in U.S. high-speed rail systems would yield real benefits for each side.

- **Push for a bilateral investment treaty**. China has the cash, and increasingly the desire, to become a major outward investor. The U.S. offers Chinese investors a wealth of opportunities in real estate, agriculture, and the industrial sector. However, it is vital to codify a set of rules that clearly delineates where investment is and is not welcome since there may be reasons for restricting foreign investment in some strategic sectors such as IT, aerospace, and critical easily-disrupted infrastructure (telecoms, pipelines, power grids) and resources (strategic minerals, rare earth elements). Concrete, clearly worded rules and transparent enforcement mechanisms for protection of U.S. firms' intellectual property rights in China are one set of concessions that the U.S. should pursue in the course of investment treaty negotiations. Negative Congressional reactions to a bilateral investment treaty with China constitute a key challenge.

- **Improve intellectual property protection.** Diplomatic engagement aimed at finding ways to help China improve protection of intellectual property rights (IPR) in its market should be a high priority. In a May 2011 speech in Beijing, Microsoft President Steve Ballmer noted that despite China having a personal computer (PC) market almost as large as that of the U.S., the company's software revenue in China is only about 1/20 of what it makes in the U.S. This is due largely to rampant piracy. More broadly, the United States International Trade Commission estimates that better IPR protection in China could increase the value of U.S. trade with China by as much as US$107 billion (more than one-third of the total U.S. trade deficit with China in 2010) and could create an additional 2.1 million jobs in the U.S. It is in China's distinct interest to strengthen IPR protection because domestic innovation is very difficult if inventions cannot be protected from infringement.

  China almost certainly has its own versions of Bill Gates, Sergey Brin, Larry Page, and Larry Ellison among its 1.3 billion citizens, but they must be able to profit from their intellectual breakthroughs and invest in building their ideas. Without robust IPR protection, China's most entrepreneurial inventors may decide that Silicon Valley is a better place than Zhongguancun to grow their ideas into businesses that generate the economic activity Beijing wants to cultivate on its own soil. Diplomatic engagement in this area needs to account for China's rising domestic interest in IPR protection and emphasize harmonization of U.S., global, and Chinese IPR standards to try and prevent future abuses of patents and IPR law to protect Chinese firms, as opposed to truly promoting innovation.[3]

- **Ensure a fair playing field for foreign firms wanting to sell products in China**. In late June 2011, the Chinese government announced that it would relax restrictions that had previously posed a significant barrier to foreign firms seeking government procurement contracts, particularly in the tech sector (*China Daily*). While it remains to be seen how closely local and provincial governments will adhere to the changes being made in Beijing, the move is a welcome start given that China's government procurement market may be worth as much as US$1 trillion per year (*Financial Times*). Diplomatically, a logical next step is engagement to help persuade China to accede to the WTO's Government Procurement Agreement (GPA), which stipulates that: "*each Party (*that has ratified the agreement*) shall provide immediately and unconditionally to the products, services and suppliers of other Parties offering products or services of the Parties, treatment no less favourable than that accorded to domestic products, services and suppliers; and that accorded to products, services and suppliers of any other Party*." The agreement also stipulates that signatory countries "*shall not treat a locally-established supplier less favourably than another locally-established supplier on the basis of degree of foreign affiliation or ownership and that its entities shall not discriminate against locally-established suppliers on the basis of the country of production of the good or service being supplied*." Thirty-nine governments, including those of the U.S., Japan, South Korea, and all 27 EU member states are signatories, with China currently holding observer status.

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[1] http://www.amodei4nevada.com/

[2] Emily Flitter, "U.S. Caught China Buying More Debt than Disclosed," *Reuters*, 30 June 2011, http://www.reuters.com/article/2011/06/30/us-usa-china-treasuries-idUSTRE75T2MI20110630?feedType=RSS&feedName=topNews&rpc=71.

[3] Richard P. Suttmeier and Xiangkui Yao, "China's IP Transition: Rethinking Intellectual Property Rights in a Rising China," National Bureau of Asian Research, NBR Special Report #29, July 2011 (27)