U.S.-CHINA SECURITY REVIEW COMMISSION TECHNICAL BRIEFING ON BUSINESS, TRADE, AND ECONOMIC ISSUES

WEDNESDAY, MAY 9, 2001

The briefing was held at 9:00 a.m. in SD–116, Dirksen Senate Office Building, 1st and Constitution Avenue, N.E., Washington, D.C., C. Richard D'Amato, Chairman, presiding.

Present: C. Richard D'Amato, George Becker, Stephen D. Bryen, June Teufel Dreyer, Kenneth Lewis, James R. Lilley, Patrick A. Mulloy, William A. Reinsch, Roger W. Robinson, Jr., Arthur Waldron, andMichael R. Wessel.

Chairman D'AMATO. Let's get going. I don't want to interrupt conversations, but we've got a full morning, four panelists beginning at 9:30, and I want to give Roger the half hour.

And what we thought, June, is we'd have your tape at lunch.

Commissioner DREYER. Okay.

Chairman D'AMATO. Okay? So if we could start, let's—go ahead, Roger. You can have a seat—here, you can sit next to me.

CAPITAL MARKETS DISCUSSION

Commissioner ROBINSON. Apologies in advance for a more conversational approach to this. We have high drama going on in this very portfolio of cap markets right now. The SEC will know something today as to whether we're going to have strength and disclosure measures, and, if so, what the character of those measures might be.

Commissioner LEWIS. Do you mean of foreign corporations, they're trying to get——

Commissioner ROBINSON. That's correct. Foreign companies seeking to access the U.S. debt and equity market. And there is increased attention to what they're up to. And as I say, I haven't seen anything quite like it since the White House 20 years ago.

The only down side is it made for a near sleepless night. I'm too old for that, I can tell you. But more on that later in the Q&A for those interested in how we might get our arms around remedying what I think is a growing national security and human rights challenge that's very relevant to our proceedings.

As many of you know, the capital markets globally have become the preferred venue for funding of governments and foreign companies. That's a shift from the 1970s, 1980s, when it used to be syndicated bank loans and bilateral and multilateral government instruments, anything from the IMF World Bank to aid programs, or export support programs, such as EXIM and the like, and their equivalents overseas.

Well, folks discovered that foreign securities are a far more efficient way to raise funds. For a few basis points over the cost of funds and this piece of paper, I can pass along an IOU, if you will, with 10-year maturity. No questions asked as to where the money is going and how it's being used, particularly in the case of, say, sovereign bond offerings, and get back billions of dollars to use at the discretion of that government, whoever it may be.

And so that's just, in a nutshell, why—big surprise—the capital markets are the mother lode today and have supplanted commercial banks, governments, and other venues.

Well, China obviously broke the code on this in the early 1980s, and began its entry in the cap markets, including our own, at that time. Now——

Commissioner LEWIS. That was the first time they did that in——

Commissioner ROBINSON. Yes, probably around 1982/83, and we have statistics on this that we can get for you. I'm trying to get updated numbers, obviously, of China's presence in the U.S. capital markets, both stock and bonds.

We have up to 1999, and I have some figures for you, but I'm missing, you know, getting on three years now. So we'll be nailing that down in our data search, no doubt. But the broad problem here is that among the companies and countries that have decided that this is a very efficient, cost-effective, no-questions-asked way to get large sums of money, the wrong sorts of foreign governments and companies likewise broke the code.

So we have a phenomena—rarely, thank goodness, but happening increasingly often—global what I call bad actors. That is, folks that are engaged in a range of activities that are either harmful to U.S. security interests, religious freedoms, human rights, labor rights, environmental concerns, and other abuses.

And, you know, these global bad actors can include proliferators, intelligence and technology theft front companies, arms smugglers, organized crime affiliated companies, companies that are aiding and abetting terrorist-sponsoring regimes in a rather direct way, human rights abusers, religious persecutors. But the ones we are obviously most concerned about are in the national security portfolio.

Now, the concentration of problems, also not surprisingly, is in the emerging market countries and economies. China is—has dominated, if you will, this concern to date. Since 1982, I believe—and we'll check that number—they have issued about $14 to $16 billion in bonds in the United States, probably around $16 billion in stock offerings, just—I'm just guessing at this stage, because we need updated numbers. But I want to give you rough orders of magnitude.

The big players for China are the U.S. and Japanese markets. They are entering Europe, but it has been modest to date, primarily Germany.

Now, what's interesting, because in the shortness of time we have to cut to those issues of greatest concern to the Commission, last year they raised in the U.S. capital markets about half of the total amount of the previous 20 years.

Commissioner LEWIS. Say that sentence again, please.

Commissioner ROBINSON. Last year they raised about $13 billion in the U.S. capital markets, which was about half of the total amount that they had raised in the previous 20 years. So if you're looking for a trend line, that's a dramatic increase, even explosion, in Japanese—I mean, in Chinese debt and equity instruments in our markets.

Now, recognizing that there is a substantial appetite for Chinese offerings, they've been very ambitious about the scale of what they've tried to do. In the oil sector, we've talked about the way China prosecutes its oil acquisition strategy. And we know, for example, that they like a stake in the ground.

None of this spot market business for them. They don't trust that. The know that if there's a blowup in the Taiwan Straits or something it could get sporty. So they like to go into places where the G–7 can't go—Sudan, Iraq, Iran. They've got weapons of mass destruction components, they've got advanced conventional weapons, they've got ballistic missile technology, to sweeten these deals, get these privileged concessions and contracts.

And sometimes it's just a lot of cash. In the case of Sudan, they've committed $15 billion, at least verbally. They've put in about $2 billion. That's a country that has a total annual budget of about $565 million a year. So you can go in and buy sort of every man, woman, and child, in a country of that kind.

The obvious problem here is that—and take Sudan—you have genocide, slavery, and terrorism proliferation among the abuses of that odious regime—Khartoum regime. So they get in partnership with the wrong sorts—Saddam Hussein, the Tehran government, etcetera.

Well, just to give you one or two quick examples of the scale of what they're seeking to accomplish, the China National Petroleum Corp. came to the markets—or made their first announcements that they were coming in September of 1999—August/September—and they wanted to raise $10 billion in one IPO, initial public offering. That would be the largest IPO in New York Stock Exchange history, period, domestic or foreign.

Once they recognized that there was—we had ginned up national security and human rights-related opposition to this offering because of China National Petroleum's 40 percent share of Sudan's oil consortium—the largest by far.

They almost overnight configured PetroChina. They took all the domestic assets out of China National Petroleum, put them into PetroChina, claimed that they had a good firewall, that Coopers or somebody would monitor this thing, and voila, no overseas involvement, no Sudan, what's the problem?

Well, if you look at the prospectus, they weren't able to put together a persuasive firewall at all. In fact, 10 percent of the holdings of the offering go directly to CNPC. CNPC owns 90—85/90 percent of PetroChina. It has all dividends, all profits, all control, complete control.

Now, and as it turned out, the short form is that a coalition of non-governmental organizations was configured, and we played a significant role in that coordination effort at the Casey Institute that I chair, that incorporated organizations across the political spectrum—AFL–CIO, which was the first time, incidentally, that they had ever opposed a domestic or foreign stock offering in the history of the organization to my knowledge. So this is a new foray for organized labor, and they were, of course, very effective. And I can get into that in the questions and answers.

The International Campaign for Tibet, Freedom House, every, you know, major human rights group, was either in the coalition or sympathetic to it, if they couldn't join the Amnesties and the Human Rights Watches were at least supportive, Friends of the Earth, National Wildlife Federation, International Rivers Network, many of—well, not many, but a few, if I may so, Reaganesque National Security Council or national security-oriented think-tanks like our own.

And the long and short of it is that the total population or the total combined memberships of this coalition reached about 20 million people. Now—and counter road shows were set up, so that when Goldman Sachs, which was the lead manager of this particular offering, went to various cities to sell the offering, AFL–CIO, for example, was in New York with—at least in an effort to be in the same building at the same time with a different story. Now, this didn't go on across the country, but there were instances of it.

There was a direct contact campaign. Over a trillion dollars of funds under management were contacted directly by the coalition, including CALPERS, TIAA-CREF, the other big ones—Texas Teachers—and a trillion dollars committed publicly that they wouldn't be purchasing the offering because of human rights/national security concerns.

Again, this is all unprecedented. South Africa, to my knowledge—and Mike Wessel would be better to speak to that—never had something put together quite like this.

Anyway, that offering almost collapsed, and were it not for BP Amoco coming in with $600 million in a private placement at literally the eleventh hour, in exchange for massive retail gasoline station concessions within China, that deal probably—and I think experts will validate this—probably would have failed utterly.

Li Kai Sheng came in with Hong Kong money for—and his associated companies for about 350, and it ended up that the deal had to be at least 50 percent privately placed and ended up at $2.89 billion. Now, that's a 71 percent hit to the $10 billion initially configured.

So large was this blow that the ripple effect was quite profound. Baoshan Iron and Steel wanted to come for about $2 billion in May of 2000—withdrew the offering because, obviously, it was right on the heels of this—how does one say?—largely unsuccessful would be a polite way to put it—fiasco in April.

Sinopec, China's second largest oil company, wanted to come to market in June for $6 billion. Now, this is $10 billion a shot, $6 billion a shot, you can see how those numbers are rocketing out of sight. When you think of $14 billion in the bond markets in 20 years, you get a sense of where we are.

They had to withdraw their offering, and as it turned out—why? Because they own Sudan 6 oil field for $35 million, not a huge investment, but enough to taint them with the same Sudan brush.

They conveniently moved those assets at an undisclosed price to—guess who? China National Petroleum Corp. in the summer of 2000 and came successfully to market, if you want to call it successful, in October for $3.4 billion.

Commissioner DREYER. Roger, excuse me. Who moved the assets to——

Commissioner ROBINSON. Sinopec moved them to CNPC, came to market with Morgan Stanley as the lead manager. They seem to have been clean. Nobody knew this slight of hand until The Wall Street Journal's Peter Wonacutt, on October 13th, broke the story that they had played this shell game and had talked to folks in Beijing headquarters and in Sudan, and apparently everyone on the record stating that Sinopec is still running that field independent of this paper machination, at least this is the allegation or assertion of The Wall Street Journal, not my own.

And, of course, it created a problem. They came to market for $3.4 billion, but there was immediate controversy. And there remains controversy, because 90 days after that deal Sinopec did a $163 million deal with Iranian National Oil Company, which was in violation of the Iran-Libyan Sanctions Act, so 90 days after the offering violated U.S. law.

The question is: were they in negotiations with Iranian National Oil before they came to market? There's no comment about it in the SEC filings or prospectus. There's no comment about the Sudan machination in the prospectus. So these issues are being looked at right now from a material omission perspective.

So I don't want to get caught in the particulars too much. It's just to say that these are a few illustrations. They had a sovereign bond offering. By the way, they have about $4.2 billion in sovereign bond offerings in the United States. Now, this is the Chinese government borrowing under its own name—no cutouts, no state-owned firms, no questions asked about where the money is going and how it's being used.

And I challenge anybody to tell me otherwise when they look at the prospectus. It says "economic development and infrastructure projects" or something like that. So it could go to hydroelectric projects, but it could go also to the mobile DF–31 and DF–41 mobile ICBMs targeted against American cities that were discussed during our last technical briefing.

Chairman D'AMATO. Let me interrupt for just a second here. I would like the members to be able to ask questions. We're going to have a hearing on this whole matter in July that Roger is going to share with Mike Wessel.

But I did want to give people a flavor of where we're going with this analysis, and we're doing some—Mr. Penner, who works with the Casey Institute, is doing a summary of all the work that you've been doing so far for the Commission. So we have sort of a summary of work to date.

But I'd like to open up to questions here, and just because we are pretty short on time, just one question per Commissioner if we could go.

Mr. Becker?

Commissioner BECKER. I'm assuming something. Certainly none of those manipulations could take place for markets that were being developed in the United States.

Commissioner LEWIS. That were what?

Commissioner BECKER. I said none of those manipulations that you were describing could take place in the United States for capital markets that were opening up here in the United States, right? They would never—it would—I'm assuming that the Securities and Exchange—that this would be in violation of their rules, is this not right? Could that be done here? Forget about China. Forget about anybody else. Could they—could you play games like that here in the United States?

Commissioner ROBINSON. Yes. I mean, there certainly are instances where all kinds of games have been played, but you have to recognize that Section 11 of the SEC Act of 1933 empowers shareholders to sue for this kind of thing.

This is legally—I'm not suggesting that we're in a circumstance where I can tell you that China's actions are legally actionable. But I can tell you that, in general, if you have material omissions from SEC filings and prospectuses, you are subject to class action or individual lawsuits.

Now, I will say that there is somewhat less disclosure required for foreign firms, including Chinese entities, than for their American counterparts. For example, foreign securities don't need to be electronically filed today, so that we have instant access.

You have to dig to get the prospectus, which is——

Commissioner BECKER. Well, let me follow up a little bit. We were really heavily involved in this—this whole machination. Because of our objections to PNTR and other aspects with China, we got involved very heavily with this. But one of the things that we were looking at ourselves is, what could be done—and I'm asking you this in a way, then—what could be done to stop that?

Commissioner ROBINSON. Yes.

Commissioner BECKER. Because there is no way to police all of these things that you are describing coming down the road, nor can we mobilize the pension funds and that each time. This was a heroic effort on everybody's part.

Commissioner ROBINSON. Yes. Well, first, I'm glad you asked that, because it offers what kind of remedies are being suggested here. The Casey Institute, I should say, goes back five years in this effort and consistently has only—is not interested in capital controls, is not interested in undue government intervention in the markets, or other measures that could impede the free flow of capital into and out of the United States. I want to be clear about that.

However, in the area of strength and disclosure and transparency, that's urgently needed and we're working it vigorously, and that's one of the reasons that we're in high drama with the SEC as we sit here.

What can you do? Well, besides electronic filing to give you easier access to the prospectuses, you could ask, where do these companies do business in the world, and with whom? Where do their subsidiaries, affiliates, and parent companies do business in the world, and with whom? Who are their senior management—key senior management figures and board of directors? And what are their outside affiliations?

We don't have any—you know, we don't have any PLA generals there, do we, or somebody involved in the intelligence community? In other words, an informed investor is, generally speaking, the best protection we can ask for. We've gone to not all the 50 states, but many of the state legislatures, and asked them to do national security-related and human rights-related audits.

California has—CALPERS has conducted such an audit. It wasn't satisfactory, and the methodology was poor, and they basically came out saying, "Oh, we haven't done a thing wrong." When their—well, that's another story, but let me tell you that's a very rich story.

But the fact is that a number of states can be approached to look at this, because this can be very effectively accomplished at a state-by-state level, if the federal government is unwilling or unable to get their arms around it. We're persuaded of this.

So getting out to the demand side of the market—remember, there's the Goldman Sachses and the Morgan Stanleys and all of our investment banks, but they don't take this risk. They offload this paper to CALPERS and TIAA–CREF and Texas Teachers and all of these types.

That's why when—to work the demand side is a very effective operation, and for them to voluntarily expand their due diligence risk assessments, for the first time to include national security, human rights, religious freedom considerations, is what we are specifically proposing.

I can state as a fact that there is not one public pension fund, one mutual fund in the United States of America today, that looks, for example, at any aspect of national security on a systematic basis in its due diligence assessments concerning whether or not to purchase a foreign security. That's a fact.

Chairman D'AMATO. Thank you.

Commissioner Dreyer?

Commissioner DREYER. Yes. What I'm concerned about is the data that we are being supplied. I mean, you are doing heroic work working on the U.S. side getting them to try to check up.

I deal with Chinese economics on a day-to-day basis domestically, and the Chinese government itself often has—is the recipient of inaccurate information by people who it's very hard for them to check up on, even if they wanted to. And in this case, they don't have an incentive to check up on these people, whether the data they're getting are correct.

And on the U.S. side, I find that we often had inadequate—people who really want to invest will find ways to look the other way when presented with unpleasant facts. Is there any way to deal with those factors, both on the domestic Chinese side and on the U.S. side?

Commissioner ROBINSON. Well, as you know, China is vigorously trying to develop its own domestic capital markets, and they're having great difficulty. I mean, it's been called by financial analysts about an equal bet to a casino.

Cronyism and the other ills that catalyze the emerging market banking or the emerging market financial crisis of 1997/98 are rife in China. That's for sure.

Having said that, the only thing I know is that if China wants to dramatically increase its presence in foreign capital markets where the United States, when we entered the 21st century, turned out to be the dominant player in terms of the depth of our markets and their efficiencies, then we have to look at—to ourselves.

Now, if we were to expand disclosure requirements, for example, and exercise more discipline about—not to the extent that it would kill foreign interest in our markets, but, again, just prudent discipline so that the investor has a darn good sense of precisely what they're investing in and with whom—that is, their identity in global activities—we would probably be able to go a long way toward, if anyone was inspired to do so in the executive branch, this is the kind of thing we'd do in the G–7.

We'd do it in not only the Treasury—respective Treasury Secretary's Ministers of Finance, but we would also bring it to the head of state level and try to have a new transparency regime as part of the economic summit process. That's something that we may wish to consider because, again, although we're speaking to China, this is a global problem.

Gazprom tried to come to market for a $3 billion bond offering in November 1997 when they had weeks before gone into violation of the Iran-Libyan Sanctions Act, and do, by the skin of our teeth, two Senate Banking Committee hearings urgently convened in a one-week period—Goldman Sachs was the lead manager on that particular deal, $3 billion, withdrew the offering—but under excruciating pressure and no thanks to statutes of Iran-Libyan Sanctions Act, which never envisioned the capital markets as being a problem.

We were going to curtail $750 million in Export Import Bank loan guarantees, but then the Russians were going to go 250 miles north of here and attract $3 billion. How does that work?

And Al D'Amato said, you know, "Not on my watch." It was a courageous step for him. And Jon Kyl, and Sam Brownback, and others participated in what was a transparent outrage.

Chairman D'AMATO. In the D'Amato tradition, I might add.

We'll take two more questions and—(laughter)—two more questions and then we'll move to our panel.

Commissioner LILLEY. Can I raise one question?

Chairman D'AMATO. Ken Lewis and then Ambassador Lilley.

Commissioner LEWIS. Can you send us copies of the Wonacutt articles from The Wall Street Journal?

Chairman D'AMATO. Yes.

Commissioner LEWIS. The question I have is, I'm really surprised to know that there is such access to our markets. And if the Chinese government, as you said—these sovereign bonds—want to come into our markets with no restrictions, essentially they are coming into the United States to get money to finance their military expansion.

Commissioner ROBINSON. That's very plausible. We can't—I mean, we can't put an electronic—I mean, a radioactive dye on those dollars and track them through the system. But I can tell you that it is as likely that they're going for purposes that could be deemed harmful to U.S. security interests as they are to benign civilian projects and undertakings.

Commissioner LEWIS. So there are no limitations on access to the capital markets, then?

Commissioner ROBINSON. That's correct. And, by the way, that sovereign bond offering in November that was attempted, the PetroChina Coalition—as this group is now called—of NGOs that fought so mightily on the PetroChina case, that has stayed together as a cohesive unit, likewise contracted a trillion dollars worth of funds.

And that deal was withdrawn after the U.S. Commission on International Religious Freedom wrote to President Clinton, said that he's authorized under the International Religious Freedom Act of 1998, to interdict financial transactions with so-called countries of concern. That is, countries that are known religious persecutors in the view of the Department of State.

Clinton wrote back that he refused to take that action and believed it would be counterproductive to be clear. But at the same time, China reconsidered whether it wanted to come up against an organized opposition of the type that they faced in PetroChina and withdrew the offering.

Commissioner WALDRON. Would you send us that? Would you send us the documentation on that?

Commissioner ROBINSON. Yes.

Commissioner LEWIS. So if there's no limitations on access to our markets, then if somebody claims that there's a firewall, which is essentially breached later, we could even be financing Bin Laden's activities.

Commissioner DREYER. We could be financial what activities?

Commissioner LEWIS. Bin Laden's activities.

Commissioner DREYER. Bin Laden.

Commissioner ROBINSON. I don't know about the Chinese associations with Bin Laden. We don't have our——

Commissioner LEWIS. No. I don't mean them, but, I mean, another company that comes in has connections, but says, "We have a firewall," and get a certification from an accounting firm——

Commissioner ROBINSON. I will say right now that if we had SEC and other responsible officials sitting before us, it's my understanding having spoken to senior levels there that today they are not screening for security-related concerns and feel they are ill-equipped to do so, which is why, in a parting comment here, one of the things that we would—we should seek to do is to establish a capital markets working group, interagency working group within the administration, so that folks like the CIA, NSC, DOD, Justice, as well as Treasury, SEC, arguably the Fed, could sit down together in suspect cases, bring intelligence sources and methods to bear, so that at least we can have a side-by-side on here's the prospectus and the SEC filings, here's national sources and methods.

In these rare cases of suspect concerns, which I think will be rare, fortunately, let's see how it shakes out, because the—and I can tell you that the SEC is supportive of the formation of such an interagency group. You know, we have CFIUS, the Committee on

Foreign Investment in the U.S., to look at security-related concerns that might be attendant to the purchase by a foreign company of a U.S. national asset.

Do we need a Committee on Foreign Financing and Borrowing, a COFFAB, as we call it? You can call it anything you want, but we've named it some years ago. I don't know if the SEC buys onto that name, but I think that they rather like it.

The bottom line is that at least we would have a structure, an advisory body, and in egregious circumstances where we really do have a serious national security or human rights abuse, disclosure and transparency alone—and an informed investor won't do it—we have a responsibility in those rare cases, I believe, to deny access to our markets for certain select foreign entities that will not do damage to our openness as a free and fair capital markets structure overall.

Chairman D'AMATO. Ambassador Lilley?

