

Country Profile: China

China: The Basics

Size (square miles)	3,705,406- Slightly smaller than the U.S.
Population	1,330,044,605- Over four times the population of the US; 1/6 of the entire world's population
Major Ethnic Groups	Han Chinese 91.9%
Major Religious Groups	Taoist, Buddhist, Christian – Numbers Unknown; organized religion is banned outside government-approved religious institutions
GDP Growth Rate 2007	11.4%

Government Overview

The structure of China's government follows a Leninist model of one-party rule established by revolutionary leader Mao Zedong in 1949. Power is held by individuals, and position matters less than personal networks in determining who wields clout. For example, Deng Xiaoping never held office as head of state, but was de facto leader of China from 1978 to the early 1990s. Power transitions can be murky, as players holding various leadership posts jockey for influence.

The claim to legitimacy rests on the ruling party's assertion that it serves the interests of the people. In China, the ruling party is the Chinese Communist Party (CCP), which came to power in 1949 and established the People's Republic of China. As the popularity of Communist propaganda has waned, the CCP has turned increasingly toward nationalism and economic development as a means of legitimizing its rule.

The CCP dominates policy making and policy execution through its members in the government. Within the government structure, the highest organ in theory is the legislature, called the National People's Congress (NPC). In practice, however, the most powerful government organ is the cabinet, called the State Council, which is headed by the premier.

Freedom House Political Rights Score: Not Free

Key Players



Hu Jintao: is currently the Paramount Leader of the People's Republic of China, holding the titles of General Secretary of the Communist Party of China since 2002, President of the People's Republic of China since 2003, and Chairman of the Central Military Commission since 2004, succeeding Jiang Zemin in the fourth generation leadership of the People's Republic of China. Since his ascendancy, Hu has reinstated certain controls on the economy following the lifting of many economic restrictions under Deng Xiaoping, and has been largely conservative with political reforms. His foreign policy is seen as more nationalistic than that of his predecessor, though China's global influence has increased while he has been in office.



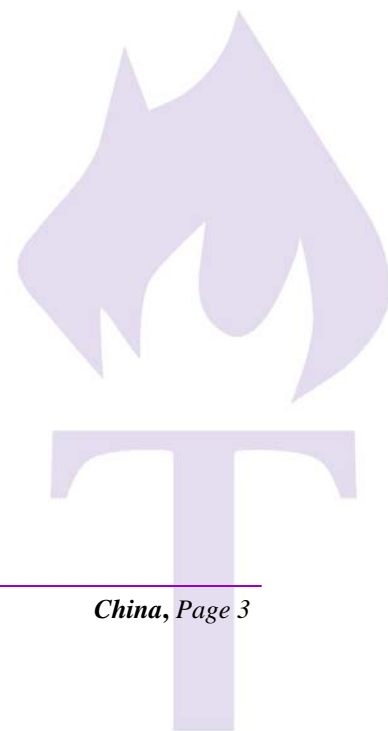
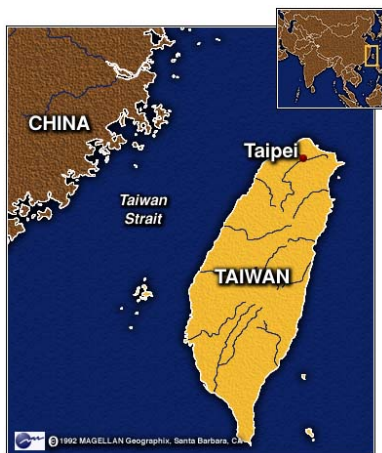
Wen Jiabao: is the Premier of the State Council of the People's Republic of China, leading the country's cabinet. He also serves as a member of its Leading Party Members' Group and Secretary of the Financial Work Committee of the CPC Central Committee. Since taking office in 2003, Wen, ranked third in the Politburo Standing Committee of the Communist Party of China hierarchy, has been a key part of the fourth generation of leadership in the Communist Party of China. Wen, having been dubbed "the people's premier," has a commoner image with the public that separates him from the rest of China's power elite. Considered modest and approachable, Wen's populist approach to policy has made him a very popular figure within China.

China, Taiwan, and the United States: the Historical Background

Taiwan has been the most sensitive issue in U.S.-China relations for decades. China's position is that Taiwan is a part of China that was lost to Japanese imperialism in 1895 and must be reunified with the mainland. Taiwan was returned to Nationalist China following Japan's defeat at the end of the Second World War, but has been ruled separately since Chiang Kai-shek's Kuomintang forces fled to the island after losing the Chinese Civil War to the Communists in 1949.

The U.S. Congress strongly supported Taiwan (then under authoritarian rule) over Communist China in the 1950s and 1960s. Since the Nixon Administration, the United States has acknowledged China's position that Taiwan is part of China, but maintains a strong unofficial relationship with Taiwan--now a vibrant democracy and an important part of the global economy--and continues to provide Taiwan with weapons and equipment necessary for its defense in accordance with the 1979 Taiwan Relations Act.

