

# ISSUE BRIEF

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## Obama's Meeting with China's Communist Party General Secretary Xi Jinping

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President Obama and the general secretary of the Chinese Communist Party, Xi Jinping, will meet June 7–8 in California. The meeting has been characterized as a way for the two to establish a personal relationship and build trust. This would all be well if it were President Obama's first year in office and Sino–American ties were on a sound footing. But it is not and they are not.

It is long past time for the U.S. to have a meaningful, tightly focused China policy. This meeting does not appear to support that goal but rather is another in a series of ostensibly important but aimless steps on an increasingly rocky path. The Administration should have specific goals for the summit and the Strategic and Economic Dialogue (S&ED) one month later:

- A timetable for a major reform to increase competition in the Chinese market, preferably in finance;
- A detailed pledge of improvement in one area of the multi-dimensional problem of Chinese cyber-aggression; and

- An actual reduction in at least one area of tension—for example, the Senkakus dispute with Japan or the disputed territories such as Scarborough Shoal or Second Thomas Shoal near the Philippines.

**Financial Reform the Best Bet.** The problem in American economic policy toward China is priorities: There has been no concerted effort to set priorities since the People's Republic joined the World Trade Organization in 2001. The U.S. moves from one temporary irritant to the next, accumulating a pointless list of demands. The goal should always be greater competition in the Chinese market, and, for his second term, the President should emphasize the financial sector.

As a large economy, China's major issues are internal: waste of physical assets, an aging labor force, wildly loose (total) credit, and an innovation-killing expansion of the state sector.<sup>1</sup> Domestic politics will determine whether market reform, populism, or the status quo will prevail. Only if there is willingness to act on reform, not just talk, can the U.S. play a role.

Additional land reform is vital but highly unlikely and too politically sensitive for U.S. input. Also out of American reach is labor market integration through further changes in the hukou system that links rights and benefits to the location of the household. Chinese monetary policy since the 2008 financial crisis has sown the seeds of stagnation, but, as with American fiscal and monetary policy, it will not be altered at foreign request. The President and American negotiators at the S&ED should not waste time on these matters.

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It is possible that state-owned enterprises will be pruned and greater competition will be allowed from domestic private firms and multinationals. This would be welcome and, depending on the sectors involved, may help American companies and workers. A sweeping contraction of the state sector, though, would be determined internally, and effective privatization in a few industries would likely benefit the U.S. only modestly.

The one exception, due to its central role, is finance. Banks and other institutions are intertwined with every aspect of the economy. Moreover, there are multiple options for market-oriented financial reform. For example, opening the capital account would allow money to leave freely and impose discipline on credit policy, discipline that Beijing increasingly recognizes is needed. A narrower step would be opening only China's bond market to foreign capital. This would help establish a true interest rate system and offers huge potential benefits to the PRC in terms of capital availability.

Happily, there is an obvious carrot to offer: meeting China's terms for better investment access to the American market. Given that Chinese politics will determine any changes in economic policy, the best choice for the U.S. is to push for market-oriented financial reform.

While the U.S. should make a purely economic proposal, another issue melds economics and security: cyber espionage. The Administration has belatedly recognized the economic importance of cyber,<sup>2</sup> but it may not yet have recognized how deep the problem is on the Chinese side. A full solution will not be possible for years. At this summit, the U.S. can tie cyber to the main economic discussion by making clear that recipients of stolen intellectual property cannot invest in American assets and that

further sanctions are likely unless Chinese espionage eases.

**Cyber and More.** The issue of cybersecurity will almost certainly extend from the economic to the military and political. The recent Defense Science Board (DSB) report, as well as the annual Defense Department report to Congress on Chinese military developments, have both highlighted the security threat posed by Chinese cyber activities. The DSB report highlighted over two dozen American military programs that have been penetrated by Chinese cyber activities, while the annual Defense Department report provided unprecedented detail on Chinese human and electronic espionage. These reports, coupled with the recent Mandiant and Verizon reports on Chinese computer network attacks, leave little doubt that not only is China one of the most active cyber-espionage players in the world but that much of that activity is undertaken by Chinese government entities.