Commissioner LILLEY. Yes. Could you put a human face on this process you described in our financial markets in New York? In my experience, the Chinese always pick out certain people who are considered reliable, and they work them. And I was particularly exposed to one of these cases where a large American firm in—financing firm in New York City was trying to convince a European investor to come into one of these big purchases in China.

And I must say, I've heard dishonest briefings in my time—this is one of the most dishonest I've ever heard—about conditions in China. This guy was a flack for China.

Are you able to pinpoint certain people, if the Chinese were to carry out these things? I mean, I don't want to get into personalities too much, but this business is personalities.

Commissioner ROBINSON. People or policy, I would agree.

Commissioner LEWIS. Yes. Do you have any names of people who do this kind of thing?

Commissioner ROBINSON. Well, let's put it this way, there are a couple of investment banks in New York that do the bulk of the Chinese business. And, certainly, we are aware of who those folks are, and——

Commissioner LEWIS. Can you tell us?

Commissioner ROBINSON. My understanding is that Goldman Sachs and Morgan Stanley Dean Witter have the bulk of the business. And they use, not coincidentally, a monopolistic Chinese entity that's always a partner. So it seems to me——

Commissioner LEWIS. Called?

Commissioner ROBINSON. Called China International Capital Corp., CICC, that has some interesting personalities in it.

And if you were to listen to the road shows in these offerings, it might be a little difficult for some of us to recognize——

Commissioner LEWIS. And one of them described China as five Switzerlands.

Commissioner DREYER. Oh, my God.

Commissioner LEWIS. A very important influential banker, who we all know, made this public statement.

Commissioner ROBINSON. Yes, I probably know who that is.

(Laughter.)

I know who that is.

Commissioner WALDRON. What does that mean?

Commissioner LEWIS. That it's a—that Szechuan is a Switzerland——

Commissioner WALDRON. Oh, I see. All right.

Commissioner LEWIS. Shanghai is a Switzerland.

Commissioner WALDRON. All right.

Commissioner LEWIS. Manchuria is a Switzerland.

Commissioner ROBINSON. Yes, it sounds like a Davos-type phenomena.

But I would only say, in closing, that do keep in mind that you have—speaking of personalities, you have folks like Wang Jun. Wang Jun, as you know, is Chairman of PolyTechnologies, a multibillion dollar arms dealing operation for the PLA. He was a poster child for the campaign finance abuses, about 600 "thou."

He was the key player, as Chairman of CITIC, China International Trust and Investment Corp., who was—whose subsidiary, PolyTechnologies in Atlanta, was picked up for—by the FBI for trying to smuggle 2,000 AK–47s to West Coast street gangs, as you also know, shoulder——

Commissioner LEWIS. West Coast street gangs?

Commissioner ROBINSON. West Coast street gangs. Shoulder-launched surface-to-air missiles were on that wish list. Had the sting not been affected by the FBI—and let me just say that Wang Jun's CITIC is $800 million deep in the U.S. bond market.

So we're talking about arguably hundreds of thousands of unwitting American investors, or tens of thousands, what—you pick the number. Our holding the paper of Wang Jun's company in their pension funds or mutual funds, and it's not so large as to affect their retirement prospects—I'm not suggesting anything dramatic.

It's merely to say that this is a—this is one of the ultimate grass-roots businesses. Sixty percent of the American people are in the markets, most of them with international exposure.

And when you see your emerging market growth fund, or your Pacific Basin growth fund, or all of these seemingly benign aspects to your own portfolios, much less those of whole states, do keep in mind that if you look in there you'll see the CITICs, the COSCOs, the China Resource holdings. You'll see the sovereign bonds, you'll see the PetroChinas, the Sinopecs, and the list goes on.

Chairman D'AMATO. I want to cut this off.

Commissioner BRYEN. Can I just ask——

Chairman D'AMATO. One quick one, because we want to move to our panels.

Commissioner BRYEN. Well, I guess more of an observation——

Chairman D'AMATO. Yes.

Commissioner BRYEN [continuing]. For Roger that it seems to me that what you're saying in a way is that putting—even putting aside the national security issue, put it to the right and look at it from a purely investor point of view, our investors are being put into a huge risk situation, unwittingly, unknowingly, and no one is telling them what's going on.

I mean, this—this guy that's smuggling arms is not exactly the most stable character in the world. And this is putting—you know, I think it's really a very dangerous—you know, particularly if investment continues, it's a very dangerous situation unless there is some way to regulate it.

Commissioner ROBINSON. I would just close by supporting that strongly. I mean, I haven't talked—because of our mandate, I haven't talked about the financial—the purely financial downside. But when you think that these proliferators and other smugglers could be subject to U.S. economic sanctions, and you think of how that would tank a stock or bond, when you think of the risk profile in being subject to IPO opposition campaigns, or divestment campaigns of the type that Talisman Energy, Inc. in Canada, and PetroChina, and others have faced because of their involvement in Sudan, let me tell you, that depresses the value of foreign securities held by the American people, and they are not given the right to accurately assess the risk associated with these investments and their money.

Chairman D'AMATO. I want to thank Commissioner Robinson for this sort of snapshot overview. We're going to have a whole hearing on this, and we also are going to have our own capital markets working group that's going to work this issue, because this is a huge area that needs—we're late at going into the exploration of it, but this Commission is going to do so. I want to thank Roger for that review.

Why don't we take a two-minute break, and then our panelists will begin. We've got them here, and we'll go until—what time? Until noon on this panel. Two-minute break.

(Whereupon, the proceedings in the foregoing matter went off the record at 9:44 a.m. and went back on the record at 9:48 a.m.)

PANEL I: BUSINESS TRADE AND ECONOMIC ISSUES

Chairman D'AMATO. We've got some distinguished panelists before us today. Greg Mastel is coming down at 10:00. He will join us when he gets here. We've got Alan Tonelson from the U.S. Business and Industry Council, Pieter Bottelier from the Kennedy School, and Ernie Preeg from the Manufacturers Alliance.

What we'd like to do, for the information of the panelists, this is a closed briefing. We are going to tape it, but the transcript will not be released. We'll keep it in the offices of the Commission, and the purpose is for us to have a candid dialogue.

The purpose of the hearing—this closed session—is really to kind of start teeing up the issues that this Commission is going to deal with over the life of the next year, and it is a permanent commission.

This is a particularly important panel, because the basic thrust of the Commission is to have a hard look at the economic impacts on our national security vis-a-vis China. That kind of integrated assessment has not been really done very thoroughly or at all up until now.

And what I'd like to do is each panelist, if you would, give us your remarks for about 10 minutes, and then we'll open up to questions from the Commission. Would you like to start, Alan?

STATEMENT OF ALAN TONELSON, RESEARCH FELLOW, U.S. BUSINESS AND INDUSTRY COUNCIL EDUCATIONAL FOUNDATION

Mr. TONELSON. It would be my pleasure to start.

Chairman D'AMATO. Okay. Go ahead.

Mr. TONELSON. Thank you, Mr. Chairman, and good morning everyone. My name is Alan Tonelson. I'm a Research Fellow at the U.S. Business and Industry Council Educational Foundation, and my organization and I are both very honored by the opportunity to present here this morning.

This Commission has the potential to make an invaluable contribution to U.S. national security policy and economic policy by helping our nation's leaders develop a sound and sensible approach to the Peoples Republic of China. Indeed, I think it's reasonable to conclude that the creation of this commission represents an acknowledgement by Congress that we don't have a policy that does this today. In particular, a failure to integrate effectively America's economic and security interests vis-a-vis China lies behind many of our China-related problems. I should add that my organization and the business organization that it has been affiliated with for many, many years have had a long-standing interest in harmonizing U.S. economic and national security interests around the world.

Congress has given you an important, thoughtful and comprehensive mandate. I think especially important is the emphasis placed on gathering and disseminating information. In my 20 some odd years of working on public policy issues, I have seen few subjects debated in such an information vacuum as U.S.-China economic relations and their broader impact on areas like national security.

And as a result, I can think of few subjects that have generated so many misleading claims and outright falsehoods. I'd like to now make some suggestions for areas of investigation that haven't been specifically covered by the mandate of yours that I read last week, and also offer a few ideas for supplementing research in broader areas that already do seem to have been contemplated.

First, given the increasingly blurry distinctions between military and civilian goods that are implied by the very term "dual use," it is essential for this Commission to identify the composition of U.S.-China trade and how it has changed recently.

In particular, U.S. imports from China are usually considered to be dominated by low-tech, labor-intensive products. My own research, I can tell you, indicates that this picture has been changing rapidly and is hopelessly out of date. I repeat, hopelessly out of date.

Given the importance of maintaining a strong defense technology and manufacturing base, I also hope that this Commission will analyze whether the United States is growing dependent on high-tech imports from China to any significant extent.

And because of Taiwan's increasingly close economic ties to China, and because of Taiwan's obvious vulnerability to Chinese influence and possibly domination, U.S. dependence on Taiwanese technology products, whose production is often moved to China relatively promptly after the initial research and development has been completed, should be analyzed as well. It's not just China, and a prime example would be advanced semiconductors.

Most of China's high-tech base has been built by U.S. and other foreign multinational corporations. U.S. corporate activity in this field is especially noteworthy, especially since Japanese, and to a lesser extent European multinationals, do not share their most advanced technologies as readily as do their U.S. counterparts.

U.S. and foreign high-tech investment in China raises many critical policy questions. For example, how much investment has been made in the last decade by semiconductor companies, semiconductor equipment companies, advanced telecommunications and networking companies, aerospace companies, and the like?

What kinds of goods do these companies currently produce in China? What are they planning to produce soon? What are they likely to produce soon? What kinds of technology training programs have they instituted?

This latter subject is an extremely important one that has received almost no official attention, to my knowledge, whatever. What is actually taught in these training programs? Who is actually trained? What controls do the companies have to monitor the flow of this knowledge beyond their specific laboratories or corporate headquarters? What does the U.S. government know about this activity? What controls has it established? Are they adequate to the task? All are very open questions right now.

The growing use by U.S. multinationals of Chinese affiliates and independent contractors has major national security implications as well. Notably, the health of the American defense technology and industrial basis depends on maintaining a large, diversified, and vibrant supplier base for large prime defense subcontractors as well as major suppliers of dual use high-technology products.

We need to know what kinds of products these various U.S. multinationals are sourcing from China today. How much outsourcing is actually done? How have these outsourcing patterns changed? And have these changes replaced American production to any significant degree? Therefore, are they potentially at the very least affecting the size of this defense supplier base?

And what are the multinational companies' future outsourcing plans? In this case, as in the case that I just discussed, the Taiwan angle needs to be explored as well, because there has been massive U.S. information technology industry outsourcing from Taiwan, and it's growing more massive every day.

We also hope that this Commission will examine some of the major conceptual issues presented by our current ties with China. Two stand out in my mind. First, the Commission should analyze whether America's stated national security policies and economic policies toward China are dovetailing with each other, or are in major conflict, or at least potential conflict?

In my view, the evidence points towards substantial conflict in our current policies, and, therefore, toward a major policy crackup in the not-too-distant future. President Bush has decided to treat China as a strategic competitor in East Asia, but to continue the policy of energetic economic engagement pursued by his two immediate predecessors.

In my view, current economic engagement with China is undermining American strategic priorities in at least three ways. First, as recognized by your very mandate, it appears to be providing China with the kinds of massive inflows of precious hard currency that must make it easier for China to avoid making hard choices between guns and butter.

These inflows result, of course, from China's huge growing trade surpluses with this country as well as from U.S. investment in China. In other words, even though the administration views China as a strategic rival, the United States continues to vastly enrich this same China.

And I must emphasize, you don't have to be a China hawk, you don't have to be a charter member of the so-called Blue Team, to recognize that China is an unfriendly power right now, it will be an unfriendly power for the foreseeable future, and that the merits of pouring resources and advanced technology into this country are at the least not obvious. The merits are not obvious, and the subject should be controversial.

In addition, much U.S. direct investment in China brings Beijing closer to its declared goals of achieving greater or total self-sufficiency in numerous industries. I put out a study last year titled "Factories, Not Markets," in which I showed that many U.S. multinational companies, like Kodak, Westinghouse, and Intel, declare on their websites for all to read their own pride in rendering such assistance to China—in helping to make China self-sufficient or more self-sufficient in their own industries, like semiconductors, nuclear power-generating plants, things of that nature.

However profitable these activities might be for American companies, they clearly weaken one of the main levers currently enjoyed by this country regarding China today—the power to deny critical products and technologies to the Chinese economy. That's an important lever.

These multinational companies also proudly declare their determination to help make China a technology superpower. Again, the merits of this policy, of this goal, given China's clear unfriendliness, are at the least not obvious.

The objects of American competition with China and East Asia presumably are China's East Asian neighbors. U.S. trade and investment policies toward China have had the unmistakable effect of weakening many of these countries economically, and, therefore, destabilizing them politically, and sapping their military strength.

By remaining wide open to Chinese exports, the United States unavoidably—this has been an unavoidable result of U.S. economic policy—has supported mercantilist Chinese policies, notably two competitive currency devaluations, in 1994 and 1996, that have placed tremendous pressure on the exports of the trade-dependent developing countries of East Asia.

These mercantilist Chinese policies were also instrumental in touching off the 1997 financial crisis from which the region has still not recovered by a long shot.

America's failure to respond to Chinese mercantilism just as unavoidably—whatever our intentions were—signaled to multinational companies that they should use China, not developing East Asia, as their main production and export base for the U.S. market.

Consequently, since the mid-1990s, America's friends and America's allies in the region have steadily lost out to China in the fierce competition for foreign investment. The actual flows make this quite clear.

And at the same time, I would encourage this Commission to question the bedrock assumptions behind the strategic competition that Washington is trying to wage. This point is obviously controversial, but I do not believe that your work will be truly complete without considering it.

I believe that these assumptions currently driving U.S.-China policy have been the same assumptions that have shaped U.S. policy in East Asia for most of the 20th century. This policy has sought goals such as maintaining American influence in this region and maintaining stability in this region as well.

Too often, however, we forget to ask why such objectives have been considered so important, and even vital in the first place. In looking at this issue rigorously and unsentimentally, the clear answer, to me at least, has been that the United States has sought to make money in East Asia. That's East Asia's inherent importance to this country.

Now, this is a perfectly reasonable, even vital objective to hold, especially if it is made explicit, and, therefore, open to periodic scrutiny, which all policies must be. Less reasonable is the evident belief that a sizeable American military presence in the region and the consequent capability to prevent the rise of a rival hegemon are still needed to achieve this goal for the United States.

For a century—a century now—Washington has feared that a foreign hegemon in East Asia would organize the region in ways that would shut America out economically. That has been the prime fear, for all the talk about strategy and geopolitics. We've been in this to make money, and that's perfectly fine.

This fear was obviously well-founded when the likely or actual rival was imperial Japan or the ideologically hostile Soviet Union. Today the fear may be less well-founded, and, in particular, the economic openness of China, however incomplete it is, and its evident determination to become integrated into the global economy, however problematic the desired terms of China's integration might be, indicate that Chinese hegemony in East Asia would not necessarily prevent American producers from making bundles of money in the region.

Even more intriguing, China's peculiar economic strategy—this peculiar combination of market structures and state-shaped policies—suggests that any obstacles that Beijing raises to American trade and investment are best dealt with by economic and not military means. Principally, Washington should use the enormous leverage that America enjoys today by virtue of its role as technology leader, as principal export market for the entire region, especially China, and as a major capital supplier to East Asia.

Finally, even if a strategy of relying heavily on economic tools to preserve American interests in East Asia is deemed problematic, the Commission would still need to examine the question of whether its flaws and risks are more acceptable and more manageable than those posed by the current military-centered strategy.

Given China's growing nuclear capability and the uncertain military reliability of many of America's regional allies, the call is much closer than the century-old conventional wisdom acknowledges. This presentation certainly does not exhaust the list of important topics that this Commission could examine, but it does represent the priority issues that have been identified by my organization to this point.

And, again, we look forward to providing you with any assistance needed in actually gathering information, in framing issues, and in developing answers. And, of course, I would be happy to answer any of your questions this morning.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF ALAN TONELSON

Good morning. My name is Alan Tonelson. I am a Research Fellow at the United States Business and Industry Council Educational Foundation. I am honored by the opportunity to appear at this briefing today, as is my organization.

This Commission has the potential to make an invaluable contribution to U.S. national security policy and economic policy by helping our nation's leaders develop a sound, sensible approach to the People's Republic of China. Indeed, it is reasonable to conclude that the Commission's creation represents an acknowledgment by Congress that such a policy does not exist today, and that a failure to integrate effectively America's economic and security interests vis-a-vis China lies behind many of our China-related problems.

Much of the recent work of the U.S. Business and Industry Council Educational Foundation has been focused on finding the right balance between the economic and security challenges presented to the United States by many actors in world politics and international economics. Our sister organization, the U.S. Business and Industry Council, has also examined these issues extensively and consistently since its creation six decades ago. On behalf of the Council's 1,000 members companies, I affirm that both organizations stand ready to assist the Commission in any way possible.

Congress has given the Commission a comprehensive and thoughtful mandate. Especially important is the emphasis placed on gathering and disseminating information. In my twenty years of working on public policy issues, I have seen few subjects debated in such an information vacuum as U.S.-China economic relations and their broader impact. As a result, I can think of few subjects that have generated so many misleading claims and outright falsehoods.

Following are some suggestions for additional areas of inquiry, or for supplementing research and analysis that the Commission's founders have already contemplated:

First, given the increasingly blurry distinctions between military and civilian goods that is implied by the term "dual use," it is essential that the Commission identify the composition of U.S.-China trade, and how it has changed in the past decade and a half. U.S. imports from China, for example, are typically considered to be dominated by low-tech, labor-intensive goods. My research indicates that this picture has been changing rapidly, and is hopelessly out of date.

Given the importance of maintaining a strong defense technology and industrial base, I hope that the Commission will analyze whether the United States is growing dependent on high tech imports from China to any significant extent. Because of Taiwan's increasingly close economic ties to China, and because of Taiwan's vulnerability to Chinese influence and possibly domination, U.S. dependence on Taiwanese technology products—whose production is often moved to China—should be analyzed as well. Advanced semiconductors is a prime example.

Most of China's high tech base has been built by U.S. and other foreign multinational companies. U.S. corporate activity in this field is especially noteworthy, especially since Japanese and to a lesser extent European multinationals have not shared their most advanced technologies as readily as their American counterparts.

U.S. and foreign high tech investment in China raise many critical policy questions. For example, how much investment has been made in the last decade by semiconductor companies, semiconductor equipment companies, advanced telecommunications and networking companies, aerospace companies, and the like? What kinds of goods do these companies currently produce in China? What are they planning to or are likely to produce in the next decade? What kinds of technology training programs have these companies instituted? What is taught? Who is trained? What controls exist to monitor the flow of this knowledge beyond specific companies? What does the U.S. government know about such activity? What controls has it established? Are they adequate to the task?

The growing use by U.S. multinationals of Chinese affiliates and independent contractors has major national security implications as well. Notably, the health of the American defense technology and industrial bases depends on maintaining a large, diversified, vibrant supplier base for large prime defense contractors as well as major suppliers of dual-use technology products. What kinds of products are these various U.S. multinationals sourcing from China today? How much outsourcing is currently done? How much of this outsourcing has replaced U.S. production, and thereby potentially affected the size of the supply base? How have the trends unfolded over time? What are the multinational companies' future outsourcing plans? In this case, as above, the Taiwan angle needs to be explored as well.

I also hope that the Commission will examine the major conceptual issues presented by our current ties with China. Two stand out in my mind. First, the Commission should analyze whether America's stated security policies and economic policies toward China are dovetailing or clashing. In my view, the evidence points toward substantial conflict, and therefore toward a major policy crackup.

President Bush has decided to treat China as a strategic competitor in East Asia, but to continue the policy of energetic economic engagement pursued by his two predecessors. Yet current economic engagement with China is undermining American strategic priorities in at least three ways. As recognized by the Commission's mandate it appears to be providing China with the kinds of massive inflows of precious hard currency that must make it easier for China to avoid making hard choices between guns and butter. These inflows result of course from China's huge, growing trade surpluses with the United States, and from U.S. investment in China. In other words, even though the administration views China as a strategic rival, the United States continues vastly to enrich China.

In addition, much U.S. direct investment in China brings Beijing closer to its declared goals of achieving greater or total self-sufficiency in numerous industries. As reported in my 2000 study, Factories Not Markets, many U.S. multinational corporations, like Kodak and Westinghouse, proudly declare on their websites their pride in rendering such assistance to Beijing. But however profitable these activities are for business, they weaken one of the main levers enjoyed by the United States in its China policy—the power to deny critical products to the Chinese economy.

The objects of American competition with China in East Asia presumably are China's East Asian neighbors. Yet U.S. trade and investment policies toward China have had the unmistakable effect of weakening many of these countries economically, and therefore destabilizing them politically and sapping their military strength. By remaining wide open to Chinese exports, the United States unavoidably has supported the mercantilist Chinese policies (e.g., competitive currency devaluations in 1994 and 1996), that have placed tremendous pressure on the exports of the trade-dependent developing countries of East Asia, and that were instrumental in touching off the 1997 financial crisis in the region.

America's failure to respond to Chinese mercantilism just as unavoidably signalled to multinational corporations that they should use China, not developing East Asia, as their main production and export base for the U.S. market. Consequently, since the mid-1990s, America's friends and allies in the region have steadily lost out to China in the fierce competition for foreign investment.

At the same time, I would encourage the Commission to question the bedrock assumptions behind the strategic competition that Washington is trying to wage. I believe that these are the same assumptions that have shaped U.S. policy in East Asia for most of the 20th century. This policy has sought goals such as maintaining America's influence in the region and maintaining regional stability. But too often we forget to ask why such objectives have been considered important—and even vital. Looking at the issue rigorously and unsentimentally, the clear answer has been that the United States has sought to make money in East Asia.