China's intransigence on Taiwan may have geostrategic elements, but is largely motivated by deep feelings of nationalism and domestic political desire for a united China. Although China's leaders have shown willingness to treat reunification as a long term goal, they frequently reiterate their determination to prevent Taiwan from moving further toward formal independence, by force if necessary. Taiwan, for its part, has become a functioning democracy. Of Taiwan's two major political parties, one is fiercely based on independence, while the other is more conciliatory towards China. Taiwan is thus the main potential flashpoint in U.S.-China relations and one of the few issues that could lead to a conflict between the United States and another nuclear-armed great power.



China and Taiwan: Today's Challenges

In June 2008 Beijing and Taipei reached an historic agreement establishing weekend cross-Strait charter flights admitting thousands of mainland tourists a day to Taiwan. Many hope this will mark the beginning of a new era in cross-Strait relations. President Ma Ying-jeou of Taiwan has indicated that he aspires to achieve the further normalization of cross-Strait economic relations over the next few years. President Ma plans to engage China on economic issues first, progressing to discussions about Taiwan's international space and finally to negotiations aimed at an agreement on a cross-Strait peace treaty. This is to be accomplished on the basis of the "1992 consensus," under which both sides acknowledge that there is "one China" but each has its own interpretation of what that means.

Many observers in Taiwan and China are optimistic about the potential for a more stable and cooperative cross-Strait relationship. The realities of domestic politics in Taiwan and China, however, may impose constraints on the scope and speed of the emerging cross-Strait rapprochement. China continues to block any Taiwanese official status on the world stage, for instance, preventing it from joining international organizations such as the World Health Organization (WHO). For its part, Taipei continues to regard China's military posture as an obstacle to realizing the full potential of the cross-Strait relationship.

China's Military Build-Up



Over the past decade, China has devoted considerable resources to military modernization programs. The Peoples' Republic of China (PRC) has increased its defense budget by more than ten percent in real terms in almost every year since the late 1990s. The acquisition of new weapons and equipment, personnel policy reforms, changes in strategy and doctrine, and improvements in training and education have enhanced the professionalism and operational capability of the People's Liberation Army (PLA), allowing China to pose a much more serious threat to Taiwan and potentially to other modern militaries in the region, including those of Japan and the United States.

China's Military Build-Up

New Military Acquisitions and Developments

Advanced submarines and surface ships
More than 1,000 conventionally armed ballistic missiles
Anti-ship ballistic missiles that could threaten U.S. ships
Counter-space and the anti-satellite capabilities
Road-mobile intercontinental ballistic missiles (ICBMs)
Preparations for a new class of nuclear-powered ballistic missile submarines

Taiwan is not the only challenge that motivates PLA modernization, as illustrated by Chinese concerns over energy security and the involvement of the armed forces in domestic crises such as the recent earthquake relief operations. Others worry that China's power projection may allow it to retake, by force, the disputed Spratly islands, which are located in strategic positions along waterways that govern global commerce in the China Sea. Nonetheless, many of the improvements the Chinese military has made over the past decade appear to be focused on developing the capability to rapidly defeat Taiwan's armed forces and deter, delay, or otherwise complicate U.S. military intervention in a potential cross-Strait conflict. Indeed, many analysts believe that the cross-Strait military balance is shifting rapidly in China's favor and that the modernization of the Chinese military would make U.S. intervention in a cross-Strait crisis or conflict much more difficult today than it would have been a decade ago.

The Chinese military still suffers from a number of shortcomings, however, as Chinese officers themselves acknowledge in their own published assessments, and the PLA remains untested (the Chinese military has not participated in major combat operations since China's 1979 border war with Vietnam), but improvements in China's military capability would make any potential conflict with China an extremely challenging problem for the United States at the strategic, operational, and tactical levels.

Expanded conventional military power is not the only security worry to emanate from China. China has invested substantial resources in cyberwarfare capabilities and other forms of asymmetric warfare, such as disabling electrical grids and, as shown by the destruction of its satellite in space in January 2007, space warfare. A Pentagon report to Congress in 2008 claimed: "[Chinese military] writings emphasize the necessity of 'destroying, damaging, and interfering with the enemy's reconnaissance/observation and communications satellites,' suggesting that such systems, as well as navigation and early warning satellites, could be among initial targets of attack to blind and deafen the enemy." Since America's Revolution in Military Affairs is largely based on enhanced communications and computer technology, China's development of asymmetric strategies is particularly threatening.