Both American and Chinese officials recognize that cyber intrusions and aggression has the potential for escalation. What is less clear is whether the PRC understands that, since cyber attacks can be "as serious as a nuclear bomb," China's persistent cyber aggression erodes not only their credibility but mutual stability.<sup>3</sup>

Nor is cyberspace the only point of mutual friction. Chinese assertiveness on its borders has antagonized a range of states, many of which are U.S. allies. Most notable has been the Senkaku dispute, as Chinese and Japanese law enforcement vessels and aircraft continue to confront each other around these islands. But China has also renewed its push in the South China Sea, not only dispatching a *naval* task force to the waters near Malaysia, but also deploying a frigate near Second Thomas Shoal, which is claimed by the Philippines.<sup>4</sup>

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1. See Derek Scissors, "U.S.-China Economic Dialogue: In Need of Tough Love," Heritage Foundation *Backgrounder* No. 2200, October 21, 2008, <http://www.heritage.org/research/reports/2008/10/us-china-economic-dialogue-in-need-of-tough-love>, and Scissors, "China Drowning in Money: What It Means for the U.S.," Heritage Foundation *Issue Brief* No. 3616, May 29, 2012, <http://www.heritage.org/research/reports/2012/05/china-s-excess-liquidity-what-it-means-for-the-us>.
  2. See Derek Scissors, "Chinese Commercial Espionage: U.S. Policy Recommendations," Heritage Foundation *Issue Brief* No. 3564, April 9, 2012, <http://www.heritage.org/research/reports/2012/04/chinese-commercial-espionage-us-policy-recommendations>, followed a year later by Flavia Krause-Jackson, "U.S. Making Cybertheft Focus of Talks With China, Donilon Says," *Bloomberg*, April 24, 2013, <http://www.bloomberg.com/news/2013-04-24/u-s-making-cybertheft-focus-of-talks-with-china-donilon-says.html> (accessed April 24, 2013).
  3. Andrew Browne, "China: Cyberattacks Are Like Nuclear Bombs," *The Wall Street Journal*, April 22, 2013, <http://online.wsj.com/article/SB10001424127887323551004578438842382520654.html> (accessed June 3, 2013).
  4. Manuel Mogato, "South China Sea Tensions Mount Near Filipino Shipwreck," *Chicago Tribune*, May 29, 2013, <http://www.chicagotribune.com/news/sns-rt-us-philippines-chinabre94r0ys-20130528,0,3445886.story> (accessed June 3, 2013).
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This militarization of the South China Sea disputes, coupled with Beijing's rejection of arbitration despite being a party to the Law of the Sea Treaty, raises the potential of an escalating crisis ultimately involving the U.S. Meanwhile, Beijing's recent foray into Indian territory underscores China's increasing assertiveness on boundary issues in general. Nor should the willingness to engage in brinksmanship with another nuclear power be overlooked.

Unlike the economic sphere, it is less clear how the two sides can reach a *modus vivendi* in the security arena. This is exacerbated by the Administration's tendency to surrender potential bargaining chips for little gain. Thus, China has been invited to the 2014 Rim of the Pacific multilateral exercises with no expectation of a quid pro quo from Beijing. Similarly, U.S. Joint Chiefs of Staff chairman General Martin Dempsey and national security advisor Tom Donilon have proffered greater military-to-military contact without any mention of a concomitant Chinese obligation.

**What to Do at the Summit.** The U.S. should:

- Ask for a detailed timeline for major financial reform, such as opening the bond market, and offer to meet demands for better treatment of Chinese investors.
- Not attempt a grand solution in cyber but rather determine if there are areas in which China is willing to curb its behavior, reflected in an actual reduction in incidences of Chinese cyber

intrusions. In the meantime, the Administration should determine the prerequisites necessary for retaliatory action against Chinese cyber aggression when it is perpetrated by the Chinese military.

- Make clear that further military-to-military contacts will be predicated upon a more conciliatory Chinese approach to its border disputes with U.S. allies.
- Fill the vacant policy slots at the Departments of Defense, State, and Treasury as quickly as possible—ideally in time for the S&ED. In policy, details are essential. Having the staff to work through them is critical.

**Feasible Progress.** If the Obama–Xi meeting and the S&ED culminate with the usual 40-point communiqué of emptiness, it will be another missed opportunity. Perhaps opportunities can be endlessly missed and bilateral relations still muddle along, but the relationship is clearly more fragile than it was a decade ago. Progress in financial reform, cyber, and territorial disputes is feasible and would put the relationship on much safer ground.

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