This is a perfectly reasonable—and even vital—objective to seek, especially if it is made explicit and therefore open to periodic scrutiny. Less reasonable is the evident belief that a sizable U.S. military presence in the region and the consequent capability to prevent the rise of a rival hegemon are still needed to achieve this goal. For a century, Washington has feared that a foreign hegemon in East Asia could organize the region in ways to shut America out economically. This fear was obviously well-founded when the likely or actual rival was imperial Japan or the ideologically hostile Soviet Union. Today, this fear may be less well-founded. In particular, the economic openness of China (however incomplete) and its evident determination to become integrated into the global economy (however problematic its desired terms of integration), indicate that Chinese hegemony in East Asia would not prevent American producers from making bundles of money in the region.

Even more intriguing, China's peculiar economic strategy suggests that any obstacles Beijing raises to American trade and investment are best dealt with by economic, not military, means—by using the enormous leverage American enjoys bu virtue of its role as technology leader, principal export market, and capital supplier (though not on a net basis).

Finally, even if a strategy of relying heavily on economic tools to preserve American interests in East Asia is deemed problematic, the Commission would still need to examine the question of whether its flaws and risks are more acceptable than those posed by a military-centered strategy. Given China's growing nuclear capability and the uncertain military reliability of many regional U.S. allies, the call is much closer than the century-old conventional wisdom acknowledges.

This presentation certainly does not exhaust the list of important topics the Commission could investigate. But it does represent the priority issues identified by our Council and Foundation. Again, we look forward to providing the Commission with any assistance possible in gathering information, framing issues, and developing answers.

Thank you.

Chairman D'AMATO. Thank you. And we'll move right on to Mr. Bottelier, and we'll go with questions after the full panel.

Welcome, Greg Mastel from the Senate. We know you've got a short timeframe, but we'll get some questions to you after your presentation.

Thank you. Go ahead, Mr. Bottelier.

STATEMENT OF PIETER BOTTELIER, ADJUNCT LECTURER, JOHN F. KENNEDY SCHOOL OF GOVERNMENT

Mr. BOTTELIER. Mr. Chairman, thank you for inviting me to this panel. If I have any value to add to your considerations, it would not be from a national U.S. perspective, but more from an international development perspective. That's how I got to know China. Not long ago, in 1992, I was assigned to serve as Chief of Mission for the World Bank in China after a long career in Africa, Latin America, and Indonesia.

So forgive me if I don't emphasize security or military aspects. That's not my area of expertise at all. I've learned to look at China from a very different perspective; namely, how does this country get out of the poverty and the isolation that it had imposed on itself for so long?

You've asked me to focus in particular on WTO. I've submitted some written remarks that are too long to read, so I'll——

Chairman D'AMATO. If you could summarize those for us.

Mr. BOTTELIER [continuing]. Summarize a few points.

The first point is that China's application for WTO membership—dating back to 1986—is entirely consistent with everything that has happened regarding economic reforms in that country since the late 1970s. It has been a consistent process of gradually opening up the economy to the rest of the world but also—and that's often forgotten—gradually opening up internally.

The internal opening up of the Chinese economy is also a historic process, and ultimately I believe as important, if not more important, than the external trade and investment development. China has internally never been an integrated economy.

There never was a national communication infrastructure—roads or air communications, or bridges across the Yangtze for that matter. Such infrastructure is now being installed at an incredibly high pace now. And I think it is important to realize that these internal developments are closely related to the external developments.

In the reforms I think the Chinese have reached a point where they cannot proceed very much further on either internal or external reform without integrating these two processes. And that's what WTO membership really means for them.

It will put the entire domestic reform process under intense pressure to conform to international norms and standards, and that is not because I think the international community imposes that on China, but because they see that as the only way to sustain the development and modernization process. So that's my point number one—the integration of internal and external economic reform processes.

Point number two: China has made, on the economic side, enormous progress. This was a surprise to most international economists. Nobody had predicted in the late 1970s or even in the late 1980s that China would become seventh largest economy and the eighth largest trader by the end of the century. In 20 years from now they're likely to be the third largest trader.

This rapid growth was a surprise, because the approach the Chinese have followed in their reforms, has been rather unorthodox by Western standards. They have not followed standard Western reform recipes at all.

To give you an example, they did not believe early on that ownership change—privatization—was an important way to achieve greater efficiency. They did believe that competition and incentives were very important, and they created an environment within which state enterprises compete fiercely amongst themselves.

That's an aspect that is very different from what you find in most other transition economies. The Chinese have only recently, since about 1995, begun to see the importance of ownership change, private ownership, protection of private ownership, associated legal system development, more transparent court systems and procedures.

WTO is terribly important for the Chinese. They are seeking the membership voluntarily, as I said, because they believe that this is the safest way for them to maintain the reform and the development momentum.

They are, perhaps about halfway in the reform process. There are still many inconsistencies and contradictions in their system. They will have, in my opinion, many more years, perhaps decades to go before they will have developed an institutional framework, a legal framework, that is internally consistent and supportive of the market economic model that they are aspiring to. They're not quite there yet.

Point number three: In terms of output growth and input income growth, they have made enormous progress, but I think we should not forget that internally there are enormous problems looming which the leadership is struggling with. I've alerted you in my written remarks to the enormous internal debt balloon in China. It's not just the registered official government debt, internal and external—that's actually quite modest—but it's the unregistered, hidden part of the debt, that is, the non-performing loan portfolio in the state banks, the unfunded nature of the state's domestic pension obligations, and the severe under capitalization of state enterprises at this point.

Chinese state enterprises, which are now becoming fewer in number and gradually more attuned to market standards, are less capitalized today than the Korean Cheabols were prior to that country's financial crisis in 1997.

So they have to work themselves out of that internal debt balloon. That will take at least a decade, if they do everything right. And there are many things that are still not being done right.

So we cannot take it for granted that this Chinese modernization process will, in fact, gallop ahead without hurdles. There is a possibility of internal financial crisis. There is a possibility of internal social crisis. I think the unemployment has now become a very, very serious situation in China.

They have hidden the unemployment problem roughly until about 1995. 1995 was a turning year when the reform of state enterprises began to be taken more seriously, and when bankruptcy laws began to be applied. As a consequence, unemployment in the state sector became serious. The long-term strategy is, of course, that under WTO the non-state sectors will absorb the surplus labor from the shrinking state sector.

The civil service is also shrinking and so is the PLA; they're demobilizing many units; at the same time massive amounts of rural surplus labor that will have to be absorbed the next several decades one way or another.

For that reason, the Chinese need high economic growth; they also need efficient growth, not necessarily a private sector growth. They know they need sector-based growths. They also have a significant collective sector in the economy, as well as numerous joint ventures (state and non-state combined).

But the paradigm shift that they are working towards clearly aims at bringing the state sector share in the economy down while promoting the non-state sector as fast as they can, with domestic investment. (which is by far the most important source of funds) as well as foreign private investment, which accounts for about 10–15 percent of the total investment in China.

If they are successful in this paradigm shift—and I must emphasize that they still have a long way to go—then China may become a significant economic power in the world and move to second or third place within the next few decades. China's economy is about the size of Italy's at the present time, but it was maybe the size of Luxembourg 20 years ago, so—(laughter)—that's for historical perspective.

Point number four: A remark on Taiwan. I've been following the trade and investment relationships between the PRC and Taiwan as closely as one can. It's not always easy. But to me, it is very striking that neither side, neither Taiwan nor the PRC, has indicated an intention to apply Article 13 of WTO.

Under Article 13, prospective members may legally exclude others from the most-favored nation treatment under WTO.

The fact that neither side has indicated an intention to do so, or even publicly talked about it—this is little noticed in the press—suggests to me that underneath all the tensions there is a long-term perspective on broadening and deepening economic and financial relations. And that's not surprising, because that's of great, interest to both sides.

I mean, PRC and Taiwan are about as close as Canada and the United States. I think the potential has by no means exploited——

Commissioner DREYER. Geographically. Geographically close.

Mr. BOTTELIER. Yes, geographically, but also economically (or potentially economically) I think. The potential of that relationship has, by no means, been exhausted. Under WTO, if, indeed, they plan to work towards de facto MFN mutual treatment, that could be a significant factor in the development of the relationship between the PRC and Taiwan.

Thank you.

Chairman D'AMATO. Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF PIETER BOTTELIER

Introduction and Abstract

I got to know China as Chief of the World Bank's Resident Mission in Beijing (1993–97) and have been closely following the country's economic reforms and development ever since. During most of the 1990s China was the World Bank's largest borrower and an important recipient of technical assistance; loan commitments ranged between two and three billion dollars per year for projects all over China. My perspective on the country was shaped by 30 years of prior experience as a development economist working on and living in Africa, Latin America and East Asia. Since I left the World Bank in 1998, I have been teaching courses on economic transition management—comparing China's approach to economic reform with that of other transition economies—at SAIS (Johns Hopkins) and KSG (Harvard) while undertaking China-related research at other institutions in the U.S. and in Europe. I serve on occasion as an advisor to the Chinese Government on economic reform issues.

I have no professional expertise in security or military matters, but I believe that regional stability in Asia and U.S. security interests are best served by an economically dynamic and successful China that is increasingly integrated in the world economy through market-based trade and investment relationships. WTO provides the best available multilateral framework—a work in progress—for the orderly development and growth of such relationships. China attaches great importance to such multilateral frameworks.

China and North America (the U.S. and Canada) have economic complementarities in agriculture, manufacturing and service industries that, under the right conditions, should permit a further significant expansion of mutually beneficial economic relations. Assuming constructive relations, China's rapid economic development and transformation into a modern, rule-based market economy is not a zero-sum game for the U.S.: it is a long-term economic and security interest.

China's economic reforms have yielded impressive interim results, but the reform process will inevitably take many more years, perhaps decades, before anyone can seriously claim that a stable and internally consistent market-based economic system has emerged. Neither success nor failure is pre-ordained. The U.S. should take a long-term perspective of the relationship and support China's economic reforms, based on an understanding of their enormous complexity and historical significance. The pace of social and political reform in China cannot be forced by outsiders. A stagnating or faltering Chinese economy presents far greater risks for regional stability and U.S. security than an economically successful China, especially when relations are not constructive. Even when there are tensions between the two Governments, efforts should be made to ensure that the Chinese people view the U.S. as supportive of China's development. Since 1999 popular opinion in China about the U.S. appears to have changed in negative direction.

China's Historic Change and the Opportunities Offered

The last 22 years represent the longest period of uninterrupted modernization and growth in modern Chinese history. Average per capita income per year rose from about $150 in 1979 (when the reforms started) to about $1,000 at present. In some of the larger cities, such as Beijing, Shanghai and Guangzhou, it is already of the order of $4,000. The economy has become substantially marketized and the role of the state in the economy continues to change fast. In 1979 there were only about a dozen state-owned trading companies licensed to engage in international trade. Now there are well over 100.000, including many non-state enterprises. An urban middle class of several hundred million people is emerging. The traditional image of China as a predominantly rural economy is out of date. Already close to 40 percent of China's 1.27 billion people live in cities and towns with an urban character.

The economic and social changes of the past twenty-two years are profound, pervasive and unprecedented. A shared national abhorrence of the excesses of the Great Leap Forward (1959–62) and the Cultural Revolution (1966–76) combined with a strong desire to modernize the economy by opening up the closed system that Mao left behind drive the reform process. Communist ideology is dead; pragmatism prevails.

For many in the West it is perplexing that the Communist Party, originally rooted in ideology, was and still is the prime mover of an economic reform process that may ultimately undermine its power monopoly. From a Chinese perspective this is less puzzling; in spite of growing pluralism in society, the Communist Party remains today the only organization capable of providing such leadership. While there is increasingly vocal opposition to particular reform measures, there is no indication that political will to sustain the reform process is petering out or that popular support is becoming too thin. It is almost certain that the new Government that will take over in the beginning of 2003 will continue the market reforms started by Deng Xiaoping at the end of 1978. WTO membership will effectively merge internal and external economic reforms into a single consolidated process that will be subject to international scrutiny and sanction. China is seeking WTO membership voluntarily. Contrasts with 19th century efforts by Western powers to forcibly open Chinese markets for opium and Western products could not have been greater.

China's growth has helped sustain America's boom with low inflation of the 1990s. Although China's large trade surplus with the United States has definitely been a boon for Beijing, we should not overlook the fact that the flow of Chinese savings to the United States to finance this deficit is far greater than the flow of American investments into China. Sales by U.S. affiliates located in China (to markets inside and outside China) probably exceed U.S. exports to China. China's market transition is more than an economic opportunity. If China eventually emerges as a prosperous and stable nation, willing to play by international rules, American security interests will be better protected than in case reforms should bog down or end in crisis.

The Depth of Change in China

With media attention often focused on the suppression of political freedom, human rights violations and increasingly obvious social problems, it is easy to lose sight of the tremendous progress than has been made by China in many areas. For example, while rural poverty remains serious in some parts of the country (and may even have increased in recent years), absolute poverty in China as a whole has been reduced on a massive scale. The World Bank estimates that 75 percent of global poverty reduction during the past two decades is accounted for by China. China's economic progress has been associated with a rapid expansion of cultural expression, major advances in sciences, sports, military modernization and public information. There are today some 3,000 daily newspapers in China and over 8,000 magazines. Chinese TV audiences for popular programs tend to be the largest in the world. Most mass media are commercial. Even the national TV station (owned and operated by the Central Government—CCTV) now depends for well over 90 percent of its budget on advertising. Internet use and telecommunications in general are exploding. Already over 200 million people have their own telephone. The Chinese market for mobile phones is already the largest in the world; the number of subscribers will soon exceed that of the United States.

The rapid growth of internal markets in China is at least as important for the country's development as external trade. For example, quantum improvements in domestic transport and communications infrastructure have ensured that fresh fruits and vegetables are now available abundantly year-round in Northern cities that used to have to do with cabbage during the long winter months. Newly acquired freedom to travel within the country is expanding to international travel. Personal passports are being issued at a rapidly growing rate. The total was well over 2 million in 1999, higher than ever before in China's history. Although living conditions in urban areas are still cramped by Western standards, the average floor space per person has more than doubled. Private house (apartment) ownership in cities has become relatively common.

Another indicator of change is that China has become a major international tourist destination. Not counting visitors from Hong Kong and Macau, China received in 1998 about half as many foreign tourists as the United States, more than Mexico or Germany. It is now the world's fifth most popular tourist country. It was not so long ago that foreign tourism in China was essentially limited to small groups in guided tours under strict Party supervision.

For Western observers and a growing proportion of China's population, the continued suppression of political dissent, human rights violations, direct or indirect control over the media, prohibition of movements such as Falung Gong, etc. is difficult to square with the progress that has been made in other areas. If these contradictions in China's society are not resolved in due course, the enormous progress that has been made in many areas may not be sustainable.

The Financing of China's Development Since 1980

An interesting characteristic of China's development during the past 20 years has been that over 90 percent of investment was financed from domestic savings. If China's domestic banking system had been well developed, the country could have financed virtually all investment from domestic savings. The fact that China has absorbed large amounts of foreign direct investment (FDI)—over $300 billion since 1980, most of it in the past 8 years—points more to the underdeveloped nature of domestic financial intermediation, than to a net-dependency on foreign savings. In this respect China differs significantly from most developing countries.

China's highly favorable savings/investment balance does not imply that foreign aid and FDI were relatively unimportant for China's modernization and growth. Quite the contrary; both are critical. Foreign aid comes with badly needed technical assistance and helps to overcome budget constraints in poor provinces. FDI was and is critical for reform and export growth. Much modernization would simply not have taken place without it. The importance of FDI for China's reforms is far greater than its modest share in total investment financing—less than 10 percent on average since 1980—suggests.

Because of its strong balance of payments and high international reserves, China has been able to cope relatively easily with a large net-outflow of foreign bank credit in 1998 and 1999 following the Asian financial crisis. China was in fact the only country in East and Southeast Asia fact that sailed through the crisis relatively unscathed. It did not have to devalue its currency and it supported IMF-led aid packages for other countries in the region. Since the middle of 1998, China has succeeded, with the aid of classic Keynesian domestic fiscal stimulus packages, in avoiding an excessively sharp downturn in the economy during the past two years, while combating deflation. It did not need an IMF program and never came close to a default on external sovereign debt. However, several non-sovereign Chinese creditors, including some public banks, did default. The GITIC default of a few years ago caused an international uproar, because foreign creditors believed that the Central Government would stand behind all state-owned enterprises.

By refusing to back external financial obligations of public banks and companies that were not covered by a formal Government guarantee and allowing several of them to go bankrupt, the Central Government in Beijing drew a sharp distinction between sovereign and non-sovereign public foreign debt. Painful as this was for many foreign creditors, the Chinese government effectively dealt once and for all with a dangerous "moral hazard" problem that had been hanging over the financial system for years. Financial markets now differentiate clearly between the creditworthiness of various borrowers within the Chinese public sector. This will promote domestic economic reform and capital market development.

China's external debt is relatively modest in size—only about 16 percent of GDP—and has been better managed than in the East Asian crisis economies, including South Korea. Its maturity structure is sound and the cost of annual debt service is only about 10 percent of gross export earnings. The truly sovereign part of China's external debt accounts for only about 6 percent of GDP. External and local borrowing by lower level governments (but not necessarily their enterprises) has been reasonably effectively controlled. China's sovereign external debt is today more highly rated by some major rating agencies than Japanese government Yen debt.

Transition Management and the Risk of Failure

China's gradualist, homegrown approach to economic reform has yielded positive as well as negative results. By conventional economic transition management standards, the Chinese did many things wrong. For example, China did not believe, at least not at first, in ownership change (privatization) as a necessary condition for efficiency improvement in the public sector. They relied on domestic market competition and price incentives in stead, sometimes with remarkable results as the break up of the national airline (CAAC) and China Telecom has demonstrated. The capitalist model that is now emerging in China was almost certainly not intended when the reforms started. The main initial focus of reform was agriculture. During the first 7 years of the reforms, until the mid-1980s, rural incomes grew by no less than 15 percent per year per capita. This ensured early popular support for the reforms from a large majority of the population.

The Chinese allowed a non-state economy to develop in parallel with the old state sector, first reluctantly and later with growing conviction. It was only recently that they began to build the legal infrastructure for a capitalist economy and accepted privatization as a legitimate tool for the reform of state enterprises. They shielded the old state sector from foreign competition as long as possible so as to protect domestic employment and social stability. The old state sector did in fact continue to grow during the first 15 years of the reforms, though much slower than the non-state economy. Total employment in China's state sector did not begin to fall until 1995 and it is only during the last 5 years that genuine private enterprise has become important as a source of incremental output and employment growth.

Outside agriculture (which has been 90 percent private since the dismantling of rural communes in the late 70s and early 80s) about 33 percent of total value added in China's economy is now accounted for by the private sector, about 37 percent by the state sector and the rest by collectives and joint ventures. China today has more than 8 million registered (non-farm) enterprises, mostly small and very small. More than 95 percent of them are privately owned. China has a vast reservoir of budding entrepreneurs ready to take advantage of market opportunities when they arise.

By delaying state enterprise reform until late in the game, China incurred heavy internal debts. But it also bought time. Time to adjust attitudes and thinking about society and the role of the state. Time to wean people from the "iron rice bowl" syndrome and to teach them how to accept responsibility for their own lives. Time to start building institutions needed for the management of an economy in which competition, private ownership and private investment gradually came to be accepted as normal. Time to understand why it is important to protect the environment, an area in which very serious problems have developed as a result of rapid economic expansion and inadequate policies.

A major risk in China's approach to economic reform lies in the huge domestic debt balloon that has developed and is still growing. This is a time bomb that urgently needs to be defused. Much of the internal debt is relatively invisible and hard to measure. A large part is hidden on the balance sheets of state banks or their asset management companies in the form of non-performing loans to state enterprises or inflated equity valuations. The state's unfunded pension debt and the severe under-capitalization of most of China's remaining state enterprises constitute other parts. Ultimately, much of this debt will have to be paid or written off. China does not at present have the resources to solve all these problems. Meanwhile, the pressures to come clean on hidden internal debt are building as a result of the need to prepare state enterprises and banks for more intense WTO-related competition under international transparency and capital adequacy rules.

China's external economic strength stands in sharp contrast with internal financial and fiscal weakness. The domestic debt problem is under control as long as there is political stability and the owners of deposits in China's state banks—the cork on which the financial system has been kept afloat—believe that their money is save. Political instability or an erosion of public confidence in the state banks could trigger a major financial crisis and undermine the reform effort. A financial crisis could also be triggered by a sudden collapse of the domestic stock markets. Already more than 60 million Chinese families keep part of their savings in domestic stock markets. These markets are not yet adequately regulated and supervised. Critics call them "worse than casinos". Strenuous government efforts to improve business accounting, auditing and disclosure standards are countered by the corroding effect of corrupt practices and wild speculation. The fight against corruption is not only a struggle for political survival, but also aimed at keeping reforms on track.

Whether China's economic reforms will ultimately be successful will depend on many factors. Drastic domestic financial reform, including the removal of skeletons from many state financial closets, is critical. The prospect of WTO membership has made this task more concrete and more urgent. A financial crisis is not pre-ordained, but it cannot be ruled out either. While cleaning up the financial system, China will at the same time have to develop domestic capital markets, strengthen its fiscal system and reform social security. The process will inevitably take many years, even under the best of circumstances. Few countries have ever faced such daunting reform challenges. On the positive side, the quality of China's economic team has steadily improved over the years and is now among the better teams in Asia. Zhu Rongji has been the principal builder of China's economic team. This may be one of his most important legacies. When he leaves the Government in 2003, there will be many competent and experienced people, both at the Center and in the provinces, to manage the economic reform effort. Whether they will have enough political clout to carry out difficult reforms remains to be seen.