China's Diplomatic Engagement

After decades of largely inward focus, China has reached out to its neighbors and the world in unprecedented levels since the late 1990s. China's primary diplomatic objective is to promote its "peaceful rise" strategy of expanding as a world power while promoting peace, stability, and economic growth, but leaders in Beijing also aim to improve China's international reputation. They have done so by:

- Increasing participation in international organizations
- Establishing "strategic partnerships" with a number of key states
- Reversing its opposition to peacekeeping and becoming the world's largest contributor to UN peacekeeping forces (though most of its participants are engineers, transport, or hospital staff, rather than combat troops)
- Boosting aid and investment overseas
- Embracing the principles of nonproliferation
- Professionalizing its approach to international relations through bureaucratic, staffing, and procedural reforms.

As China assumes a more proactive role on the international stage, it is also developing new strategies for reassuring others that China's intentions are benign by:

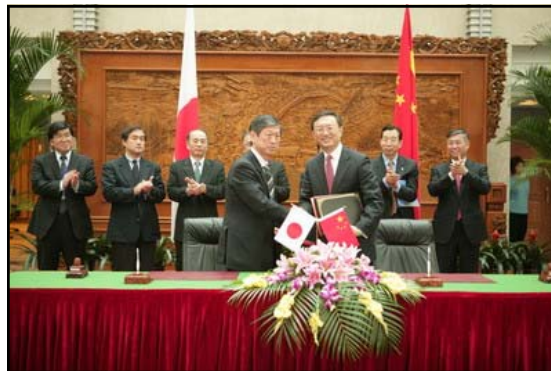
- Becoming an active participant in the nonproliferation and arms control regime
- Playing a leading role in the Six-Party talks on North Korea's nuclear program
- Assuming more leadership in the UN Security Council
- Signing agreements on the South China Sea
- Endorsing confidence-building measures (CBMs) in Central Asia
- Increasing the level of ASEAN+3 bilateral dialogues with its Southeast Asian neighbors (The Association of Southeast Asian Nations (ASEAN) is a geo-political and economic organization of 10 countries located in Southeast Asia. ASEAN+3 refers to meetings taking place between the ASEAN countries plus China, Japan and South Korea.)
- Proposing a China-ASEAN Free Trade Agreement

China's Diplomatic Engagement

Despite its long-standing opposition to formal military alliances, Beijing recently improved its ability to conduct joint operations and participated in joint military exercises with Australia, France, Germany, India, Mexico, Pakistan, Russia, the United Kingdom, the United States, and states in Central Asia, among others. Chinese military diplomacy has also increased, bringing together leaders from China and other countries to improve transparency and understanding of one another's objectives, in hopes that interaction between military leaders will ultimately make conflict less likely.

While it is heartening that China's strategy is that of "peaceful rise" (in contrast to Russia, for example, which appears to be rising in a less benign manner) China's economic expansion and outreach to the world inevitably bring it more power and clout, which puts it at odds, at times, with U.S. policy. It is also displacing the U.S. as prime regional power in Asia, a position that the U.S. has held since WWII.

China's Bilateral Engagement



Japan. Relations between Japan and China have improved in the past year, after a long chill under Japan's former Prime Minister Koizumi, a nationalist whose visits to Yasukuni shrine honoring Japanese war dead were seen as an affront by China, which was invaded and occupied by Japan during WWII. High-level visits have increased over the past year and military leaders agreed to strengthen bilateral defense cooperation. In early May, President Hu Jintao spent five days practicing "smile diplomacy" in Japan. In the rare summit meeting, leaders from both countries pledged to cooperate as partners and build mutual trust despite ongoing (and emotionally-charged) disagreements.

China's Bilateral Engagement

Central Asia. China has also sought closer relations with Russia and its Central Asian neighbors (Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan) through the Shanghai Cooperation Organization (SCO). The Chinese-led SCO is not a strong political bloc, but it has taken steps to increase trade, promote energy cooperation, conduct joint military exercises, and resolve border disputes. Earlier this year, Russian President Dmitry Medvedev and President Hu signed a \$1 billion agreement for Russia to supply uranium and build a nuclear fuel enrichment plant in China. The two leaders also openly challenged America's approach to human rights promotion abroad, indirectly condemned U.S. proposals for a missile shield in Europe, and constructed a direct military hotline.

India. Despite long-standing tensions (including a border war in 1962) and current competition over resources and influence in Asia, Sino-India ties have also improved dramatically over the last few years, as both countries work to resolve border disputes, increase economic ties, and find new ways of rising peacefully together. President Hu visited India in November 2006, marking the first time a Chinese head of state had visited India in ten years. The two countries held their first joint military exercise in late December in the mountain ranges of Yunnan province, and continue to seek new opportunities for cooperation in trade and energy.

Africa and Latin America. Beyond its immediate neighbors, China has also made great efforts to establish closer relations with states in Latin America and Africa. This outreach often originated with efforts to secure diplomatic recognition from these states (and thus prevent them from recognizing Taiwan), but in recent years, China has used a variety of diplomatic and economic tools to open markets for trade, secure favorable contracts for resource extraction, and promote stronger political ties. China has more inward investment in Africa than all of the OECD¹ countries combined, and provides more loans to Africa than the World Bank. China's aid and trade investment in Africa is not linked to requirements for anti-corruption measures, good governance, or transparency—and therefore tends to undermine Western attempts to use aid and trade as leverage for improving African government. China's energy needs are also supporting problematic governments, with no strings attached. China imported nearly \$2 billion in goods (especially crude oil) from Sudan in 2006, and is now the largest foreign investor in the country. The Chinese are the largest foreign investors in Sudan and are expected to be sub-Saharan Africa's largest trading partner by 2011.

Iran: Iran is a major market for China, and is a key source of energy resources that China's economy depends upon. China currently receives 14% of its oil from Iran, and provides Iran with major arms systems including small arms, ballistic and cruise missiles, as well as sensitive technology potentially of use in Iran's nuclear program. China also assists Iran with its indigenous arms production. China is the second largest exporter to Iran. Its extensive trade ties have made it more difficult for Western countries alone to apply meaningful economic sanctions that will adversely affect the Iranian regime.

¹ The OECD is an international organization of thirty countries that accept the principles of representative democracy and free-market economy.

Chinese Economic Growth



Time	Average Annual Growth (%)
1960-1978 (pre-reform)	5.3
1979-2007 (post-reform)	9.8
1990	3.8
1991	9.3
1992	14.2
1993	14.0
1994	13.1
1995	10.9
1996	10.0
1997	9.3
1998	7.8
1999	7.6
2000	8.4
2001	8.3
2002	9.1
2003	10.0
2004	10.1
2005	9.9
2006	11.1
2007	11.4

Since China abandoned its Communist economic model for a more capitalistic economic system in 1979, China has become one of the world's fastest-growing economies. Although the benefits of China's stunning growth have affected the business and government elites more than the Chinese people, leading to growing inequality, China's economic growth allowed 300-400 million Chinese to emerge from poverty over the last twenty years – the largest single reduction in poverty in human history. However, while China is expected to enjoy rapid economic growth in the near future, and could become the world's largest economy within a decade, it faces a number of challenges. The Chinese economy is plagued by widespread corruption, an inefficient banking system, overdependence on exports, and fixed investment for growth. Pollution poisons the land, income disparities increasingly polarize the population, and growing inflationary pressures threaten to undo many of the economic gains that have been made of the last thirty years.

The United States and China: Economic Relations

China's economy presents both challenges and opportunities for the United States. In terms of opportunities, China's low-cost exports to the United States have saved U.S. consumers billions of dollars, while the emerging Chinese market is a major destination for U.S. foreign direct investment. By engaging the world through trade and acting through status quo international organizations – such as the World Trade Organization (WTO) and the International Monetary Fund (IMF) – China is proving that it seeks to become part of, not overturn, the international order founded by the United States and its allies after World War II. So long as China believes it can participate in such organizations, the occasions for major conflict between rising China and the currently dominant United States will be greatly reduced. Indeed, fostering a relationship between China and the wider world based on negotiation and institutions, instead of conflict or war, might be the single most important foreign policy challenge the United States faces in the 21st century.

Yet the growth of China's economy has also imposed serious costs on the United States:

- Although the U.S. has not experienced a *net* loss in jobs, the growth of manufacturing in China has displaced the jobs of hundreds of thousands of American workers, particularly in the manufacturing industry.
- By artificially depreciating its currency, China makes its own exports more competitive, while making U.S. exports less so.
- Through the purchase of U.S. debt and the creation of a sovereign wealth fund, China's ability to turn its economic power into leverage within the U.S. economy and federal government has also increased.
- China's rising demand for energy and raw materials has put upward pressure on oil prices, while its use of fossil fuels - particularly coal - is wreaking environmental havoc in Asia and around the world.

The net result of these challenges and opportunities is an oddly symbiotic economic relationship between the United States and China. China depends on the United States as a market for its exports and a reference point for its own currency policies. The United States depends on China to purchase its national debt and maintain a friendly business climate for U.S. investors. Neither country's economy can function without the other. As a result, efforts to resolve the differences between the United States and China are likely to be slow, painstaking, and require tough choices and significant tradeoffs between Chinese and American officials.

*US Merchandise Exports to Major Trading Partners in 2001 to 2007
(\$ in billions and % change)*

	2001	2007	% Change from 2006- 2007 (%)	Percent Change from 2001- 2007 (%)
Canada	163.7	248.4	7.9	51.7
Mexico	101.5	136.5	1.8	34.5
Japan	57.6	62.7	5.1	8.9
China	19.2	65.2	18.1	239.6
United King- dom	40.8	50.3	10.8	23.3
Germany	30.1	49.7	20.2	65.1
South Korea	22.2	34.7	6.9	56.3
Netherlands	19.5	33.0	6.1	69.2
France	19.9	27.4	13.2	37.7
Taiwan	18.2	26.4	14.5	45.1
World	731.0	1,162.7	12.1	59.7

U.S. Jobs

Imports from China – and other developing countries – often destroy jobs in parts of the U.S. economy that produce the same products. This is especially true in the manufacturing industry, where cheaper unskilled labor in China is displacing more expensive unskilled labor in the United States. Economists disagree about the effects on the U.S. economy, with some claiming high rates of U.S. job loss to China, and others arguing that job creation in other parts of the economy has prevented the United States from experiencing a net loss in jobs.