Social pressures and public discontent

Since around 1995, open unemployment has become a serious factor in China. This is a direct result of accelerated reform in state enterprises, plant closures and, since 1998 also from drastic cuts in the civil service and the demobilization of PLA units. China's employment problem had, of course, always been there, but it had been hidden in the state controlled economy with artificially suppressed urbanization. With rapid rural income growth in the 1980s and a gradual relaxation of restrictions on labor mobility, came large-scale labor migration away from the farms and the phenomenon of a "floating population".

During the 1980s almost all surplus agricultural labor was relatively quickly absorbed in thousands of collective rural industries that developed more or less spontaneously, and in public enterprises that were still expanding. Between 1992 and 1997, it was the uncontrolled construction boom in and around the cities—perhaps the largest construction boom the world has ever seen—that absorbed most surplus labor. But, when the need for greater financial discipline and inflation control became apparent and was politically accepted in the mid-1990s, the state ceased to function as an employer of the last resort. One result of the overheated construction boom of the mid-1990s has been (and still is) a significant excess supply of office space and luxury housing in many cities. Commercial rents and real estate prices has plummeted. This has not triggered a banking crisis as it otherwise might have, because (1) the main banks are state-owned, and (2) much of the construction was financed by both foreign and domestic equity capital.

The economic slowdown of 1998 and 1999, intensified by the Asian financial crisis, led to further rapid increases in unemployment which is believed to have reached an average rate of 9–10 percent in urban areas. The situation is worse in areas where large numbers of inefficient state enterprises were concentrated such as the Northeast. Moreover, many state enterprises can no longer pay unemployment benefits or pensions, because they are unprofitable and have lost access to state bank credit. The need for fiscal discipline makes it impossible for the Center to provide full compensation. Traditional social safety nets broke down before new ones were fully functional. Social hardship and public discontent are also related to growing crime rates (which are, however, still low by American standards) and corruption. An economic slow-down would worsen these problems.

Yet, the public discontent and anger one can observe in China today affects only a minority of the population and does not translate in significant pressures to discontinue or roll back economic reforms. Many press for accelerated reforms. As long as the economy as a whole continues to grow rapidly, most younger people who are laid off in the shrinking state sector find employment in the rapidly rising non-state (including private) sectors. The old, the sick and the unskilled suffer most in the economic transition. Social security reform is indeed one of the most urgent reform challenges. A basic reform plan has been mandated by the State Council, but implementation is slow and extremely difficult. In seeking WTO-membership, the government has demonstrated leadership, confidence and a forward looking long-term vision.

WTO and the Taiwan question

The likely impact of WTO-membership on Taiwan's economy is not nearly as intense as it will be for China, but it is still significant. The biggest gains for Taiwan may result from increased economic interaction with the mainland. For China too, intensified and direct trade and investment relations with Taiwan under WTO principles will be very significant. It could help to sustain the growth momentum which is so critical for the implementation of economic reform and the preservation of social stability.

There is no automaticity to the removal of bilateral trade and investment barriers, however. Technically (under article 13 of the WTO Charter), either or both parties could choose to exclude trade with the other from standard WTO treatment before accession. It appears significant that neither side has indicated an intention to exercise this option (although Taiwan might still do so if Beijing introduces new obstacles to the island's accession.) This suggests that both sides are intent on applying WTO principles to the development of bilateral trade and investment relations in the future. This would be a breakthrough of great economic, financial and political significance.

Conclusion

China has made enormous economic progress since the start of market economic reforms twenty-two years ago, but the reform process is only about half-complete. The fuses to two domestic (one social and one financial) time bombs—unemployment and domestic debt—are burning. To defuse the bombs and maintain stability under a new economic system China needs high domestic growth for many years to come and continued reform to improve the quality, the labor intensity and the environmental sustainability of growth. China will also need political reform and a more independent judiciary. WTO-membership will make it easier and more compelling for China to do the right things in the economic arena. It is in the interest of the United States to support China's economic reforms and development.

STATEMENT OF GREG MASTEL, SENATE FINANCE COMMITTEE

Chairman D'AMATO. We welcome Greg Mastel from the Senate Finance Committee. I just wanted to mention to you, Greg, that what I did before you arrived, and that is this is an off-the-record presentation, and we'll keep it that way. We're going to transcribe it just for our own internal purposes, but—so that we can encourage a candid exchange of views on where we're going as a Commission.

So if you would go ahead for about 10 minutes, and then we'll open it up for questions afterwards.

Mr. MASTEL. I should mention that I'm speaking today as a private citizen, not the Senate Finance Committee. I spent a good part of the last decade working on U.S.-China trade issues, and I think I come at this from a different perspective than most of the China scholars you might hear from.

I consider myself to be a trade expert, who is focused on Taiwan-China, not a China expert. I think that changes my perspective on a lot of these issues.

Commissioner LEWIS. Say that once again, please.

Mr. MASTEL. I consider myself a trade expert, and a trade expert who is focused on China, not a China expert per se.

Commissioner LEWIS. All right.

Mr. MASTEL. So I look at China as a trading partner for the United States from a broader perspective than some may bring to it. As a trading partner for the United States, there are really some good things in the relationship, but on the whole China has been a poor trading partner in the sense of agreeing—complying with trade agreements its has struck with the United Sates. Its record, in fact, is quite poor.

Now, some will point I think to other countries that also have problems—Japan—many other countries have had issues over time. But I think only in China will you find a case where every single major trade agreement that the U.S. has struck with China has had serious compliance and enforcement problems, every single one.

(Laughter.)

Let me give some examples, just to give you a sense of the issue. I think some of the problems will emerge as you study this carefully. Intellectual property—this is probably the most—the best-known issue with China. The U.S. has been pressing China for about 15 years to improve protection of intellectual property, of patented, copyrighted, and trademarked materials.

In 1992, the Bush administration, the first Bush administration, under threat of sanctions, negotiated an agreement with China to improve its intellectual property protection. That agreement was, in many ways, strong. It changed Chinese trademark/copyright/patent laws close to a world standard. The laws were really very good, with some small exceptions.

The problem was that those laws made little difference on the ground. Almost nothing changed in terms of the piracy on the ground, and by the mid-1990s it was clear that China's piracy industry had gone from being a kind of a backwater, backwoods, kind of industry, where people copied CDs into a world-class exporter that was exporting several billion dollars a year in pirated CDs out of China to the rest of the world.

So, clearly, the laws had not had much effect on the actual action on the ground in China, particularly southern China.

The Clinton administration, in the mid-1990s, twice challenged China about the issue of pirated intellectual property, and in 1996 it threatened sanctions.

It looked for a long time like we were actually going to have an imposition of trade sanctions on China. That didn't happen. At the last minute, another agreement was struck for China to increase enforcement, and some CDs got steamrolled in squares, and so we saw some very high-profile action.

And in fairness, I think some things have changed in China. There has been some increased enforcement initiatives on the part of the Chinese. But if you've been to China, still piracy is a very commonplace, especially on the streets. And according to intellectual property rights organizations in the United States, piracy continues at a very high rate.

And much of that piracy involves Chinese government ministries who use pirated software throughout their operations. So this is not just something that happens in the backwater area.

The Chinese government is directly involved in piracy for its own purposes. So this problem is still at a very high level in China. And there is also the problem that has been talked about in a number of cases of high-level involvement in the piracy problem. The PLA, for example, has been directly involved in piracy.

There is one well-known story of one of the pirated CD plants that actually was located on a PLA base. When they asked the pirate, "Why is it there?" he said, "This is the place where the police won't raid me."

(Laughter.)

And that's the kind of problem you've seen time and time again in China, and it's provincial involvement, and families of senior Chinese officials are involved.

This is, keep in mind, I think the best possible case of U.S. involvement. Here's a place where for over a decade we've had a high-level effort to enforce an agreement. We have threatened sanctions on three occasions, which have had direct, high-level governmental involvement by two administrations, and still this is the progress that has been made. This is the best case.

Okay. The second point is the market access agreement, which is not quite a good case. Also, in 1992, the U.S. negotiated a sweeping market access agreement with China that reformed its trade regime, made import licenses, lowered tariffs, all kinds of things, which, if enforced, would have solved many of the trade problems we had had with China to that point and even to the current point. It would have brought China very close to a WTO compliance level had it been enforced.

Now, in its annual reports, the U.S. Charter has reported that China has generally fulfilled its commitments. Well, I think that probably the U.S. Charter people would agree that it's really a political statement as opposed to a substantive one, in the sense that we've decided not to challenge China on issues. But, in fact, again, there are numerous problems. Let me just cite three important examples.

One of the most important provisions in the 1992 agreement was an agreement by China to stop using import substitution policies. That means to stop replacing domestic imports with domestic production. That was one of the fundamental kinds of protectionism.

That would have been a big step, but, unfortunately, that is still—import substitution remains an important part of Chinese ministry and economic central reform planning. In at least three plans approved by China in the last 10 years—autos, pharmaceuticals, and heavy generators—China has explicitly used import substitution policies in those areas, in direct violation of the 1992 agreement.

Another area where there's a problem is the example of import licenses. Import licenses are one of the common forms of protectionism. It means that you have to license the imported product, basically.

China agreed to abolish those in 1992. And it did abolish those licenses, but for about half of those products it quickly replaced them with a registration requirement. A registration requirement is functionally the same thing as a license. So you still have kind of one license replaced with another, one barrier replaced with another, that was virtually the same, with little effect for exporters trying to enter China.

Transparency also remains a major problem. Probably the most important provision of this agreement in 1992 was an agreement to make this process transparent—all regulations, all laws, would be available to the public. That would be an enormous step forward, but it just hasn't been implemented.

In the area of government procurement, we are still to China's regulations in many—for many ministries on how government procurement works, how it can be accessed by the outside agencies.

So, again, on paper there have been agreements, but, partially because of little effort by the United States, some serious problems in implementation and enforcement.

Now, because of time limits, I'm going to summarize these last two issues, the last two agreements. Textile trans-shipment—the U.S. has, with—the U.S. and all developed countries have with most countries quotas which are negotiated on textile and apparel products. There's the MFA, the multi-fiber agreement.

China being the world's largest textile maker is subject to a lot of these. And China has routinely circumvented Chinese companies—routinely circumvented this agreement by labeling clothes that were actually made in China as being made in Hong Kong or Macau.

According to the U.S. Customs Service, which keeps some records on this, they estimated—this is several years ago—that this product—this problem cumulatively resulted in $10 billion—that's billion, not million—in additional textile imports to the United States every year.

Commissioner LEWIS. Every year?

Mr. MASTEL. Every year. $10 billion.

Now, records are obviously hard to keep on this kind of thing. The problem obviously continues. We keep fining companies on this issue most years. And it's really a matter of political will on the part of the Customs Service how hard we push.

But I think that anyone who has examined this excellent system in China would agree there's a very large problem. Whether it's $10 billion or $8 billion is hard to know, but it's clearly very, very large.

The last point I'd like to talk about is prison labor, and this is something I promised to talk about with Ernie here earlier, but I'll be brief. There's a U.S. law, a Depression era law, that prohibits the imports of good made with prison labor. That's essentially part of the Smoot-Hawley Act.

In 1995, the Clinton administration struck an agreement with China to improve enforcement of prison labor, had that law in China, to allow onsite inspections by Customs, and to cooperate in the effort to try to locate prison labor goods.

Well, I notice you have Harry Wu testifying this afternoon, so he can testify as to this in more detail than I can perhaps. But there is enormous evidence, and much has been provided by Mr. Wu, that this problem continues almost unabated.

There have been a few examples of the Customs Service hitting Chinese exporters that clearly is prison labor that were caught in kind of little sting operations, but I think anyone who has followed this problem closely would agree that the prison labor system in China is an enormous part of the Chinese economy.

I think it would be almost impossible to carefully be able to distinguish the prison labor goods from the rest of the economy. And so I think we are still importing a number of goods made with prison labor, and there are many examples, anecdotal examples you'll see. Again, Mr. Wu has many of them.

But I think this is a place where you've really seen very little effort on the Chinese part to actually enforce the agreement. And the agreements about onsite inspection by the Customs Service have never been implemented. So we have here again a clear violation of the letter of the agreement with China.

Let me just summarize. I think there are three lessons from all of this that I would suggest for future policymakers. First, enforcement in China is an enormous problem. It is not a footnote. It is not a sidebar. It is an enormous problem that goes right to the heart of where—it calls into question the wisdom of negotiating agreements at various times.

So without an effort to make—to enforcement agreements, it is not very worthwhile to negotiate them. And real progress requires consistent enforcement. China's lack of a strong domestic rule of law, deep corruption, make it very hard to enforce trade agreements. And simply assuming they'll be enforced, because that's what it says in the paper, is a deeply-flawed approach.

Second, in China there are many levels of problems in enforcement. First, you have examples of agencies willfully ignoring agreements and laws. For example, I cited the import substitution requirements, and the PLA's involvement in piracy. Those are obvious examples of places where the government agencies directly ignore agreements.

A second problem is the lack of competency on the part of officials, or interest in enforcing laws. I think this is what you saw in a lot of intellectual property cases. They didn't have the personnel or didn't have the interest in getting involved in trying to confront the PLA or go out on a widespread campaign against piracy.

The last problem is corruption, which is linked to the second one in many ways. Corruption is a deeply-rooted part of many of these problems. It's hard to get the Chinese authorities to crack down on industries when they are personally involved with the industries, and that's a problem we see again and again , with intellectual property being a good example of this.

But until this problem is also dealt with in some fashion, it will be hard to rely upon China's commitments in trade agreements.

The last lesson I'd like to point to, in conclusion, is that the WTO is not a magic solution to this problem. I will say personally that I support China's WTO membership and PNTR with China, but we have to recognize that WTO is sort of the ultimate rule of law-based, market-oriented international organization—the ultimate kind of example of that.

But China is neither a rules-based economy, nor a market-oriented economy. And so it's the ultimate square peg for a round hole fit. It doesn't work very well.

The WTO is not a self-enforcing organization. It requires countries to bring complaints for there to be enforcement. But will countries be willing to complain against China, given the possible diplomatic pressures that might be brought to bear? Will they be able to even determine what's going on in China given the lack of transparency?

Again, the WTO relies upon very much a judicial process. Can you even prove, before a WTO dispute settlements panel, what's going on in China? These are very much open questions. And at the very least, to make a WTO membership work, we have to be willing to commit enormous resources to this problem.

And to be—I guess I say this in this forum, we have to recognize that this means we have to do it—in other words, the United States has to do it—because as a real prospect, no other country in the world is really going to take that effort. No other country is going to be willing to confront China. And so if we don't do it, no one will.

And on that note——

Chairman D'AMATO. Thank you for that note. It's a good note.

STATEMENT OF ERNEST H. PREEG, SENIOR FELLOW IN TRADE, MANUFACTURERS ALLIANCE

Chairman D'AMATO. We'll go to Mr. Preeg for 10 minutes, and then open it up to questions.

Mr. PREEG. Thank you. I'm also delighted to be here, and I should mention that I also am not speaking for Manufacturers Alliance, MAPI, but individually.

I should also say, for those of you who have never heard of Manufacturers Alliance, that unlike NAM, which is essentially a lobbying institution, MAPI is sort of a private sector think tank, mostly focused on peer interaction at senior levels, with 450 members and a few professionals like myself trying to stimulate debate on current issues. It is in this context that I'm here.

I've been asked to address economic sanctions and exchange rate manipulation as related to the very large buildup of official dollar holdings during the 1990s by the government of China.

These subjects are related, I presume, to a study I did on the sanctions issue a couple of years ago at CSIS and on the trade deficit issue last year at Hudson Institute. I believe you have relevant portions of those works. I am also pleased to note that at least a couple of Commissioners were active advisors to me on both of those projects, which might also explain my presence to some extent.

There are also some prepared remarks, which I believe you have, so I'm going to try to be brief. Sanctions, in particular, are a very wide-ranging subject, with some important distinctions. Multilateral sanctions provide greater leverage than unilateral sanctions. Sanctions on U.S. imports—for example U.S. imports from China—can provide greater leverage than unilateral sanctions on U.S. exports where we can just be displaced by others.

In that context, I have characterized in these opening remarks five categories of sanctions. The first relates to the international trading system. This has already been well described by two previous speakers, where unilateral economic sanctions have been part of the trading system for 60 years.

When one member breaks its commitment for market access, others can threaten sanctions as leverage. And it works, by and large. The actual imposition of such sanctions is done relatively rarely. In this context, even bilaterally in the commercial context we've used the threat of sanctions effectively against China and could continue to do so when China is in the WTO through the dispute settlement mechanism, which is a much stronger mechanism as a result of Uruguay Round Agreement five years ago.

Certainly for IPR for prison labor, which is included in the GATT, we can apply sanctions. We might very well want to use the dispute settlement mechanism against China actively in the WTO. And I believe WTO dispute panels would concur if we had reasonable evidence.

The second category is to use economic sanctions to promote basic human rights and democratization within China. There's a good deal in my chapter on China about this. Sanctions didn't work. We tried it after Tiananmen Square, until President Clinton in 1994 finally threw in the towel and said, "We just can't pursue it. It's not working."

The problem was that, within China, this is a direct threat to their form of authoritarian government, a question of sovereignty in this context, and the U.S. Government was split within the Congress and within the Clinton administration.

The net result was considerable counterproductive results in terms of U.S. policy credibility. So I agreed with President Clinton that we had run the course on sanction threats related to human rights/democratization.

There are some more narrowly focused initiatives in this area, but again, I we could not achieve real change on the ground in China by threatening or imposing unilateral sanctions. No one else agrees with us that we should use trade sanctions for these purposes.

The third area is sanctions to limit the proliferation of weapons of mass destruction. Here there's a mixed record during the 1990s, with very limited results. One such result occurred when we withheld investment in the commercial nuclear power reactor sector until China moved on non-proliferation in two or three specific areas, including full participation and membership in the Zangger Committee.

That did work because—at least that's my assessment, which is controversial—China wanted U.S. bidders on their commercial nuclear projects, and were moving in this direction on non-proliferation anyhow. We did probably lose a billion or two billion dollars to Canadian and European sales of commercial reactors as a result of the sanctions, but in the end we achieved our objective in that limited context, the exception, in effect, proving the rule.

In the area of ballistic missile proliferation, on again/off again sanctions by both the Bush, the father, and the Clinton administrations didn't produce much. To this day, China has refused to become a member of the Missile Technology Control Regime. I do quote the Rumsfeld Commission conclusions—and believe they still hold today.

This is a very difficult area. Much better for missile technology would be a multilateral response, including a potential threat of sanctions by all members of the MPCR. But, unfortunately, European and other allies aren't very eager to go this route.

But I nevertheless believe there's a stronger case in the area of proliferation of weapons of mass destruction than it is in the fourth category, namely to restrain the modernization of Chinese military capability. This is a very important area for trade. Again, there are many difficulties, and if anything it's more difficult now than even five years ago.

We do have agreements with our allies on restrictions on exports of military technology to China, Russia is playing the rogue state by selling a good deal of advanced equipment and technology expertise to China.

There is also the whole range of dual use goods and services that could be of significant benefit to the Chinese military, which creates further problems with our allies. I make reference to another congressionally-mandated commission that came out a couple of weeks ago in which I was somewhat involved—Enhancing Multilateral Export Controls to U.S. National Security. That Commission concludes that our allies are not willing to target China in this area, including within the Wassenar Arrangement, the successor to COCOM.

More and more, these dual use goods and technologies can be supplied by third countries. Even for supercomputers, or high-performance computers, it's more and more difficult to where we can restrain our exporters while others offer a comparable networking response from lower performance computers. The job gets done either way from the Chinese point of view.

This is a very difficult issue. I have read the first report—I'm sure you'll be getting it—co-chaired by four Congressmen. There's not that much scope for effective sanctions against China. The Wassenar Agreement is largely information-gathering, and China is not explicitly mentioned.

There are some areas of unilateral export controls in place that need to be more narrowly targeted. They need to be kept in place, where we're clearly ahead of Europe and other suppliers, but it is an ever narrower list as more and more dual use goods and services are available from other sources.

Finally, number five, which is not in the book, relates to the Chinese threat against Taiwan. We're clarifying our policy as to what measures we might take in the security-military area. It might be useful to explain how economic sanctions might play into this relationship. This issue could become sensitive if we move toward a crisis.

It could well be that economic sanctions precede military actions, including from China against Taiwan. I offer four basic points. Number one, even modest military engagement with some casualties on both sides would certainly create a very strong U.S. reaction, probably including economic sanctions, perhaps even a total cut off of trade and investment. The Chinese have to be aware of this.

Points two and three are that there is a vast difference between impact of total economic sanctions related to Taiwan on the Chinese economy compared with that on the U.S. economy, far, far greater on the Chinese economy.

Not only is China twice as open to trade and FDI 20 percent of GDP versus 10 percent in terms of exports—but Chinese growth is now, compared with a few years ago—its growth, is much lower and more strongly driven by the external sector. Exports and FDI thrive while the domestic sector is bogged down in a mismanaged financial system, including the state-owned enterprises.

An excellent set of papers on this subject was given last week at the AEI. I'm sure one of your Commission members who moderated that session will make those papers available to you.

For the U.S., in contrast, only two percent of exports now go to China, and one percent of FDI. We are a more domestically-driven economy. We can have high growth even while we have a current deficit of four percent.

The last point is that Taiwan is highly vulnerable. Forty percent of GDP is in exports. And if China should seriously harass the commerce of Taiwan through boardings, inspections or whatever, and which threatened the Christmas market for exports in the U.S. in particular, the result could be very threatening to the overall Taiwanese economy.

There is then a big potential sanctions dimension in playing out scenarios vis-a-vis Taiwan.

Finally, then, going——

Commissioner LEWIS. Did you mention the percentage of Chinese exports that come to the United States today?