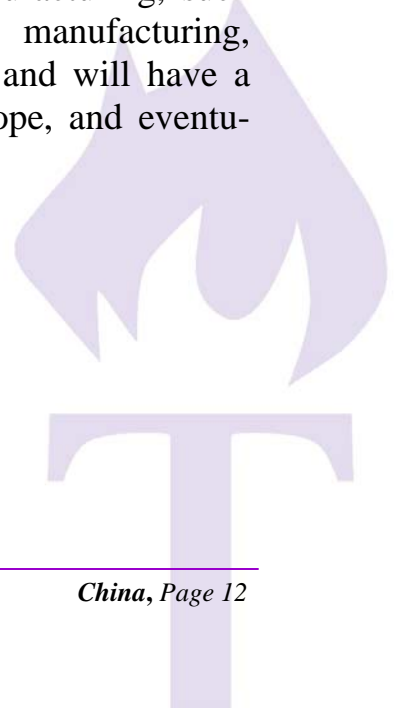
The Bureau of Labor Statistics (BLS) provides some perspective on the possible employment effects of trade with China. Beginning in 2004, the BLS has collected data on job loss due to outsourcing. These data show that through 2005, lay-offs caused by outsourcing account for only 2% of the total layoffs per quarter. This is considered an extremely small share of the U.S. total labor force, given its more than 149 million workers.

U.S. Jobs

Nevertheless, China skeptics argue that China has not lived up to the commitments it made when it joined the World Trade Organization (WTO), and claim that the lack of labor and environmental standards in China allows Chinese workers to compete unfairly with American workers. Chinese officials argue otherwise, claiming that what looks like “unfair” advantages are temporarily necessary because of the difficulty of transitioning from a command economy to a market economy. They also point out that China has lost 15 million manufacturing jobs since the mid-1990s, while the U.S. has only lost 2 million, arguing that manufacturing jobs always gravitate towards poorer countries.



To move China closer to “fairer” practices, the U.S. will likely have to work assiduously through the WTO, as domestic protectionism in the U.S. will allow China to lower its standards even further. Investing in job-training, wage insurance and new technologies – where the U.S. has a significant advantage – is probably the surest way for the U.S. workforce to recover from job losses and move to newer, higher paying jobs. Rather than holding onto commoditized manufacturing jobs that China can perform more cheaply than the U.S., America should also consider leap-frogging to more technically and creatively demanding manufacturing, such as the new wave of “green” manufacturing, which plays to U.S. strengths and will have a ready market in the U.S., Europe, and eventually, China itself.





Chinese Currency

China tightly pegs its currency – the “yuan” or “renminbi” – to the U.S. dollar. In order to maintain a target rate of exchange with the dollar, the government maintains restrictions and controls over capital transactions and has made large-scale purchases of U.S. dollars (and dollar assets, such as U.S. Treasury Bonds) to artificially depreciate the yuan. Although China has allowed its currency to appreciate a little, most economists, U.S. policymakers, and business representatives charge that China’s currency is significantly undervalued vis-à-vis the U.S. dollar (estimates range from 15% to 40%), making Chinese exports to the United States cheaper, and U.S. exports to China more expensive. Such advocates argue Chinese currency policy has particularly hurt several U.S. manufacturing sectors (such as textiles and apparel, furniture, plastics, machine tools, and steel) competing against low-cost Chinese imports. They demand China significantly appreciate its currency or to let it float freely in international markets.

Chinese officials deflect these accusations and defend their currency policies, citing its importance in providing economic stability during its economic reforms (such as closing down inefficient state-owned enterprises and restructuring the banking system). Chinese officials fear an appreciated currency could reduce jobs and lower wages in several sectors and thus cause worker unrest.

Responses to the Chinese currency policies are varied. China-skeptics argue that the Chinese economy is not as fragile as its government would have one believe, citing its \$1.5 trillion foreign exchange reserves at the end of 2007. Such indicators suggest China’s economy is healthy enough allow the yuan to appreciate. This in turn would enable China to lower import costs, which would be balanced by greater domestic consumption. However, some fear that Chinese currency appreciation would prompt the Chinese to purchase fewer U.S. Treasury securities, which might result in higher U.S. interest rates. China is the second largest foreign purchaser (after Japan) of U.S. Treasury securities, which totaled \$406 billion at the end of 2007. So long as the U.S. continues to increase its national debt—now at record highs—we are dependent on China to buy Treasury securities. Since both the United States and China have an interest in seeing the yuan appreciate – and since drastic appreciation could portend economic trouble in China and/or the United States – U.S. officials will have to continue working with Chinese officials to allow the yuan to appreciate at a modest pace.