Mr. PREEG. It's in the paper, yes. There is a big difference—25 to 35 or 40 percent, depending on whose statistics you use. It's related the Hong Kong/Macao Transit Trade. It's definitely more than the official Chinese figure of 25. 30 or 35 percent is a good figure, compared with two percent of U.S.——

Commissioner LEWIS. I heard over 40.

Mr. PREEG. What?

Commissioner LEWIS. I had heard over 40.

Mr. PREEG. Forty. Well, if you use U.S. statistics, it's a little over 40, but you've got a CIF/FOB adjustment to make. But in any event, it's up at least in the 35 percent range, in my assessment.

Going to the second subject, exchange rate manipulation—largely an international finance/trade deficit-related issue, which is discussed briefly here and much more in the trade deficit book. There's no question in my mind that China, along with Japan and a couple of others, during the 1990s, have manipulated—that's a term of art from the IMF articles of agreement—exchange rates to achieve a larger trade surplus. They are export-driven growth economies.

It's mainly a trade deficit financial issue. In fact, I think the financial dimensions are more important to our trade deficit than trade policy with most trading partners, although China is the one big exception in my view.

The focus of this Commission is what implications does manipulating the exchange rate to keep your exchange rate down have for the larger trade deficit. First, the way others manipulate is through buying foreign exchange, mostly dollars, and predominantly dollars among Asian countries. The central banks buy dollars to keep the exchange rate down. And that in turn relates to how the IMF defines manipulation.

Certainly China has been doing this. China now has approximately $170 billion of official hard currency holdings. I estimate 80 percent of this to be dollars. It's a secret figure, but I never miss an opportunity with central bankers to ask, "Well, is it about 80 percent?" and they'll say, "Well, a little high." Anyhow, that's just an assessment.

The fact is they have all these dollars. How might they use them? It's far in excess of what they would need for financial adjustment or the normal economic reasons. What are adequate reserves? The World Bank says 25 percent. China has 85 percent. The United States has, I think, about two or three percent, incidentally.

Chairman D'AMATO. Two minutes and then we'll open it.

Mr. PREEG. Yes. Two minutes and I'll be there.

Two things. One, China could use these dollars for disruptive sales in commercial markets or by switching to Euros. I cite a book, in which Chinese military strategists talk about George Soros. This is not going to happen now, because they don't want the dollar to go down now. It could, however, happen in future circumstances that I describe.

A second thing they could do is use some of these dollars to try to have less dependence and vulnerability on exports to the U.S. and more on East Asian regional markets. Thus greater independence of action from us. There's a camel's nose under the proverbial tent with agreement, I believe to be concluded this week for swap arrangement among Asians—Japan and China—essentially offering a few billion dollars of standby credit to other East Asians. That could go further.

There's thus considerable financial flexibility for Japan, China, others have, to move toward a greater East Asian economic integration. There's related concern in Southeast Asia about a greater and greater position, even a hegemonic position, of China over time within the East Asia region.

I just want to add one other comment. It's not in the paper, but it came up earlier. There has been talk about if China gets a billion or two billion dollars of trade finance, doesn't that add to their ability to buy military equipment abroad? And does it add-on, in particular, if it's a military company to start with?

My reaction is that hard currency, and especially dollars, are fungible. Here we are in the Dirksen Building, and I would say one or two billion here, one or two billion there are relatively small amounts. But when you get to $170 billion, we're talking about real money.

(Laughter.)

And they have that $170 billion, and they could spend $5 billion a year for overseas military purchases for 10 years and still have excessive foreign exchange holdings. So this gives them a lot more flexibility in anything to do with overseas purchases or other expenses to military modernization.

Thank you, Mr. Chairman.

Chairman D'AMATO. Thank you very much, Mr. Preeg.

[The statement follows:]

PREPARED STATEMENT OF ERNEST H. PREEG

It is a pleasure to appear before the Commission to offer my views, as requested, on economic sanctions and exchange rate manipulation as they relate to the U.S.-China security relationship. These subjects are addressed in considerable detail in my two recent studies, *Feeling Good or Doing Good with Sanctions* (CSIS, 1999), and *The Trade Deficit, the Dollar, and the U.S. National Interest* (The Hudson Institute, 2000). My comments here present the highlights of these works, updated in a few instances, with the studies referred to as *Feeling Good* and *Trade Deficit*.

A. Economic Sanctions

Economic sanctions come in various forms to achieve wide-ranging policy objectives, and important distinctions need to be recognized. Unilateral sanctions by the United States alone, for example, are generally much less effective than multilateral sanctions as policy leverage against the target government, in this case China. Likewise, unilateral sanctions on U.S. exports to China provide less leverage than on U.S. imports from China because third country suppliers can—and readily do—simply replace U.S. suppliers in the case of export sanctions. There can also be important differences between the immediate and longer term impact of sanctions, both in terms of realizing the policy objective in question and U.S. commercial interests which inevitably suffer, particularly from unilateral sanctions.

In this overall context, there are five basic categories of economic sanctions that have been threatened or imposed against China in recent years, differentiated by the U.S. policy objective involved:

1. *Improved access to the Chinese market*.—This category of sanctions falls in the domain of the international trading system and it is the one area where unilateral sanctions are the normal recourse when one trading nation violates market access commitments contained in existing trade agreements. The principle has been imbedded in the General Agreement on Tariffs and Trade (GATT) multilateral trading system since 1949, and was enhanced by the successor World Trade Organization (WTO) in 1995 through a greatly strengthened dispute settlement procedure and the general inclusion for the first time of developing country market access com-

mitments. The greatly preferred alternative to sanctions is for violations to be rectified and market access restored, but the threat of sanctions against the exports of the guilty party is a strong incentive for compliance.

The market access/sanction threat relationship is important for U.S.-China relations in view of China's pending entry into the WTO, but the concept has already been part of the U.S.-China trade relationship, as when the United States complained that China was not living up to commitments in a bilateral agreement related to the protection of intellectual property. The U.S. threat of retaliation against Chinese exports was fully credible in this narrowly defined commercial context, and China took actions to rectify the U.S. complaint.

These potential trade sanctions within the trading system are relevant to the U.S.-China security relationship in two ways. First, such sanctions, which play a useful role within the trading system, need to be clearly distinguished from the other categories of sanctions, where unilateral sanctions, in particular, with rare exception, are not effective and often counterproductive. And second, the longer term U.S. strategy of fostering market-oriented democracy within China as the only lasting way to reduce security threats from China is most powerfully pursued through open trade and investment, and to this effect Chinese membership in the WTO, including the dispute settlement procedure with possible recourse to trade sanctions, can play a significant role.

2. *Promotion of basic human rights and democratization in China*.—The threat of sanctions against China as leverage to pressure the Chinese government to improve basic human rights and democratization was center stage in the U.S.-China relationship from the Tiananmen Square massacre in June 1989 until President Clinton declared in May 1994, “We have reached the end of the usefulness of that policy.” In fact, the threat of withdrawing most-favored-nation (MFN) status, now more appropriately called normal trade relations (NTR) status, was a total failure, with considerable negative consequences for U.S. interests (see *Feeling Good*, pp. 145–156). The Chinese government strongly opposed such direct intrusion in its internal political structure while U.S. support for the sanctions was deeply split both within the Congress and the Clinton Administration. More recent attempts to improve human rights conditions in China, such as the 1998 Freedom from Religious Persecution Act, include very limited ultimate recourse to trade sanctions which, if ever imposed, would probably be equally unproductive. U.S. objectives for fostering human rights and democratization in China need to focus on other policy instruments, including diplomacy, technical assistance for pro-democracy activities within China, and support for the substantial positive impact currently being achieved by U.S. companies with production facilities in China (see, for example, the May 2001 MAPI/NAM survey, *U.S. Manufacturing Industry's Impact on Ethical, Labor, and Environmental Standards in Developing Countries: A Survey of Current Practices*.

3. *Limiting the proliferation of weapons of mass destruction*.—The threat and actual use of economic sanctions in this area has a complicated history with mixed but on the whole very limited results (see *Feeling Good*, pp. 157–161). One instance where U.S. unilateral sanctions appear to have produced significant positive results was in withholding U.S. investment in the Chinese commercial nuclear power sector until China took steps with respect to nuclear nonproliferation, including full membership in the Zangger Committee. This exception tends only to prove the rule, however, in view of the unique circumstances in this sector during the early 1990s. In the area of ballistic missile proliferation, on-again off-again U.S. sanctions had little if any positive effect, and China still refuses to become a member of the Missile Technology Control Regime (MTCR), designed to limit proliferation of such technology to third countries such as Iran and Pakistan. The July 1998 Rumsfeld Commission report on the ballistic missile proliferation threat concluded that it is unlikely that China, “will soon reduce its . . . sizable transfer of critical technologies, exports, or expertise to the emerging missile powers.” More effective pressure could be brought against China through a multilateral approach by all MTCR members, including the threat of multilateral economic sanctions in this sector, but at this time there is little disposition on the part of European and other allies to follow this route.

4. *Restrain the modernization of Chinese military capability*.—This is the most difficult and ambiguous area of sanctions policy. There is agreement among the United States and its allies not to export advanced weapons to China, but even in this area Russia plays the rogue state in supplying China with advanced military supplies and expertise of potential direct threat to the United States. The sanctions card, in this instance, should be directed against Russia, perhaps to positive effect if given sufficient priority. Exports to China of wide-ranging other “dual-use” goods and services, which can provide significant benefits to Chinese military modernization, are generally available to China because U.S. allies—as well as Russia—do not spe-

cifically target China for restraint. Some telecommunications and other advanced technology equipment and services, where the United States has a substantial lead over other suppliers, can be withheld from China through unilateral U.S. export controls, but the eligibility list tends to narrow over time. Stringent limits on U.S. high performance—or super—computers ten or even five years ago have now been largely undermined through networking of lower performance computers, easily accessible to China. The multilateral Wassenar Arrangement, successor to COCOM, which seeks to restrain sensitive dual-use goods and technologies, is essentially an information-gathering exercise with no significant implementation capability. Moreover, Wassenar members do not target China as a country for constraint. The April 2001 report of the Study Group on Enhancing Multilateral Export Controls for U.S. National Security, co-chaired by Congressmen Berman, Bingaman, Cox, and Enzi, concludes that "many European countries do not perceive China as a significant threat" and that these "divergent transatlantic interests could hinder efforts to forge a common U.S.-allied approach on the issue of technology transfer to the People's Republic of China." Selective U.S. unilateral export controls need to continue, but beyond this, with respect to Chinese military modernization, the best offense is a good defense.

5. *Counter the Chinese threat against Taiwan*.—This U.S. interest has generally been viewed more in military/security terms than as an issue of potential economic sanctions, and it was not addressed in *Feeling Good*. However, recent developments warrant consideration of how economic sanctions, including by China against Taiwan, may come to play an important if not dominant role if a deepening conflict should evolve between the United States and China over Taiwan. Four such considerations are:

a. If there were any form of military conflict between the United States and China, there would be enormous political pressures in the United States to sanction trade and investment with China, perhaps entirely. It is one thing to consider trade sanctions to alleviate repression in Tibet, and quite another to respond to the loss of U.S. military personnel in combat with China. The Chinese government should be aware that such economic consequences would follow from a violent showdown over Taiwan.

b. The adverse impact on the Chinese economy from such a cutback or stoppage in trade and investment with the United States is far greater than only a few years ago in quantitative as well as qualitative terms (see *Feeling Good*, pp. 166–169). Quantitatively, the Chinese export sector has been growing rapidly and now amounts to about 20 percent of GDP, of which a quarter to a third goes to the United States, depending on whose trade figures are used. The new qualitative dimension is that the overall growth of the Chinese economy is now clearly driven primarily by the external sector through exports and foreign direct investment, while the domestic economy is bogged down over a badly mismanaged financial sector and nonproductive state-owned enterprises, not to mention that official growth figures overstate actual growth, perhaps down from 9 percent to 7 percent in recent years.

c. The economic impact on the U.S. economy would be far less from a cutoff of Chinese trade and investment. Only 2 percent of U.S. exports goes to China and 1 percent of foreign direct investment is in China. Potentially larger, longer term U.S. commercial interests are, of course, also at stake, which is one reason why the United States strongly supports open trade with China, but if a crisis were to occur over Taiwan, the immediate impact on the U.S. economy would be far smaller than that on the Chinese economy.

d. Taiwan is highly vulnerable to economic sanctions applied by China. Taiwanese exports as a share of GDP are at the extremely high level of 40 percent, and actions by China, even to harass Taiwanese shipping through boardings and inspections, could pose a substantial threat to the Taiwanese economy. Indeed, actions in this area could be the preferable course from the Chinese point of view, if events move toward crisis, posing difficult options for response by the United States.

Such possible trade sanctions related to Taiwan remain highly contingent at this point, but they are elaborated here because they do not appear to have been addressed elsewhere, while the clarification by President Bush that the United States will do whatever it takes, including military action, to defend Taiwan, requires parallel clarification as to what might become involved on the economic front.

B. Exchange Rate Manipulation

The term of art "manipulation" derives from Article IV of the IMF Articles of Agreement, whereby members shall "avoid manipulating exchange rates to gain an unfair competitive advantage." Such manipulation has been self-evident during most of the 1990s by a number of U.S. trading partners, most prominently Japan, Taiwan, China and, more recently, South Korea. The motive has been principally mercantilist—that is pursuing a large trade surplus as a policy objective—and the modality has been a consistent pattern of central bank purchases of foreign exchange, mainly dollars. The net effect is to maintain the manipulators' currency weaker than would be dictated by market forces alone and the dollar stronger, with a consequent increase in the manipulators' trade surplus as well as the U.S. trade deficit. This mercantilist practice is explicitly recognized by the IMF in citing, "protracted large scale intervention in one direction (i.e., buying dollars) in the exchange market" as an indicator of possible manipulation.

The exchange rate manipulation issue relates most directly to the course of the now chronic U.S. trade deficit, which has tripled since 1997 and is described in detail in *Trade Deficit*, pp. 50–58 and 118–125. A significant indirect effect, however, is that manipulating governments can accumulate excessively high levels of foreign exchange holdings, well above those needed for stabilizing financial accounts, which can be used for other noncommercial objectives, including as leverage in the foreign policy and national security fields. This clearly is the prospect for the very high level of Chinese foreign exchange holdings, currently at about $170 billion or 85 percent of annual imports, more than triple the World Bank norm of 25 percent as adequate reserves. Moreover, the large majority of Chinese reserve holdings are in dollars, probably about 80 percent although the actual figure is kept secret.

The pertinent question here is how might China use its large official dollar holdings as leverage against the United States in the foreign policy or national security fields. The most direct way would be to sell or threaten to sell dollars in commercial markets or more simply to convert official holdings from dollars to euros and yen. The Chinese have in fact been considering such a course. Two Chinese military strategists published a book in 1999, *Unrestricted War*, that includes financial war as one component of a possible integrated response to U.S. threats against China. The plans pinpoint the global world economy as a weak point to be exploited. The officers expressed admiration for George Soros, whose attack on the British pound in 1992 is suggested as a template for disrupting an unsuspecting rival's economic system (see *Trade Deficit*, pp. 87–89). Such a course of action is clearly not in the Chinese interest at this time or for at least several years ahead, however, because the result of disruptive dollar sales would be a weaker dollar and a stronger yuan, which would have adverse impact on Chinese exports and the struggling domestic Chinese economy described earlier.

A longer term and broader strategy for using dollar holdings nevertheless also needs to be considered and almost certainly is in Beijing. The central objective would be to reduce Chinese export dependence on the U.S. market and U.S. economic hegemony within East Asia more broadly. One modest step in this direction is a proposed currency swap agreement facility whereby Japan and China will offer hard currency loans to other Asian nations in financial need. Far larger export and investment finance support could be made available in view of the large reserve holdings of Japan, China, and South Korea. One result would be to foster greater economic interdependence within the East Asia region. To the extent any such loans were to become tied to procurement within the region, there would be an additional mercantilist effect, that is a larger trade surplus for the lenders. The United States and the IMF have opposed formation of the currency swap facility, but it is moving forward despite the objections.

Projecting ahead ten or even five years, it is thus possible that China could become less dependent on the U.S. market while moving itself toward a hegemonic economic position within East Asia. China/Hong Kong exports should rise above Japanese exports within a few years, foreign direct investment in China already exceeds that of any other nation in the region by far, and when the yuan becomes convertible Shanghai should quickly develop into a major financial center. At that point, the threat of large scale sale of dollars or conversion to euros and yen related to foreign policy or security differences between the United States and China could present a problem for the United States, especially if it occurred in conjunction with an already declining dollar related to the denouement of the generally acknowledged unsustainable U.S. current account deficit. Such a projection is based on an optimistic assessment for economic reform within China, but it is a course of events—especially the emergence of China as economic hegemon within East Asia—of growing concern to Southeast Asian nations in particular.

As for a U.S. policy response, the U.S. Treasury should actively challenge, bilaterally and within the IMF, further exchange rate manipulation by trading partners. China and Japan, among others, should be urged and pressured, as appropriate, to cease official purchases of dollars which inevitably result in a lower than market-based exchange rate and larger trade surpluses. The United States could also be more forceful with Japan in opposing extension of the currency swap facility, including a discussion of the longer term geoeconomic considerations described in the previous paragraph. Beyond that, China will retain significant potential political leverage from its large dollar purchases during the 1990s, which need to be factored into overall U.S.-China security relations. Not only will Chinese military capability continue to grow and modernize, but so too its economic capability buttressed on the international financial front by $170 billion of official foreign exchange holdings.

PANEL I DISCUSSION AND QUESTIONS AND ANSWERS

Mr. Mastel is going to have to leave in a little while, so those Commissioners who have questions for Greg Mastel, we'd like to have them go first.

Commissioner Lewis?

Commissioner LEWIS. Greg, is there any way to find out the total amount that we are buying from China in the U.S. market, what portion of that is owned by U.S. companies or U.S. companies either producing there or a U.S. company buying the output of particular factories there? What percentage of the exports to us is really U.S.-owned?

Mr. MASTEL. Do you mean related parties? I can provide you some statistics to help you along that road. Sometimes ownership can be kind of difficult, given that some of those companies are owned through Hong Kong companies and——

Commissioner LEWIS. Yes, yes.

Mr. MASTEL [continuing]. So you can't get a crystal clear or absolutely 100 percent certain figure, but you—that rate is very high. It's called related party transaction, and it's a high part of U.S. trade generally.

Commissioner LEWIS. Or even like Nike made by the output of 10 factories. They may not own it, so it's not related parties, but it's essentially Nike production.

Mr. MASTEL. When you get into those kind of ongoing contract relationships, that's very difficult to draw lines and to separate categories. I can give you some information that I think it might be useful to you, but I don't think anybody—as in the case with even GDP figures in China, I don't think anybody has the Bible.

Commissioner LEWIS. Is this information that we should get? Should we recommend, for example, that somehow rules occur that forces companies to give the United States this kind of information? Would that be helpful for us in making policy decisions?

Mr. MASTEL. It may be. The fundamental problem—and I kind of touched on it in my comments—is that, especially in those areas where China has a disincentive to cooperate—things like textile trans-shipment, where the information could be used against them. I have no faith in the information that is given from the Chinese Customs officials.

I don't know, short of onsite investigations, you can't get better numbers. It's sort of like the GDP problem that I guess may have been alluded to earlier. The Chinese figures are widely assumed to be unreliable, but there really is no alternative available.

And especially when you get into the areas where ownership is very confusing, as in Hong Kong-based companies that have invested through Hong Kong to buy programs in China, it's almost impossible to trace it back, because those companies don't want to be traced back. That's the whole reason they went through that circuitous route for ownership.

And so you're not going to get 100 percent crystal clear figures like the U.S. Customs Service would provide here ever. I can provide you some stuff that might be useful.

Commissioner LEWIS. And one final question. You said there isn't a single agreement that we've made with China in which you feel that they have fulfilled without problems?

Mr. MASTEL. In terms of major trade agreements, yes.

Commissioner LEWIS. Yes.

Mr. MASTEL. Yes. I think in every case there have been enforcement and compliance problems to a significant extent. And as I said during my testimony, it's not that enforcement and compliance problems are unusual. As I say, we've had them with other countries, too. Europe, as you've seen, we have some disputes there.

But I think the extent and the regularity with which problems occur in China, and the fundamental problems from which they grow out of, is unique. You think often of the situation with China where it's not clear, first of all, if there's any will on the part of the government to actually keep the agreements they've negotiated.

And, secondly, even if they have the will, had the desire, do they have the ability and the competency to do it?

Commissioner LEWIS. I remember when I was serving on the Commission on U.S.-Pacific Trade and Investment Policy, and there were people from intellectual property companies there. And they said the Chinese just denied outright that this was going on. And then they would tell them where the factories were, and then they'd go to the factories and they would find it. They'd close the factory; they'd open another factory.

Mr. MASTEL. It's a common problem. As I said, the example of intellectual property—intellectual property is a place we've looked hardest, so we know the most. I think there are similar problems probably elsewhere; we just haven't looked hard enough to find them.

But the examples of the PLA being involved in running pirate factories or renting real estate to pirate factories on their bases, the senior Chinese officials being directly involved in the piracy operations. This is troubling, and it gives you a case study I think of the kind of problems you confront with China.

Japan was very difficult—continues to be very difficult for the U.S. to strike deals with that we're happy with. But in Japan at least you have a site this is based on a kind of rule of law, and we've made some progress over the years I think.

In China, it's a much tougher challenge. I mean, it is totally apples and oranges, so it's hard to compare them directly. But it's a very tough challenge, and I have no doubt that in two decades, three decades, if I'm still around, many of these same problems will still be going on.

Commissioner LEWIS. What would you recommend?

Mr. MASTEL. Well, I think the only real option we have is to move forward with China, because I'm not sure that economic sanctions would work. I think China has already essentially ended up being close to it.

So I think we should focus on how best to make China a good WTO member, but it's an enormous task. We will spend years and enormous resources doing that, trying to push China into compliance. And we won't be totally satisfied with outcomes, then. It will be a long and painful, difficult process.

I just don't think there's any alternative that is more attractive, but it's the worst option except for everything else.

Chairman D'AMATO. Other questions for Mr. Mastel?

Commissioner BECKER. Just of Mr. Mastel?

Chairman D'AMATO. Well, because he is going to be leaving in about 10 minutes.

Commissioner BECKER. I'd like to pose a question, really, to Mr. Tonelson and Mr. Mastel.

Chairman D'AMATO. Okay.

Commissioner BECKER. We hear an awful lot about the problems and what's wrong, and the lack of enforcement, some of it willfully happening, the fact that China has never honored any of the agreements they've entered into with the United States or possibly with any nation, the fact that the military itself is an industrial power in China, and the dual usage, transfer of technology.

You state that this is hard to deal with, and maybe it can't really be dealt with in that light. So I guess I'm—my question is much more simpler. Does it make sense for us to continue this kind of economic involvement with China, if we're going to consider them a strategic rival or a competitor?

I mean, that—we can control that. We can control the economic relationship that we have with China. Does it make sense for us to continue this under—really, from all of you gentlemen?

Mr. TONELSON. Greg, you've got the time constraints, so——

Mr. MASTEL. Okay. Well, let me answer the tough question first. At some point, no doubt, military security concerns, if they become so gray it changes fundamentally the relationship we have with any country.

I think the WTO is premised on nations having a relative—somewhat peaceful state of affairs, and it seems to me that particularly in light of the U.S. spy plane controversy, U.S.-China relations have pushed the envelope of that.

The WTO and the GATT before was really written to recognize that when countries go to war or establish a state of hostility the rules really don't apply anymore. And if we get to that point with China for other reasons, well, the WTO will not be a major factor. And it shouldn't be.

To answer your broader question, we have pursued in the last 50 years, we, this country, the Western countries generally, pursued a strategy where initially after World War II the GATT was a group of like-minded countries who shared similar economies and similar values and similar ideas. And, you know, again, it was still controversial, but I think that works reasonably well.

Free trade I think works pretty well among countries that have a good rule of law, you know, open economies, transparency. We have tried to expand it over time to cover a number of economies, most of them in Asia, Japan being the most notable, where that fit was rough—you know, the rule of law not the same as we understood it, the system of government organization not the same thing that we're used to. The separation between business and government particularly was not what we were used to.

And that fit, as I say, was rough—not as smooth as it was before. Now, with China, and maybe Vietnam, and down the line, we're really taking that—stretching the rubber band to the ultimate extent. And it's a very tight fit.

I mean, I'm not sure the rubber band will hold. It depends how the Chinese and the Vietnamese behave. If we're right that they will evolve in a positive direction toward more rule of law, toward more democracy, then maybe the rubber band will hold while they do that. If they don't, I think it will snap.

Commissioner LEWIS. Then what?

Mr. MASTEL. Well, then, actually, I was just getting to—I've always thought personally that if we started this differently 10 years ago, a better approach would have been to create a special approach for integrating China and Vietnam, countries like that, with different—in WTO, but in a much more—a much slower process.

That we withhold—that we—instead of giving the benefits kind of all in one wave, we've provided benefits in a measured way. You know, we benchmark to particular things. You know, when the economy evolves to this point, then we provide this level of MFN treatment or this level of trade benefits. When it gets to this point, they eventually get total MFN, kind of a graduation process.

I think that would work better, frankly, I mean, than what we try to do now. But, again, that would have been great if we had tried doing that in 1985. I'm not sure it's easy to go back and take that approach now.

If the rubber band snaps, well, then, I think we fundamentally kind of rewrite the rules at some point. And, you know, maybe that will happen. I don't know.

Commissioner DREYER. I'm sorry. Rewrite the rules of the WTO or what?

Mr. MASTEL. Yes, the WTO, the rules of international commerce. I think at some point if things break down to that point you have to go back to the drawing board and maybe—maybe you draw a smaller system, maybe you find some other way to address the problems with countries that have systems that really are not fundamentally compatible with the WTO, the market-based system.

Commissioner BECKER. Could we go to Mr. Tonelson for——

Mr. TONELSON. I'll just briefly preface my remarks by noting that I'm one who does not believe there is any usefulness whatever for the United States taking seriously the notion of international law in any foreign policy context that I can possibly think of, with the possible exception of using it as a convenient fig leaf.

Commissioner LEWIS. Would you say that again, please?

Mr. TONELSON. I do not believe it has been useful for the United States to take seriously the notion of a strong system of international law, with the possible exception of using this law as a fig leaf. It's been convenient in certain circumstances.

I think it's a huge mistake for the world's strongest military power and the world's strongest economic power to be engaged in an activity that can only water that power down. That is the unavoidable effect.

Again, whatever our intentions, I am also a person who thinks it was a huge mistake for the United States to pioneer the strengthening of the World Trade Organization that resulted from the Uruguay Round talks.

I think it's a huge mistake for the United States to stay in the WTO. With 30 percent of world economic output, and representing the largest market for most major trading countries outside Europe, we are amply capable of securing our own economic interests, quite frankly, in a unilateral sense, without the kind of legally authorized interference that the World Trade Organization permits. So I think that was a huge mistake.

Leaving all of that aside, just so you know what philosophical standpoint I'm coming from, think of how we conceive the U.S.-China relationship now. We call the trade relationship normal trade relations.

I don't think China is a normal country. I don't think forcing down a U.S. reconnaissance plane is normal behavior. I don't think violating every single major trade agreement that we've signed with them in the most brazen, wholesale way—that's not normal behavior. And the U.S. military doesn't view China as a normal country either. Last spring, we got the first reports that planning for the upcoming defense review—the structure of which has now been changed with the change of administration—was viewing China as the principal threat to U.S. interests in East Asia.

We are on the verge of seeing a new defense review published. By all accounts, it will not only recognize the problems posed by China, perhaps not explicitly. It will, again, reportedly call for a shift in America's strategic emphasis from Europe to East Asia, precisely because of the problems, if you want to use a——

Chairman D'AMATO. Summarize in one minute now.

Mr. TONELSON. The Defense Department doesn't treat China normally. The Bush administration, which presumably would endorse this, doesn't treat China normally, yet we have decided to trade with China normally. And, to me, that makes absolutely no sense at all. Again, it's incoherent, and I think a choice does need to be made now.

Chairman D'AMATO. Thank you.

Mr. Robinson?

Commissioner ROBINSON. Yes. This is for Mr. Mastel. I know you're headed out, but—and it's really something that I'll want to get back to with Mr. Preeg, that's for sure.

But I thought I'd, on your way out, ask you—as I think most of us would agree that multilateral economic sanctions are not exactly faring well, and the trade sector have all but been eviscerated. The PNTR probably put a stake in what potential there remained.

Have you—and, frankly, given the fact that our allies are not inclined to engage in any economic sanctions, almost irrespective of how grave the offense underlying it, have you ever given thought to the degree of leverage and effectiveness offered by the use of unilateral U.S. financial sanctions, notably in the capital markets area, for specific egregious national security and human rights abusers?

Mr. MASTEL. Yes. And I also—just to back up a little bit, I guess I wouldn't say that the trade—economic sanctions and trade sanctions are completely off the table. I think that it has—the WTO changes the form which those can take, and it requires us to go through a WTO process first.

But I still honestly think that in the trade area what is most likely to change Chinese trade behavior are the sanctions or the threat—precisely the threat of sanctions. I mean, the progress we've made with——

Commissioner LEWIS. Unilateral as well as multilateral?

Mr. MASTEL. Well, it usually ends up being unilateral in this case, or unilateral sanctions by a multilateral body, i.e. the WTO. But since it wasn't a WTO member, it was always unilateral before.

But I have to say that the progress we've made in intellectual property, for example, such as it is—such as it is, has largely been made because of the threat of sanctions. And if we didn't have the threat of sanctions, it wouldn't have happened.

And so I'm actually a believer that we need to keep the sanction option alive in some way. And the other reality is——

Commissioner LEWIS. So am I.

Mr. MASTEL [continuing]. That we're the only country that's likely to do that. In any kind of realistic scenario, I think that Japan, Europe—it's likely to kind of free ride behind the United States. They have the same problems, but they prefer not to raise them, and they know the U.S. will do it for them. So I think that it has to remain a part of our repertoire.

But, actually, in a totally different life before doing this, I actually do know a little bit about some other economic sanctions options. We should look hard at equity markets in the United States as a point of leverage—de-listing Chinese companies, putting limits on so-called red chip companies' entry into the U.S. marketplace.

These are things that—they raise some issues, but, you know, I think if you're talking about points of real leverage, particularly vis-a-vis the PLA or the so-called "bad guys" in China, these things bear some consideration.

Commissioner LEWIS. Greg, when you say "equity markets," do you mean bond markets, too?

Mr. MASTEL. Stock markets, yes.

Commissioner ROBINSON. Stock and debt.

Mr. MASTEL. Yes. Yes.

Chairman D'AMATO. Commissioner Wessel?

Commissioner WESSEL. Let me just follow up on that. Thank you. And I apologize for being late, so I—if I'm going over old ground that you've gone over, I apologize.

To follow up on Roger's point, the access to U.S. equity markets is not a right guaranteed by the WTO. So that if we were to use that as leverage, unlike a banned tariff, there would be no need to go to the WTO for authorization. Is that right?

Mr. MASTEL. There is some other legal issues that equity markets have some concerns about doing that. But, yes, we can—it's a different set of matters.

Commissioner WESSEL. Right. So, in that area, we would be within our rights to be able to restrict access to the markets without having any rights accruing to the Chinese to take us to the WTO, should they become a member.

Mr. MASTEL. Yes. There would be no WTO issue.

Commissioner WESSEL. Right. Number one.

Number two, and I see in some of your writings you address the issue of slave labor and the law we retain on our books that as far as I know has not necessarily been enforced in any way.

If China becomes a member of the WTO, our rights to restrict products coming in, if they're made with slave labor—of course, if we can prove that, our rights are not restricted. Is that also true?

Commissioner WESSEL. Yes. Article XX allows—contains an exemption to allow those restrictions.

Commissioner WESSEL. And that would also include child labor, if we chose?

Mr. MASTEL. We'd have to renegotiate Article XX I think for child labor.

Commissioner WESSEL. We would?

Mr. MASTEL. Yes. You're straining my memory here, but I—we'd have to renegotiate, yes. Slave labor would be covered, but child labor would not.

Commissioner WESSEL. Okay.

Mr. PREEG. Or prison labor. Any coercive——

Commissioner WESSEL. Any forced or compulsory——

Mr. PREEG. Prison labor as well as slave labor.

Commissioner WESSEL. Right.

Commissioner BRYEN. Isn't child labor forced?

Commissioner WESSEL. There are forms of child labor that are obviously not——

Commissioner BRYEN. Not something the child is able to consent to, because it's below age, so you could probably argue that it's—I mean, I'm sure it's the same thing.

Commissioner WESSEL. If it was below the age of the ILO, which—that raises a good point. We need to look into that to understand whether we have rights.

Commissioner DREYER. But would you not need to show that there was government compliance or pressure behind this? And what the Chinese are going to argue is this is isolated pockets, and we had nothing to do with it. And at that point we're going to say, "Oh, gee, we're sorry we brought it up."

Mr. MASTEL. Well, I think that they can make that argument, but I think the U.S. sanction would still survive that scrutiny.

Mike, getting back to the point you were making, too, one thing that has always frustrated me a little bit about this child labor issue is that I actually think that it would be hard to fit this through Article XX. But that doesn't—I mean, I've always felt the U.S. should just impose whatever restrictions it wants to do, and then let a country challenge us in the WTO.

I think you would find very few countries willing to defend the principle of child labor, maybe even fewer panels who are willing to rule on that topic. The WTO is a political institution in the international sense. It is not an automatic—and just like a U.S. court would be aware of political sentiments, the WTO is as well.

Mr. PREEG. If I might—ILO 16 is straight over, even 14 part-time. So you'd have to find that they have people under 16, large numbers. I'm not sure it's as much of a China problem—child labor—as in other countries. And I would doubt that would get much support in the WTO to push this envelope.

Commissioner WESSEL. I believe if you found—and I agree with Greg that exposing it before the WTO, it would be hard to find member countries who would want to support it. I mean, clearly, there are countries—Pakistan and others—that have more general problems of child labor at lower ages. But there is still a problem in China.

Chairman D'AMATO. Thank you. Let me ask you one question before you leave.

Greg you mentioned in your presentation that you felt that the amount or the size of the goods coming into this country from laogai—forced labor—was substantial. Can you give us any kind of—how would you estimate that, just a ballpark, in terms of—because we're talking here about an agreement that makes that importation here illegal.

Mr. MASTEL. Right. Well, it's funny—actually, it's not funny. I've been looking at this question of prison and forced labor in another context recently, and there are probably half a dozen countries where there are substantial prison and forced labor, slave labor issues—Burma, for example, is one we all know of.

I think in most cases, and particularly in China, given that the products go into commerce generally; it's sort of like going through a haystack and trying to sort out the subtlety different colored strands. I mean, it's almost impossible, and I think it is absolutely impossible without the Chinese cooperation, which I think is unlikely.

The best we can probably do on these issues is to—what we've been doing, maybe do more aggressively—is to find particular examples and act in those cases. It would be, you know, largely, you know, a symbolic fact, but I still think we should do it. I mean, quite frankly, I think if we believe this is something that is bad, a bad act—and I think we all do—we should be willing to stand up for it.

And we may not be able to get 100 percent or anything close to it. But that doesn't mean we shouldn't act.

Chairman D'AMATO. Yes. In other words, a good is coming into this country; we say we think it's being made by forced labor. Customs should be allowed into your country to examine the facilities, and then they say no, so you cut it off on the import side and do it that way, I suppose would be your only technique.

Mr. MASTEL. Exactly. We would not get any significant percentage of the goods, but there is compelling evidence that particular goods have been made with prison labor in China. You know, Mr. Wu has actually gathered some of that evidence, whereas there's really no debate that these goods—particular goods are prison labor goods.

We shouldn't be shy about doing that, and I think the Customs Service over time has maybe—maybe just throwing up their shoulders in frustration about how enormous the task is and how they can really not make much of a dent, have given up, or deprioritized it periodically.

But I think we should make—continue to make an effort on this topic. And, again, it is largely symbolic, but symbolic should be important.

Chairman D'AMATO. Yes. That's right.

Did you have a question, Commissioner Bryen, before——

Commissioner BRYEN. Yes, I did. In terms of PLA-owned enterprises, is there any—in your opinion, would there be any basis for legislation that would ban trade with those kinds of organizations?

Mr. MASTEL. Well, it's something that Congress has considered at different times. You see, the problem is similar to the prison labor, is that I think it's hard to find those——

Commissioner BRYEN. You do have a law against that, right?

Mr. MASTEL. Right. We do. But it's hard to locate those products, especially red chip firms, because they tend to even be more integrated in commerce and harder to distinguish. In some instances, it's even hard to distinguish the capital ownership without Chinese cooperation. And the harder that we push, the less cooperation we'll get.

Commissioner BRYEN. There are some pretty obvious ones. Great Wall is one of those——

Mr. MASTEL. Right. Exactly.

Commissioner BRYEN [continuing]. Currently that's owned by PLA. Everybody knows about it.

Mr. MASTEL. Sure. No, I'm not saying it's—again, it's somewhat like prison labor in the sense that we—there are a few examples that if we wanted to target we could, and if we wanted to make our wrath felt, I guess, in the PLA there is a list of red chip companies. I can come up with half a dozen pretty easily.

Commissioner BRYEN. But we want to not be subsidizing the Chinese military buildup by buying products from—made by the PLA. That's the point.

Mr. MASTEL. No, that is a reasonable argument. The problem is that I think the harder you look, the harder it will become to distinguish those companies. The Chinese will get more creative at how to hide that fact.

But, right now, we are——

Commissioner BRYEN. We have to get more creative, too. I mean, I'm just asking in principle, not the nuances of it, but just, in principle, would you think there would be support for it? And is it possible to legislate in that area? That's one of the topics we'll consider.

Mr. MASTEL. Certainly, it's possible. There are WTO issues raised by that, given that, you know, PLA generals are, you know, people, too, I guess in that sense. So it may be hard to——

Commissioner DREYER. Greg, excuse me. The Chinese maintain that the PLA has been severed completely from business.

Mr. MASTEL. Right.

Commissioner DREYER. So how do we get at that?

Mr. MASTEL. Well, as you know, I think—I suspect there are at least, as I say, half a dozen companies that it's not too hard to get at it, because they—in Hong Kong they are commonly called the red chips.

Commissioner DREYER. Yes.

Mr. MASTEL. No one on the stock market discussed it as such, were listed as such in some newspapers. I mean, you don't have to be, you know, too good of a private detective to find one or two things in China where there are still military ties.

And, you know, clearly, it's one of the cases—the example you just gave is one of the cases where, you know, the stated law and the actual practice are quite a bit different.

Chairman D'AMATO. Thanks, Greg, for coming very much. We really appreciate it.

Commissioner Dreyer, you had another question for the rest of the panel.

Commissioner DREYER. Yes. This is a question for Mr. Bottelier. What I'm asking from you I think is reassurance, because what I—I don't think you meant to imply something that I thought you were implying, and you were talking about, well, they are 20 years behind; they're catching up. And you were talking about legal codes and various other things.

I, frankly, see laws being passed and not being complied with. If you disbelieve me, check out Stanley Lubman's massive tome, Bird in a Cage, on the Chinese legal system. And he finds what I just said—you know, there are codes on the books, there are laws being passed, that are being undone by nepotism, by corruption, by political protectionism, by half a dozen other things. And he doesn't see any evolution, and neither do I.

And I'm just wondering about the implication, which you may not have meant to imply, that there is—you know, in 20 years it'll all be all right, because they're evolving and they're evolving in the direction we want. And I'm not sure you meant to say that, and I need to hear you clarify that.

Mr. BOTTELIER. I wish I could give you that kind of assurance. I think the way you look at China depends very much on whether you put all the emphasis on the current problems—and there are plenty of those to be worried about—or whether you look at the structure from the perspective of where they came from 20 years ago, where they are now, and where they are trying to go. I think——

Commissioner DREYER. How do you know they're trying to go?

Mr. BOTTELIER. I'm not a legal system expert, but it's clear that China, 20 years ago, had no legal framework at all.

Commissioner DREYER. Absolutely.

Mr. BOTTELIER. In fact, the legal profession in China was banned under Mao Tse Tung. There was no teaching of law at the universities. Today you have a large number of Chinese law firms. You have more than 100,000 licensed Chinese lawyers, trial lawyers, commercial lawyers, and this is clearly indicative of a trend towards codification of commercial relationships, of creating and providing access to dispute settlement mechanisms that previously weren't there.

I don't know the particular source that you are referring to, but there is a Chinese legal expert at the Carnegie Endowment for Peace, Minxin Pei, who has documented over time how the emphasis has shifted from arbitrage settlement to court settlement in—for commercial disputes.

And there is a striking quantitative shift towards law-based, rule-based settlement of commercial disputes. I would hope that this trend will continue, as I believe it is. I don't believe that external pressure will significantly accelerate it, but internal pressures will.

There has been a lot of discussion about IPR protection here. External pressure is important, but what will ultimately make the critical difference is whether and when Chinese companies are going to claim IPR protection. And that is in fact happening. Increasingly, Chinese companies are feeling the pain of their rights being violated in China and it is their pressure for improvement that will make a difference. They can now sue other companies. They and individual citizens can even sue their own government, and do so in droves. They never could in the past.

Well, I think this is suggestive of dynamics in a direction.

Chairman D'AMATO. Commissioner Mulloy?

Commissioner MULLOY. This is actually for the panel. Mr. Tonelson makes the point on page 5 of his prepared testimony "that we need to examine whether America's stated security policies and economic policies toward China are dovetailing—are in conflict."

And I think by that—what I take from that is that whether our current economic and trade policies are strengthening China, making its ability—if it is to become a hostile power, a much stronger hostile power, whereas others would say that these economic and trade policies are the correct way of civilizing or bringing China into the integrated global community, and thereby that's the way to deal with China, and that we have to take the gamble.

It is a gamble, I think everyone would say, even the second is a gamble. I would like to know where members of the panel would be. If you had to bet and gamble one way or the other, would you gamble in staying on the course we're on, or modifying it, or actually changing course altogether?

So I'd start with Alan, and then go to Mr. Bottelier, and then to Mr. Preeg.

Mr. TONELSON. It seems to me that if you are going to be serious about national security, rather than simply pretending to be serious about national security, you would never ever entrust this nation's fate in a region considered to be vitally important to the hope or even the expectation that at some point, at some indefinite point down the road, China will become democratic, and, further, will become easier to deal with.

We've actually seen signs that even if China does become a government more accountable in some "legal" way to its own people, that's absolutely no guarantee it will become an easier government to deal with, because nationalism on the popular level in China seems to be on the rise.

Now, that's, of course, partly because the government wants it that way. Even though there are now lots of non-governmental ways to get information if you are Chinese, the Chinese government still exercises substantial control over the media. Substantial control. We should never forget that. For all the talk about Rupert Murdoch coming in, this is just the tip of the iceberg of what remains a state-controlled system.

So I would argue that if you are serious about national security, if you really do think, as I heard at a meeting at the Heritage Foundation last week, that it's Chinese military doctrine to cut off Japan's oil supply from the Middle East, if you really think that's what the Chinese are planning to do in certain circumstances, you would never ever say, "Well, there is that on the one hand. But on the other hand, maybe they will become more democratic, and maybe they'll become friendlier as a result."