Trade Deficit/Balance

The U.S. trade deficit with China has surged in recent years, as imports from China have grown much faster than U.S. exports to China. That deficit rose from \$30 billion in 1994 to \$256 billion in 2007. The U.S. trade deficit with China is significantly larger than that of any other U.S. trading partner. In 2007, it was more than twice as large as the U.S. trade deficit with all OPEC states combined, larger than the entire U.S. trade deficit with the 27 countries that make up the European Union combined, and three times larger than the trade deficit with Japan.

In order to address this trade imbalance, the U.S. will have to send more exports to China and prompt China to appreciate the yuan. One way the U.S. can produce more exports is by investing in hi-tech industries (such as bio-tech or green technology) in which the U.S. has an advantage over other countries. Another way is to prompt China to appreciate the yuan. As the yuan appreciates, American exports become more competitive against their Chinese rivals. Reducing the trade deficit is thus a matter of smart domestic investment and careful cooperation with the Chinese regarding the yuan (see above discussion of “Chinese Currency” for more on the yuan).

U.S. Merchandise Trade with China: 1980-2007 (\$ in billions)

Year	U.S. Exports	U.S. Imports	U.S. Trade Balance
1980	3.8	1.1	2.7
1985	3.9	3.9	0
1990	4.8	15.2	-10.4
1995	11.7	45.6	-33.8
2000	16.3	100.1	-83.8
2001	19.2	102.3	-83.1
2002	22.1	125.2	-103.1
2003	18.4	152.4	-124.0
2004	34.7	196.7	-162.0
2005	41.8	243.5	-201.6
2006	55.2	287.8	-232.5
2007	65.2	321.5	-256.3

*U.S. Merchandise Trade Balances with Major Trading Partners:
2007 (\$ in billions)*

Country or Trading Group	U.S. Trade Balance
World	-791.0
China	-256.3
European Union (EU27)	-107.4
Organization of Petroleum Exporting Countries (OPEC)	-127.4
Japan	-82.8
Canada	-64.7
Mexico	-74.3
Association of Southeast Asian Nations (ASEAN)	-50.6

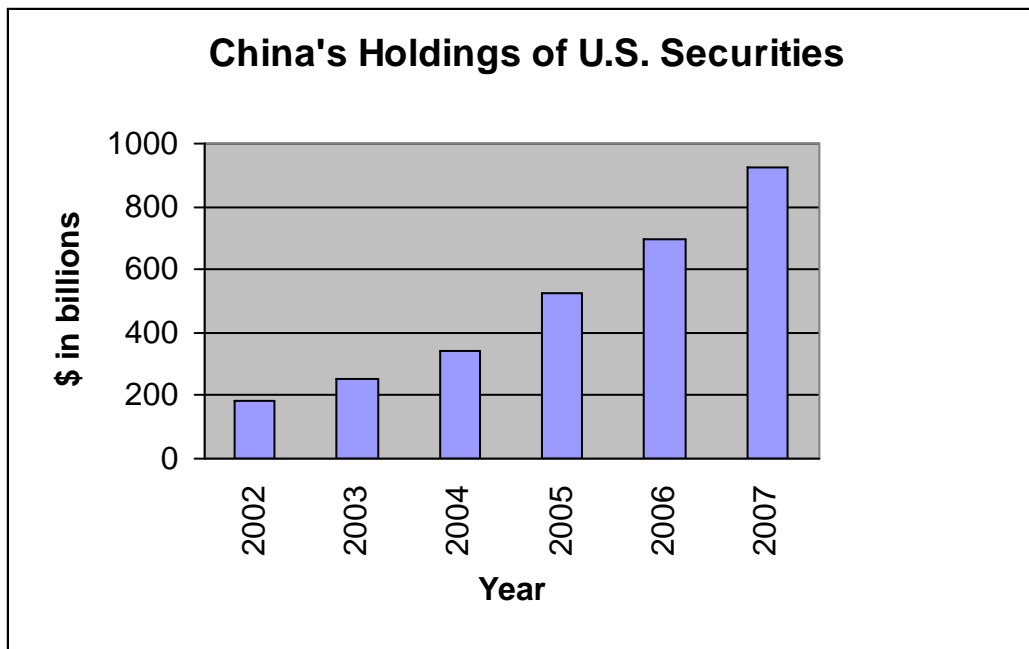
Buying U.S. Debt

Given its relatively low savings rate, the U.S. economy depends heavily on foreign capital inflows from countries with high savings rates (such as China) to help promote growth and to fund the federal budget deficit. Aided by its currency policies, China has become the world's largest and fastest growing holder of foreign exchange reserves (FER), which totaled \$1.5 trillion at the end of 2007. A large share of those foreign exchange reserves are held in U.S. securities (\$922 billion as of June 2007). U.S. Treasury securities are issued to finance the federal budget deficit. As of March 2008, China's Treasury securities holdings were \$491 billion, accounting for 19.5% of total foreign ownership of U.S. Treasury securities, making China the second largest foreign holder of U.S. Treasuries after Japan.