I'd like to add one more point. I think that the aim of integrating countries into an international community is not a wise aim for America to pursue, because in addition to not taking the concept of international law seriously, in terms of geopolitics and also trade and commerce between nations, I don't take the idea of a world community too seriously either. So I think that would be a huge mistake.

China is a country. It's going to present opportunities for us. It's going to present challenges to us. We should deal with those as they come up. And these notions—world community—I think we leave those to people who write op-ed pieces for a living.

Commissioner MULLOY. Mr. Bottelier?

Mr. BOTTELIER. I have a different perspective, sir, on this very important question. If you look at it with some historical perspective, I think what we are seeing now is that one-fifth of humanity is voluntarily applying for membership in international clubs, knowing full well that their internal system is still rather different from what the requirements are. But it is them applying for the membership; it's not the rest of the world pushing them or requiring them.

If you compare that with China a century and a half ago when the Western countries were trying to pry open the Chinese market, by force if necessary, the current situation is infinitely more hopeful. In the past, China that wanted to be closed and it was unable to establish order domestically. China after the revolution of 1911 when it was a political mess, or China under Mao, when it opted to be isolated from the rest of the world. Today you have a China that is seeking international ties, is building its entire strategy on those ties, trade ties, investment ties, education ties. They are some 60,000 Chinese students studying at the American universities.

To me, the opportunity presented by a China that clearly indicates a wish to be part of the club is not something that we can look at cynically or with a short-term perspective. This is a very important matter of global development, global security.

A world with China in an adversary role to the U.S. or to the West in general, would be a very different world from a world where China, with difficulty, is accepted as a partner in global development with increasingly intensive trade ties, investment ties, and so on.

The view you take on this matter is very much conditioned by how you see China now, as an adversary, a potential adversary or even an enemy, or as a potential contributor to world development or world peace. Perhaps partly inspired by my experience—I've lived in China four and a half years, and I interacted a lot with the Chinese people at all levels. I don't start from the premise that China is an adversary. I am well aware of the tensions between China and the U.S. and I am not belittling those, but I think you can construct bilateral relationships in such a way that, over time, they become more constructive and positive. Alternatively, you can construct a relationship in such a way that precisely the opposite is going to happen. And I think we are at that juncture now.

Mr. PREEG. May I also——

Commissioner MULLOY. Go ahead. Yes.

Mr. PREEG. Well, first of all, it definitely is a gamble. By having open trade and investment, you are giving more resources technology for them to modernize and strengthen their military capacity, whatever.

On the other hand, open trade and investment is having major positive effect in driving China toward a market-oriented democracy, if that's the ultimate objective. "Taiwanization" of China is one—is really what our objective is, even though we don't want to clarify that too much either officially.

So, should we take the challenge? I think definitely yes, and the facts are overwhelmingly in that direction, because if we didn't, it's not that we'd put a few more export sanctions here and there. That would have a very minor impact. It's really to cut back in a major way on our trade investment.

It would slow them down a bit, but everybody else, including Europe, Japan, Russia, would continue open trade and investment. And you might gain a little time, but it wouldn't have that much impact. And you would lose all of the positive benefits, because if the U.S. was not engaged with China economically it would be very different, politically as well as everything else.

And we've heard before the legal system is changing, and in a lot of countries—and I've lived in a number of them—developing countries—commercial disputes usually get out front of human rights and political ones in terms of having to have a legal system that works. Open trade and investment means decentralization. As you move from producing textiles and shoes to higher technology things, they have to decentralize power. It's a struggle they have.

And I'll just mention one other thing. It's on the second page of my statement. Next week—actually, next Tuesday, we're doing a press conference.

It's a joint survey that I happen to be—it's a very time-consuming thing that I did, a survey of current practices in developing countries by U.S. companies—over 300 specific examples by companies of how they are in country improving ethical labor and environmental standards, including political in some ways, in these countries. China and Mexico are the two that have the most examples.

So there are a lot of aspects to the positive side of this challenge, but it is a gamble. On the other hand, you don't gain much by cutting off trade and investment. We gain some time, but that's about it. On the other hand, if it's ever going to work, the longer term hope of pushing them in the direction of being a more stable, market-friendly, market-oriented democracy, trade and investment is really central. And that's where it is today.

Commissioner MULLOY. Thank you.

Chairman D'AMATO. Commissioner Wessel?

Commissioner WESSEL. Let me follow up on this question as well and ask a question about, since there is still—China has not yet become a member of the WTO. There is an annual review required still this year by Congress, which could delay further China's accession.

In light of the comments that have been made by several of the panelists, wouldn't it be better to have a provisional membership status for China that they have to continually earn the right to become a WTO member, rather than simply conferring upon them all the benefits of WTO membership?

As a country that adheres to the rule of law, the U.S. and Western nations, if China comes in and does not live up to its word and the agreement, we will decide to use the lengthy and laborious task of going through the WTO dispute resolution process, giving China that much more time to continue to reap the benefits of the WTO and the open system.

If we are to have a provisional system that would allow them to earn the right of WTO benefits based on your knowledge of China, wouldn't that be a more appropriate way of bringing them into the system?

Mr. PREEG. May I answer? Because I've been involved in GATT, as you may know, back to the 1960s.

Look, that's going back to square one. For years, starting in 1986, we were sort of saying it should be provisional, step-by-step. China and just about everybody else had said no. You know, China was very firm, no, it's all or nothing.

And we were sort of back and forth on this. We were a little split, as you know, in our administration. There is the agreement. We signed off on it. And even the permanent MFN last year was—the Congressional support was there as well as two administrations.

So what you're suggesting, which sounds reasonable—and there's even some historic precedent in the way Japan came into it in the 1950s, incidentally—you're back to square one, and you're really—if the Bush administration should do what you're suggesting, which has a lot of logic, Claude Barfield has written a book about it, etcetera, we're just sort of walking away from the agreement, because China would just oppose it, and we'd have to go back essentially and start over again where we were in 1986 and 1987.

Commissioner WESSEL. Well, except the agreement has been negotiated, and they would be earning all of their rights under that agreement as they proved their willingness to adhere to the rule of law.

Mr. PREEG. Oh, yes. Yes. But it's a very fundamentally different agreement, stage by stage, which was debated for 15 years, and we finally went the other way on the——

Commissioner WESSEL. We haven't gone all the way yet.

Mr. PREEG. No, not yet, but we're pretty close.

Mr. BOTTELIER. The narrow legal answer I think to your question is that under the current WTO Charter that form of conditional membership doesn't exist. You would have to amend the Charter first and that will not be easy.

Now, two comments. Yes, China does earn rights by joining WTO, but it earns principally obligations. The entry deal that China negotiated with the U.S. in 1999 and with the EU in 2000 entails 99 percent adjustment on China's side and maybe one percent on the other side. So, yes, China gains rights, but many more obligations, some of them quite onerous. They have voluntarily agreed to enter into these obligations.

By negotiating this deal—and I must congratulate the U.S. negotiating team for having stuck it out, because I think by negotiating this tough deal they have done a greater service to China than they could have done through technical assistance. China is subjecting a large part of its domestic reform agenda to international scrutiny and even sanctions under the WTO clause.

The deal has raised the entry bar to join the WTO significantly. No other country joining the WTO in the past has agreed to anywhere near the terms that China has agreed to. That means that Russia and some 30 other countries that are in the pipeline for membership will almost certainly have to adhere to tougher entry conditions than would otherwise have been the case.

Furthermore, I'd like to remind you that under the entry conditions, the U.S. has negotiated a set of safeguards for itself and other members, which are extraordinary. No other country has ever agreed to the set of safeguards that China has agreed to.

So, yes, conditional membership might have been worth considering if it was a legal option, but I think the safeguards achieve effectively something very similar.

Chairman D'AMATO. Commissioner Bryen?

Commissioner BRYEN. Thanks. I want to pursue three topics that have been—come up in the discussion. One is—I'll start with Mr. Bottelier. Is that the right pronunciation?

Mr. BOTTELIER. Yes, that's fine. Thank you.

Commissioner BRYEN. Close.

(Laughter.)

Mr. BOTTELIER. It sounds French and——

Commissioner BRYEN. You had talked about the hidden crisis in the Chinese economy.

Mr. BOTTELIER. The hidden?

Commissioner BRYEN. The hidden crisis—unemployment, the banking debts, things of that sort. How serious—I mean, my question is: how serious is that? How imminent is that problem? Because you hear a lot of talk that the stability of the country may be in doubt because of these kinds of internal economic difficulties.

With the country sitting on huge amounts of hard currency, which it could also spend for social welfare programs if it wanted to, I just wanted to get your take on how serious a situation that is and what we should expect.

Mr. BOTTELIER. Thank you for that question. I've been struggling with that for years and I'm not sure how to answer your question, how serious it is.

Let me explain how the situation came about. The Chinese, unlike the Russians and the East Europeans, continued to protect their state sector, their state-owned enterprises, for an extended period of time.

That was partly because they hadn't really fully thought through the implications the economic liberalization process or while this embarked in the late 1970s. The Chinese reforms have no timetable, no blueprint. They are sort of learning by doing.

The safest way for them in the initial 15 years of reform was to protect what they had, to protect the state enterprises for employment and social stability reasons.

As the economy became gradually more marketized and more deeply involved in international competition, they became more keenly aware of internal inconsistencies in their half-reformed system. The critical turning point in my mind was the period 1993–95.

In 1995 they adopted their first serious commercial banking law, central banking law, labor law, and other major institutional changes. That was a turning point in the sense that they consciously, willingly, began to accept that state-owned enterprises had to become efficient or close. This process of internal economic adjustment is now going on in a very serious way. However, the earlier protection of enterprises has generated a huge amount of non-performing loans on the balance sheet of state-owned commercial banks. That means these banks are essentially insolvent; they have grossly inflated asset valuation on their balance sheets.

They have begun the process of cleaning up the mess by transferring large amounts—they have done about $160 billion so far—to asset management companies. So the process has started, but the amounts involved are staggering. It is hard to estimate how much it is, but it's probably somewhere between $300 and $500 billion of bad debt. On top of that, the Chinese have massive amounts of unfunded pension debt and most remaining state enterprises are severely under-capitalized.

Now, most of this internal state debt is long term, but sooner or later the state will have to come up with the resources. If China's fiscal situation had been stronger, it would have been easier to deal with the problem, but their fiscal situation is weak. Part of the solution lies, of course, in asset sales—privatization—to both foreign and domestic buyers. But it will not be easy and solving the internal financial problem will take many years.

One approach to the resolution of the internal debt problem that the Chinese are following is through the stock exchanges. They are doing IPOs for state-owned companies. They sell minority shares in Shanghai, Shenzhen, and some in Hong Kong, and even a few in New York. The state initially keeps majority holdings which they may sell later. They've done about a thousand of those enterprises in this way.

The strategy is to build up the domestic stock exchanges, making them less like casinos, better regulated, with international accounting and disclosure standards. This process is very difficult and involves domestic political struggle because the traditional Chinese culture is not towards transparency.

Significant cultural changes are in fact being forced upon the Chinese system through the dynamics of the economic reform process. If they are successful, they will be able to gradually sell more state assets through the stock exchanges and otherwise—including private deals. And in that way, over a period I would say of 10 years sell their way out of the tremendous internal debt balloon.

But nobody can predict whether they will actually succeed or not. A financial crisis cannot be ruled out in China. Let's hope it won't happen, because if it does it will not be pretty. The Asian crisis of 1997 would look small by comparison.

Neither success nor failure is preordained. I mean, if they keep level headed, and keep the long-term perspective, in an international environment that is basically supportive of where they want to go, I believe that ultimately they can make the grade and become a more modern, rule-based society.

Commissioner BRYEN. Is there an anti-reform faction, big faction?

Mr. BOTTELIER. Not anti-reform per se. There are significant groups that would like to take things more slowly, change the sequencing. I am not aware of any significant group that wants to stop the reforms or roll them back.

Commissioner BRYEN. So the military is supporting the reforms?

Mr. BOTTELIER. Well, the military has been told in 1998—as Mrs. Dreyer mentioned, that they, like all other government organizations, have to divest themselves of commercial interests.

Commissioner BRYEN. But there are some doubts there.

Mr. BOTTELIER. Sure. I accept that. But, I mean, they could have also said, fine, go ahead keep your monopolies and finance yourself outside the budget. They have said and are doing the exact opposite. They are trying to make the budget into a real instrument of government policy; hence the PLA and others to divest.

Prior to that, many government activities were financed outside the budget in a totally non-transparent way. They are trying to create a situation within which the budget is a tool of economic management.

And no doubt, in an increasingly pluralistic society, there are pressure groups, which don't agree. Adjustments of the kind that China is trying to make cannot be accompanied without internal political fights. PLA divestment probably involves neck fights as to the changes announced for the telecommunications sector.

What I am saying is that you should look at the internal dynamics of the Change process in China and not just at the problems of the moment. I don't buy the cynical view of China, because I believe that most internal change dynamics push in the right direction.

Commissioner BRYEN. But where I was going with this is the idea that there might be a difference between, let's say, the military and the non-military sectors in regard to the overall Chinese policy. There probably isn't—is that a fair judgment to make?

Mr. BOTTELIER. Well, I'm not——

Commissioner BRYEN. There was this whole—during the aircraft—the P–3 crisis, there was this whole nonsense—I thought nonsense—of Chinese military demanding this, and then not telling the truth to the government, and the government is, you know, being misled, and so forth and so on. And I thought that was for our consumption, not for theirs.

Mr. BOTTELIER. I think it's unfortunate that the airfield where they had to land was a military airfield. Had they landed in Beijing or Shanghai, I think the whole crisis might have had—taken a very different tack.

The PLA was in control over the information flow and came out with a self-serving story. It took the leadership three or four days to find out that there was another story. I think the questions of the PLA in the Chinese economy is a very important one. We don't know too much about the details. The PLA is to some extent still a black box, maybe even for the Chinese. However, the PLA remains under civilian leadership. There is no military person per se in the Central Committee——

Commissioner BRYEN. That was my point exactly.

Mr. BOTTELIER [continuing]. The central committee. PLA is ultimately under civilian control as per their own Constitution.

Chairman D'AMATO. Thank you.

Commissioner Becker?

Commissioner BECKER. Yes. Thank you.

Mr. Preeg, I was very interested in what you had commented on right at the very—at the last, this poll about the changes or the accomplishments of business company, I guess throughout this world. This wasn't just restricted to China, was it?

Mr. PREEG. No. Very briefly, it's developing countries.

Commissioner BECKER. Developing countries.

Mr. PREEG. And I think there were 42 developing countries in the responses to the survey, and China included—China and Mexico had the most examples, and there were a lot of—there were about 60 questions put to the companies. So it's really what is the impact of American companies on the ground, in China we're talking about today, in changing toward a more market-oriented democracy?

In other words, they have stated policies—the companies—translated into Chinese, non-discrimination in hiring workers, promoting them in all ways, anti-corruption, respect for certain rights, and just decision making.

So I think this is positive. At least the people that work—and my experience in other developing countries is that there is a positive effect for people working for American companies in terms of the differences of how our companies operate with the Chinese or Communist regime, etcetera, in state-owned enterprises.

Commissioner BECKER. But business generally rejected a code of conduct when we were negotiating the agreement with China, the PNTR, to try to require companies to do this. This was rejected by business. Is this not right?

Mr. PREEG. Well, I don't want to go too far. It is the difference between being required—and this was the problem with the OECD code last year—and doing it voluntarily in their best interest. And in certain areas, you know, about 95 percent of the respondents have corporate codes on ethical behavior, and it gets quite specific.

But in certain specific areas, you know, some companies go further than others, and others say in an environmental area, "If I came up to U.S. standards," some companies do U.S. standards throughout the world and it brings it up, others say, "If I had to come up, I couldn't do business in that country. I do better than that."

So without, again, getting into a lot of detail, there is a big difference from the U.S. business sector, as I understand it, between being required where their laws and where governments then get—you know, get on top of them or sue them, and doing voluntary things that—as the survey will show—that is good for business, and at the same time is having a substantial positive impact on the ground.

And I might even say just one of the questions, because I did the questionnaire—I say, "To what extent do you use good practices and labor and, even more, environment as a marketing tool?" And there are some very good examples where companies market their products by saying, "In this country we have better"—you know, our international paper in Brazil saying, "We do all these things much better than other companies in Brazil to try to help them."

So that's what it is. That's it. It's the distinction between being required and having laws and possible legal suits versus voluntary actions.

Commissioner BECKER. So then your organization, the Alliance, the Manufacturers Alliance, would oppose any kind of mandatory——

Mr. PREEG. We don't—it was a joint project, except we have the analytical capability, namely me. So we don't—I doubt that we would take a position; we normally don't.

I have my own personal views, and I tend to feel that we can go further on the voluntary, and that's probably—usually, that's the way to go, but it's a little different—not prison labor, that sort of thing.

So that's it. Now, I don't know where—I think the NAM, because it was joint in terms of trying to get this survey out, that I don't know if they have a specific position, but they would probably certainly go in voluntary and not mandatory.

But, again, it depends what is the specific mandatory requirement—that you'd put in an OECD code or—in U.S. legislation, for example.

Commissioner BECKER. The government, as one of the last acts of the Clinton administration I think, was going to negotiate a free trade agreement with Jordan.

Mr. PREEG. Yes.

Commissioner BECKER. In which Jordan voluntarily agreed to enforce its own laws, which is one of the problems with China, to enforce—including environmental standards, wage standards, that they would enforce all of these—designing a trade agreement.

And I understand now that this is being opposed strenuously by manufacturers in the United States and that we're—and that, further, the Bush administration now is seeking to negotiate a side agreement, not touching the treaty, but to negotiate a side agreement, a side letter, that would set aside these requirements.

Would you care to comment on that?

Mr. PREEG. I've been one of the few—I've read the whole agreement. I'm not sure—it's not a treaty, it's an agreement. In any event, and I don't think the Bush administration has yet taken a position, even though it wouldn't be a side agreement—we would be taking out one phrase about trade sanctions.

But where the agreement is, if I might, and related back to American companies, it's not wages. It's—there are four fundamental—labor fundamental rights. There's child labor, there's prison labor, there's union—right to organize—and there is discrimination. Those are in the ILO.

Three of them are in the agreement. Child labor and prison labor—prison labor I'm not sure is a problem in Jordan in this context—freedom to form unions and, in fact, it's just implementing existing law, which in Jordan says that unions cannot strike unless the government approves. So it's a pretty restrictive that they're doing.

But the fourth one, which is I think the most important—nondiscrimination in the Moslem country—women, non-Moslems. Where is it? It's not in the agreement for some reason. I've been raising the question. Probably that's the most difficult one from the Jordanian.

But American companies in this survey—almost every American company, because it's good corporate policy here, says non-discrimination with reference to women, religion, ethnic background. On the ground in these countries I think that has more impact than the Jordan agreement, which, again, is 120th of one percent of U.S. trade.

Commissioner BECKER. Well, given that most countries and most companies, most people, are decent people and would do these things without laws, even in the United States, isn't the law—isn't the agreement written for those—that small percentage that does not want to do it voluntarily? Isn't that the purpose of that?

Mr. PREEG. I mean, let's say 99 companies out of 100 would——

Commissioner BECKER. I'm not sure 99 out of 100 national companies in the Moslem—in a Moslem country give absolute equal non-discrimination of women, or maybe non-Moslem people.

Chairman D'AMATO. We're running out of time.

You had a follow up, Commissioner Wessel?

Commissioner WESSEL. A quick follow-up question, and I apologize because I find these self-certifying polls that a company says that it's a good player in a foreign country and it's doing great things, I often question whether that's accurate.

Are these public results which you're going to be releasing Tuesday? Because I know that at least I, and I think other Commissioners, are going to be going to China as well as we travel to some of the other countries, and I'd like to——

Mr. PREEG. Yes. There is going to be a press briefing by the presidents of MAPI and NAM Tuesday and——

Commissioner WESSEL. Will it be listing the companies that participated in the polls, so that their activities can be validated?

Mr. PREEG. What it has—for the 331 good practices, each one—the specific practice is named by company, as usually done on the questions that are yes, no, or maybe. I mean, I'm just giving you a preview. Normally, you don't list who said yes and who said no.

Commissioner WESSEL. So if——

Mr. PREEG. And we don't do that.

Commissioner WESSEL [continuing]. The companies are saying they're making a real difference in China, when we have the opportunity to go there we can visit and determine whether the——

Mr. PREEG. Oh, yes.

Commissioner WESSEL [continuing]. Local people believe the same thing.

Mr. PREEG. Oh, yes, definitely. Definitely. And the 28 specific instances of good practices in China, each listed by company and what the specific practice is.

Commissioner WESSEL. Okay. If you can share that with the Commission when it's released that would be very——

Mr. PREEG. Oh, yes. I'll send a copy over Wednesday, but it's not released yet.

Chairman D'AMATO. Thank you.

Commissioner Robinson? Do you want to go first? Commissioner Dreyer? You're next. Commissioner Dreyer?

Commissioner ROBINSON. You'll notice I didn't speak.

(Laughter.)

Chairman D'AMATO. Okay.

Commissioner DREYER. I read your paper, particularly the part on the exchange rate mercantilism.

Mr. PREEG. Oh, that was——

Commissioner DREYER. With great interest. And this occasions a question, and I am not an economist, so forgive me if this is simplistic.

Mr. PREEG. Ken had to live through that in the Trade Deficit Review Commission.

(Laughter.)

Commissioner DREYER. Anyway, they are spending—the Chinese government is spending a considerable amount of money to manipulate exchange rates in its favor. So, therefore, what is it—that money not available for doing, and what repercussions are there? What adverse repercussions does that have for the Chinese economy?

Mr. PREEG. Okay. I don't want to get too much into this. It's a little bit complicated. But, basically, if you want to keep your exchange rate lower, not have pressures, but you want to strengthen vis-a-vis the dollar, one way to do it is to buy up dollars on the market.