Some U.S. policymakers are concerned that China might use its large holdings of U.S. securities as leverage against U.S. policies. For example, the Chinese government may harm the U.S. economy by quickly dumping (or threatening to dump) a large share of its holdings. Some economists believe such a move on China's part could have a significant negative impact on the U.S. economy (at least in the short run), especially if it causes the dollar to depreciate in international markets, inducing other foreign investors to sell off their U.S. holdings as well. Retrieving those investments would require U.S. interest rates to rise, stunting U.S. economic growth.

Buying U.S. Debt Continued...

However, other economists counter that it would not be in China's economic interest to suddenly sell off its U.S. investment holdings. Doing so could lead to financial losses for the Chinese government, and any shocks to the U.S. economy caused by this action could ultimately hurt China's economy as well. The issue of China's large holdings of U.S. securities is part of a larger debate among economists over how long the high U.S. reliance on foreign investment can be sustained, to what extent that reliance poses risks to the economy, and how to evaluate the costs associated with borrowing versus the benefits that would accrue to the economy from that practice. If the United States government does not either raise taxes to cover the costs of its wars and social entitlement programs, or drastically cut its social programs and reduce its defense spending – or some combination of the two – the U.S. will continue to rely on foreign countries to fund the U.S. government's own spending.



Foreign Investment in U.S. Debt

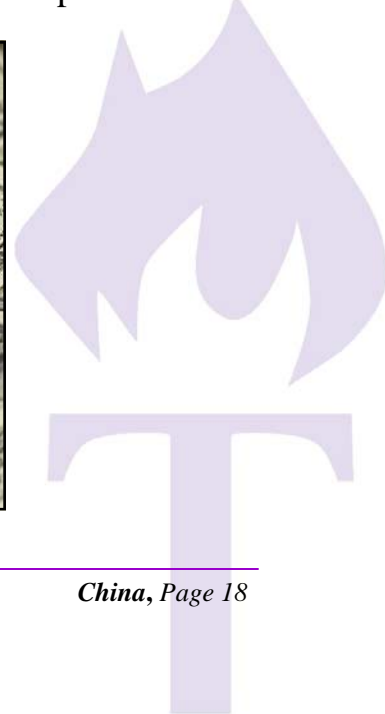
Country	Amount Held (\$ in billions; as of Dec. 2007	Percent of all foreign holdings in federal debt	Country	Amount Held (\$ in billions; as of Dec. 2002	Percent of all foreign holdings in federal debt
Japan	581.2	24.7	Japan	378.1	30.6
Mainland China	477.6	20.3	Mainland China	118.4	9.6
United Kingdom	157.4	6.7	United Kingdom	80.0	6.5
Oil Ex-porters	137.9	5.9	Caribbean Banking Centers	50.3	4.0
Brazil	129.9	5.5	Oil Ex-porters	49.6	4.0
Caribbean Banking Centers	116.7	5.0	Hong Kong	47.5	3.8
Luxem-bourg	69.7	3.0	Korea	38.0	3.1
Hong Kong	51.1	2.2	Taiwan	37.4	3.0
German	41.7	1.8	Germany	37.3	3.0
Singapore	39.8	1.7	Switzer-land	34.0	2.8
Total top 10 coun-tries of foreign investors in US debt	1,803.0	76.6	Total top 10 coun-tries of foreign in-vestors in US debt	870.6	70.5
Total of all foreign investment in US debt	2,353.8	100.0	Total of all foreign in-vestment in US debt	1,235.6	100.0

China's Sovereign Wealth Fund

A sovereign wealth fund (SWF) is a state-owned investment fund composed of financial assets such as stocks, bonds, and property. China established its major sovereign wealth fund, the China Investment Corporation (CIC), in September 2007. Financed with \$200 billion in initial capital, the CIC is one of the largest sovereign wealth funds (SWFs) in the world. According to top Chinese officials, the CIC was created to improve the rate of return on China's \$1.5 trillion in foreign exchange reserves and to soak up some of the nation's excess financial liquidity. Since its creation, the CIC and its subsidiaries have already made several investments, including the purchase of 9.9% of the U.S. financial firm Morgan Stanley.

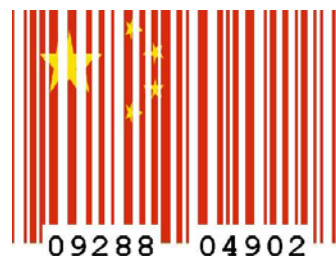
While wealthy countries with small internal markets, such as Singapore and Norway, have long invested through sovereign wealth funds, and allied countries such as the United Arab Emirates have SWFs that appear to be more financially than politically motivated, some experts worry that the new Chinese (and Russian) SWFs may make more political or strategic investments.

A number of experts in international finance have expressed concern about the recent growth in SWFs and China's creation of the CIC. They argue that shifts in SWF investments could disrupt global financial markets and harm the U.S. economy. Politically, a country such as China could use its SWF to exact concessions out of countries in which it is heavily invested. It could also invest in strategic technologies that could be of military or intelligence use. Although a state investor might be adversely affected by suddenly divesting from a particular country's economy, the potential that a SWF could be used as an economic weapon remains.



China's Sovereign Wealth Fund

Other experts are less concerned about SWFs and the CIC, and welcome their participation in international investment markets. To ease whatever tensions SWFs create, international financial experts suggest stricter regulation on Sovereign Wealth Funds, including standards for transparency, governance, and reciprocity. Other experts have suggested that the United States should review its current laws and regulations governing foreign investments in the United States, and possibly implement special procedures or restrictions on proposed SWF investments, such as implementing financial reporting requirements, limits on SWF ownership of U.S. companies, and restrictions on the types of equity investments SWFs can make in U.S. companies.



Leading Sovereign Wealth Funds

Country	Fund	Size (\$ billion)	Year Created
United Arab Emirates	Abu Dhabi Investment Authority (ADIA)	500-875	1976
Singapore	Government of Singapore Investment Corporation (GIC)	100-330	1981
Norway	Government Pension Fund-Global (GPFGB)	308	1990
China	China Investment Corporation, Ltd. (CIC)	200	2007
Kuwait	Future Generations Fund	174	1976
Russia	Stabilization Fund for the Russian Federation	122	2004
Singapore	Temasek Holdings	108	1974

China: Friend, Foe, or “Frenemy”?

While China is able to manage its rise today by focusing on peace and development, it may one day need to make a choice – should the country position itself as the United States’ partner or competitor? There is much the U.S. can do today to retain its global edge and help shape China’s choice in the future.

By strengthening its bilateral relationships and increasing participation in international institutions, China has acquired more international leverage and a stronger diplomatic voice, with which it might either challenge the United States or become a cooperative partner and “responsible stakeholder.” China is integrating into the world order through Western-created institutions such as the United Nations and the World Trade Organization, which suggests that the U.S.-Chinese relationship can proceed through negotiation and compromise, rather than conflict or war. The fact that the United States, China, and other major world powers already possess nuclear weapons makes it less likely that armed conflict will occur – the risks would simply be too high.



However, while China’s increased interdependence with the rest of the world makes its leaders more invested in promoting peace and sustaining the existing world order, it also means that a system shock in China could reverberate throughout the entire world. Slowed or reversed economic growth, domestic instability, pandemic disease, or natural disasters, to name a few, all threaten China’s stability and may have enormous trade, environmental, financial, health, or security implications for other countries. Since the Chinese economy is highly dependent on its exports to the United States, and because the United States is dependent on China to finance its national debt, each country has a large stake in maintaining peaceful relations with the other.



China: Friend, Foe, or “Frenemy”?

As China continues to grow more powerful, the United States must also seek new opportunities for its own economic, diplomatic, and security relations. We must continue to embrace innovation in order to maintain our edge in economic competitiveness, bolster our security structures to protect our interests, better address the needs of our allies, and use our diplomatic carrots and sticks in a more thoughtful and creative manner. In recent years, China’s diplomats have engaged countries on their borders and around the world, often winning favor by paying particular attention to the needs of states who feel the United States has overlooked their interests and taken their support for granted while Washington diverted its eyes and energies to the “War on Terrorism” and Iraq. In most cases, the United States can help regain its influence by simply “showing up,” listening to the concerns of our friends and allies, and reassuring them that Washington is invested in their continued stability, growth, and development.

Put simply, China and the United States share enough common interests to maintain a peaceful, if not always tranquil, relationship. As for the differences that divide the U.S. from China – such as democratic values and human rights – they should be viewed as an opportunity. The United States is the world’s pre-eminent power. China is the world’s rising power. Developing countries look to China’s recent growth and see a model worth emulating. In order to persuade more countries to sign on to democracy and respect for human dignity, the United States must continue to perform economically, and treat developing countries with respect, to show the greater power of our values system.

The Chinese and American/Western systems have both proven their ability to produce wealth. Only the American/Western system has done so while also guaranteeing democratic rights to its citizens. By crushing protesters in Tibet or supporting human rights violators in Darfur, China makes itself unattractive to millions around the globe. But if political repression is the cost of a strong economy, many will make that choice if there is no alternative. It is up to the United States and its Western allies to make sure that developing countries need not choose between prosperity and liberty. By spreading democratic rights *and* markets, the West can win developing countries to its side, and slowly force China to liberalize its own political system.

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