Commissioner DREYER. Exactly as you said.

Mr. PREEG. And that's what these countries have been doing. One of the—and that's the direct mercantilist, whatever you want to call it, manipulation effect on the trade balance. And goodness knows in the U.S. manufacturing sector this is where it all hits, and there is a lot of interest in my book, incidentally, in the U.S. manufacturing sector.

But this is the indirect impact, because if you keep buying dollars year in and year out, Japan is—all of a sudden you have all of these dollars, and they have no purpose to have all of these, especially if you have a floating exchange or you don't need reserves in the first place.

But even China—$170 billion now—which they're never going to have to use presumably to defend the yuan or something—they don't even have a convertible currency at this stage and a capital account. So what this does mean is that the government has a huge amount of dollars that they can spend and that they've kind of saved up. And they could use that in any way they want.

So it—that's where I get in my comments today, how might they use that as leverage in some way in the foreign policy or security field, rather than in the narrow, you know, financial market trade field?

Commissioner DREYER. Meanwhile, those dollars are not available to them, because they are sitting on them.

Mr. PREEG. They——

Commissioner DREYER. To use in some other fashion.

Mr. PREEG. They can use it today or tomorrow. They can use it anywhere they want. They can use it for the swap agreement, $2 or $3 billion. They could set up a payments yuan in East Asia, and between Japan, China, and South Korea they could put up $50 billion, kick in $20 billion and have—so there's lot of possibilities.

No, this is a fungible, huge amount of money that they could use any way they want. If they wanted—they don't need—the question: why do we give aid? The World Bank gives aid, the Asian Development Bank, which is credits for the most part, it's no longer a soft window—to China? If they've got $170 billion of reserves, why don't they use that?

Commissioner DREYER. Well, you saw where I was going with that question.

Mr. PREEG. But what this really means, and I want to keep it on the security side, is they have huge amounts of dollars sitting in the central bank that they can sign a check any day to buy anything they want, you know, around the world.

Commissioner DREYER. Thank you.

Chairman D'AMATO. Commissioner Robinson?

Commissioner ROBINSON. Mr. Bottelier—I've probably massacred that, too, but——

Commissioner DREYER. Do you want to say it for us correctly, so we can——

Mr. BOTTELIER. That's fine. Bottelier is fine.

Commissioner DREYER. Okay.

Mr. BOTTELIER. I normally say Bottelier, but——

Commissioner ROBINSON. Very good. I think you've laid some very important groundwork for the Commission on discussing the scale of the financial requirements, the capital requirements of China.

Whether they attract those funds domestically or overseas, just to recount the bidding in a nutshell, roughly a $300 to $500 billion banking crisis, I think you'd agree, 25 to 40 percent non-performing loans, a massively under funded set of pension obligations, a state-owned sector that needs fundamental restructuring, that's hundreds of billions of dollars more, a fairly weak set of domestic capital markets to date that are still in the casino phase, albeit they're working the problem.

So far I am tracking with you?

Mr. BOTTELIER. Yes, sir.

Commissioner ROBINSON. Okay. Now, what I think the Commission is trying to get its arms around here, and which we spent part of the morning on prior to your arrival, is, what kind of capital overseas—what kind of numbers are involved that China is going to have to raise on the global capital markets?

And what I want to try out on you here is the fact that—given the fact that all of the other capital markets in the world combined may or may not be the size of the U.S. capital markets—now, we're going to need statistics on this as a Commission, and I don't have them.

But my understanding is that we have roughly 40 to 50 percent, some even say a little more, but say—call it 40 to 50 percent of the action in terms of global capital here in the United States. And I don't think you can compare any capital markets in the world to our own, not the Hang Seng, not the Frankfurt, not remotely. These are thin-volume events.

So what I'm trying to understand is, do you buy the idea that China is going to require tens of billions of dollars a year or need to attract tens of billions of dollars a year in overseas, and primarily, by definition, the U.S. capital markets?

Mr. BOTTELIER. This is somewhat of a technical subject, and it may come as a surprise to some of you that precisely because China has such a strong reserve position and a balance of payments, it's in a better position to solve domestic debt problems.

China, in the aggregate, over the past six, seven years, has been a net capital exporter. The fact that they have accumulated so much foreign exchange is the reflection of that. They have exported more than they have imported. On top of that——

Commissioner LEWIS. Of capital.

Mr. BOTTELIER. Yes, sir. Yes.

Commissioner LEWIS. By buying U.S. securities.

Mr. BOTTELIER. If you export more than you import, somebody has to pay you. Well, the rest of the world has been paying China in a way, either by allowing China to buy assets and securities in their own country or you can pay the trade debt by letting the surplus country use more cash dollars in their domestic circulation, which is also happening. China is a major owner of U.S. government securities, like Japan is—while represents U.S. debt owed to those countries. The trade deficit can also be financed through borrowing by the private sector, which is also a part of the picture.

So in the aggregate, China has exported more capital in the last six years than it has imported. Now, that is an unusual situation for a developing country. Most developing countries are the other way around. They have current account deficits. China has had current account surpluses consistently, and large ones, including with this country but not only with this country, also with the EU. If China had had efficiently-functioning domestic capital markets, they would not have had, from an aggregate point of view, a need to import a lot of private foreign capital, because their savings were more than adequate, to finance all of their investments.

So you have this paradoxical situation that a country is simultaneously an exporter of savings at the aggregate level, and an importer of investment money. They have in fact attracted huge amounts of FDI, foreign-directed investment. Only the U.S. has attracted more. China is number two in the world over the past six, seven years.

So how do you explain that paradox? It's in the fact that China's domestic financial systems cannot yet bring savings and investment together, in an efficient manner.

Commissioner LEWIS. Didn't he give the answer, though? There is currency manipulation going on, so they are buying U.S. securities.

Mr. BOTTELIER. Well, that's a technical point that can be debated. China's purchase of U.S. securities is in fact the logical result of the large current account surpluses. It is part of the same story.

China will eventually have to change its overall posture in trading relationships with the rest of the world. They cannot, in the long term, sustain a large current account surplus. That is unnatural. Over time they will probably become a net capital importer. When that will happen, I don't know. They have been a net capital exporter for most of the past decade.

I think that, if the Chinese reform game works, and it will take years or decades, then—and they will sell their way out of the debt and also become more heavily indebted externally. They will have to sell more and more of their assets abroad. They will also continue to invite foreign investors to put their money in China, eventually also—when their currency becomes more convertible—through portfolio investment.

In terms of its financial relation with the rest of the world, the U.S.' current position is the reserve of China's. The U.S. has large and growing current account deficits. It finances the deficit by borrowing abroad, by allowing greater cash dollar circulation abroad, or by allowing foreigners to buy securities and other assets in this country, for example, through New York Stock Exchange. That's how it works.

Mr. PREEG. But I think—could I just——

Mr. BOTTELIER. Go ahead.

Mr. PREEG. If I may, just a word——

Commissioner ROBINSON. But there is going to be a convoy of 150 to 200 Chinese state-owned companies that want to raise funds in the U.S. capital markets in the fairly near term.

Mr. BOTTELIER. I would expect that to happen, over time, yes, sir.

Commissioner ROBINSON. Which means, for the purposes of the Commission, tens of millions of dollars of funds that China will seek to raise in the U.S. debt and equity markets. Is that correct?

Commissioner LEWIS. That won't be invested here.

Mr. PREEG. Globally. Globally.

Commissioner ROBINSON. Yes. But here—I mean, only because of our—the size of——

Mr. BOTTELIER. They have already done that, to some extent. Many of the so-called red ship and H-shares issued by Hong Kong listed, Chinese state-owned corporations were purchased by U.S. investors. H-shares for China-registered companies. Red chips for Hong Kong-registered, Chinese-owned companies. The U.S., directly and indirectly, has already invested substantially in H-shares and red chips, and so have investors from many other countries.

Commissioner ROBINSON. They buy right out of Hong Kong, of course.

Mr. BOTTELIER. Yes, sir.

Commissioner ROBINSON. I agree.

Chairman D'AMATO. Commissioner Lewis?

Commissioner LEWIS. Let me just hear, you want to respond.

Mr. PREEG. Well, not a real disagreement, but if there's a current account surplus, by definition there is a capital account outflow. But it has to be adjusted if you're buying—if the central bank buys up dollars that equals the current account, then there's not—I mean, that offsets.

So just to clarify, to the extent there was a dollar buildup or foreign exchange buildup, that would reduce the current account surplus in some years almost to zero and reduce the outflow.

On capital accounts, though, there can be long-term foreign direct investment, which is a big inflow. Whether or not, in view of the capital current account, if these SOEs want to borrow abroad, which is another question when they're bankrupt to start with, whether they would have problems or whether we could do something to make problems that aren't there, I think that's something you need to examine further.

My quick reaction is that probably not, that China is—in its external accounts is in a pretty strong position, because of current account surplus, a large inflow of FDI and huge reserves, and there are various markets around the world. You might have to pay a little bit more, but if you wanted to place bonds or whatever that you could probably do that. But, again, you might want to look——

Commissioner LEWIS. But you would agree if it's a higher—let's say a proliferator is restricted from the U.S. cap markets. We're talking cap market sanctions, something that——

Mr. PREEG. Well, if we ever were to do that, which is a complicated step to take, they could go to Europe or elsewhere.

Commissioner ROBINSON. Yes. And they would have a higher risk profile, they would have a higher cost of funds, not I don't think trivial. And ultimately over time they could book up those thinner volume markets and actually run into inadequate inability to attract capital.

Mr. PREEG. My experience in developing countries—I have lived in several of them—the real is, when they—when an SOE borrows abroad, do they get a central bank guarantee?

Now, when I was living in Peru and working in the Philippines and Haiti, that was questionable. They couldn't do it because of an IMF constraint, but even so the central bank might go bankrupt.

A central bank guarantee from China today with $170 billion sitting there is pretty secure. But I'm not saying they would do that. The question is: is the loan guaranteed in some way by the Chinese government? I think that would make a significant difference in the cost of the loan.

Commissioner LEWIS. One of the questions I have is, Alan, you referred before to the trade relationship—the relationship with China is not normal. And you went through a litany of things that are not normal today, and we know that they have recently jailed some Catholic bishops and Catholic priests. We know what they're doing to the Falun Gong.

We know that when people are striking for wages that are not being paid for them they are also thrown in jail and sent to prison.

Now, Senator Sarbanes pointed out to us at one of our meetings that we have a trade relationship with Japan that is very significant. We're running an $80 billion deficit with Japan, but it's a major two-way relationship, and Japan essentially shares with us values about human rights and democracy.

Our trade with China is $15 billion we're selling to them and $100 billion they're selling to us, so we're running an $85 billion deficit, which is the biggest in the history of the world, and it's the most one-sided trade relationship probably ever.

Now, if China is having this enormous military buildup, which it didn't have 20 years ago, and I don't see where China is being threatened by any country for which they need a military buildup, so the question is, what is a military buildup's purpose? And we do know that they're putting lots of ballistic missiles on the Taiwan Straits to threaten Taiwan, and we also know that they are having access to our capital markets. They are running an $85 billion surplus with us.

Now, if there are hidden crises in the PR economy right now with unfunded pensions and debts and unemployment, obviously there's a lot of money that they could use for that, from the surplus that they build with us, the capital markets, the $170 billion in U.S. treasuries that they're now having.

Why should we allow China to have the access to our markets, both in terms of imports to us and the capital markets, if they are running this incredible military buildup, they are proliferating weapons of mass destruction, they are doing business with countries that are totally hostile to our way of government, like Iran and Iraq and Libya and Sudan, what's the point of doing this?

Mr. TONELSON. I'm actually not a China hawk in the sense that I'm not really terribly worried about China's potential to challenge U.S. national security concerns, provided we take proper steps to keep the problem in some control, which I don't think that we're actually doing.

Unlike a lot of folks who comment on Chinese ambitions from places like Washington and New York and, you know, wherever, I don't have any special pipeline into the Chinese politburo. I couldn't pretend to tell you what their strategic priorities are.

All I know is——

Commissioner LEWIS. All we know is what they're doing.

Mr. TONELSON. All I know is——

Commissioner LEWIS. What they're doing, not what they're thinking. Right.

Mr. TONELSON. They have exported weapons of mass destruction and technologies associated with weapons of mass destruction. They have interfered with reconnaissance flights that the very international law that I have no regard for at all entitles us to fly, and, which more important, our own national security requires, because we need to know what's going on there.

Commissioner LEWIS. They have jailed some U.S. citizens and kept them in——

Mr. TONELSON. And I would argue that their trade practices do significant damage to the American economy and to the American workforce in particular.

So it's not a normal country, and my point is simply to point out the whopping contradiction between viewing them as an abnormal country strategically and viewing them as a normal country economically, to the extent, again, of providing them with massive resources that surely will be used in part to further challenge our own interests.

And I just need to make one point about this macro discussion about China's investment—about China's capital account surplus and China's consequent need or maybe not so great need to rely on U.S. capital markets.

Yes, it's true China is a significant exporter of capital right now. That doesn't mean that China's capital requirements in the future can be handled by the amount of capital that China generates today, which is in surplus.

There is a large capital surplus largely because China has not begun to address these problems, like the unfunded pensions, the full impact of the privatization of state industry, massive unemployment, which will be one result of that.

These are barely on the drawing board, and so, again, in terms of what China spends right now and the capital that China generates, yes, there is a surplus. Yet once China begins to address these immense needs, the capital requirements will balloon, and they will depend very heavily, as Dr. Robinson pointed out, on the American capital market and the American trade account and American foreign investment in Chinese factories, Chinese laboratories, Chinese research, etcetera.

Commissioner LEWIS. Well, the question I asked you I would like to ask the other two people, but I'd like to add one more factor to this. China is trading with the European community to a lesser total dollar amount than they're trading with us. And yet they are buying from the European community far more than they're buying from us.

So our deficit with them—with China is much more than the deficit of the European community, and I don't believe anything in China happens by accident.

Mr. TONELSON. Not much, at least when you're talking about a phenomenon this large.

Commissioner LEWIS. So what's the purpose, unless it's this—the book "Unrestricted War?" What's the purpose of their buying more from Europe than they are from us to build up more American dollars, so they have this greater access to—this leverage over our economy that you referred to, Mr. Preeg? I mean, that's one of the questions.

Mr. TONELSON. I think even more important than that is recognizing that, regarding exports, the United States has clearly been the target of opportunity, because other major targets just don't exist.

And in that connection it's also important to understand that precisely because China's growth prospects are so export-dependent, and precisely because so much of all foreign investment in China is geared toward exporting——

Commissioner LEWIS. Alan, I'm not talking about what they're selling to us.

Mr. TONELSON. Okay. Yes.

Commissioner LEWIS. They're buying from Europe more than they're buying from us.

Mr. TONELSON. I haven't looked at the figures in the last maybe two years.

Commissioner LEWIS. They are. They are.

Mr. TONELSON. But I would certainly take that.

Commissioner LEWIS. See, that's the question is——

Mr. TONELSON. That wouldn't seem to be a product of market forces.

Commissioner LEWIS. That's correct.

Chairman D'AMATO. So there's a difference in the pattern of trade, and the question is, what is the purpose and the——

Commissioner LEWIS. And unless the purpose is——

Mr. PREEG. Well, certainly, I think it is important that we're the most open market on the export side. On the import side, there could be market forces at play.

Commissioner LEWIS. Not when they tell Boeing that if you want to sell us planes, build them here in China.

Mr. PREEG. Well, no, I'm getting to it. The strong dollar vis-a-vis the euro and the yen could be a commercial reason why we don't do as well. But, in addition, China is not an open economy. They do not have a convertible exchange rate. They have a lot more regulations, and it's a much more planned economy, and the government obviously can make a lot of decisions as to where they procure. And that has to do with politics.

So it's a lot more complicated. There may be some market forces at play, and particularly the strong dollar, but there are also—the Chinese government—and I don't know exactly how they go about it—but certainly has a lot more intervention and say in where things are procured.

Commissioner LEWIS. How much credence do you give to what you read in Unrestricted War?

Mr. PREEG. didn't read the book, to be honest with you. I just read excerpts from it. I believe that the book is there and they've been thinking along these lines. But still, it's, as I said, underlined here. It's not something they can do now to disrupt dollar markets——

Commissioner LEWIS. But it's not something we should ignore.

Mr. PREEG. Well, it's potentially there, yes. And that's it, yes.

Commissioner LEWIS. I'd like to ask you that question about—could you answer the question I have, why we should give China this unrestricted access to our markets when these other factors are also considered?

Mr. BOTTELIER. Well, it's U.S. tradition to have open markets, and I believe it's ultimately in U.S. interest and everybody's interest to have markets as open as possible.

Commissioner LEWIS. But if Nazi Germany were alive we shouldn't be trading with a Nazi Germany, should we?

Mr. BOTTELIER. Well, I personally don't believe that China should be compared to Nazi Germany. I don't see the historical parallels, quite frankly. But I think it's a question that ultimately has to be decided at the political level.

If the U.S. is uncomfortable with the very large and still growing trade deficient with China, it may well, for political reasons, decide to do something about it.

But allow me to remind you that this—the deficit with China and Japan is, in part, a function of the overall U.S. deficit. The U.S., as a nation, has a four percent of GDP trade deficit. And that is a function of savings and investment behavior in this country. It is not a function of individual behaviors. The aggregate deficit issue cannot be tackled by artificially reducing the deficit with individual nations.

Commissioner LEWIS. We had Allen Sinai make a report for us, and he said that if our deficit with China went down our total deficit would go down, and it wouldn't be with another country. I mean, this theory that our savings is the reason for our deficit is something that he didn't necessarily buy and he didn't——

Chairman D'AMATO. Wait a minute. I think we're getting way far a field here. We have two more quick questions, Commissioner Mulloy and Commissioner Dreyer.

Commissioner MULLOY. Yes. I just want to go back to that question of the gamble or the—what we're taking here. And Mr. Bottelier and Mr. Preeg, you both were in favor of the gamble, of continuing to integrate—the efforts to integrate China.

The question is—for me is—if you go that direction, are there modifications that you make? Mr. Bottelier, you just said that if we're uncomfortable with the size of the trade deficit we can take measures. One of the concerns is once they're into the WTO any measures we take we have to take consistent with our WTO obligations, which makes it a much more difficult problem for us.

So I'm just wondering, are there—and, Ernie, on your point about the currency manipulation, obviously that's a problem. So are there things that you would tell us, if we stay on this course that you're recommending, that we ought to modify it to deal with problems like that?

Mr. PREEG. Well, again, time is getting late. And definitely there are ways to modify——

Commissioner MULLOY. You could definitely——

Mr. PREEG. There are definitely ways to modify, which is in the trade policy field, totally consistent with open—free and open—fair, open trade investment.

Certainly, dispute settlement—I don't know why we backed off on the IPR and the prison labor. It was early in the Clinton administration, but then as we became strategic partners we backed off. I think Bush should go back and hit it harder, but he's—right now he's got other problems with China, so this hasn't—so I think we should use it.

I'm not sure the dispute settlement procedure in the WTO might help us. We have to pick two or three. We might get the Europeans with us here or there. That's one.

There are big issues of anti-dumping and countervail with China. It's very hard to figure out, but they do subsidize in a lot of respects. So all of these—and the exchange rate manipulation, goodness knows I'm on record that we should—which I think is an important part of our deficit, and it's not just a savings gap, which is a big part, but it's—this is another area.

So there's a number of things we should do in the opening up more effectively, aside from the security-related issues, which are sanctions, but they're limited and it gets more and more difficult as you have—as we go, but there are certainly areas, and there have been two reports the last two or three weeks—one CSIS and one—this other one—showing how we might tighten up in certain ways, or other—this is something that you're going to have to get into.

My own view is that it's kind of limited leverage there, but in certain key areas we've got to make sure we are fully effective in the sanction area, where it's more directly related to national security and their military modernization.

Commissioner MULLOY. Thank you.

Mr. Bottelier?

Mr. BOTTELIER. I think you would do the Chinese a service by holding them accountable for what they have pledged to do. I think the WTO provides a good framework for structuring China's economic and trade relationship with other nations.

WTO provides sanctions on possible misbehavior by the Chinese. You have a dispute settlement mechanism which has some bite, I think, on top of that you have safeguards. I think the safeguards have to be used in a judicious manner, not in an arbitrary manner. Through WTO, the Chinese are locking themselves in a set of rules, that the rest of the world must make use of.

It's not a given that the Chinese will, 20 years from now, be an orderly and normal nation, as you call it. But I think the potential is certainly there. The way other nations are structuring their relationship with China will have some influence on the outcome of the reform process.

I would not artificially restrict Chinese imports outside the rule-based system that the U.S. is also party to, but I would hold the Chinese accountable under the international rules they are signing off on. Definitely.

Chairman D'AMATO. Commissioner Dreyer? And then we'll be done.

Commissioner DREYER. This I think is going to be really quick. It's a question for Mr. Tonelson.

You mentioned the technology leakage—that's my word, but you understand what I mean—between U.S. companies and China. There is a huge Taiwan investment in Mainland China. Are you aware of any way in which Taiwan has tried to restrict the technology leakage out of Taiwan to the mainland?

Mr. TONELSON. Sure. The main policy instrument has been restricting, not prohibiting but restricting, investment by Taiwanese business, and the Chinese—in the Chinese semiconductor industry.

Taiwanese businesses thus far have been restricted from setting up production in China, which it would very much like to do, that's capable of producing chips that meet certain performance standards.

These restrictions, to my knowledge, have been steadily weakened and will be weakened further as the years go by, and Taiwanese businesses have also found ways to go around these regulations that their own government has set up largely to avoid the kind of industrial and technological hollowing out that many people feel has happened to too great an extent in this country.

But when we talk about Taiwan's high-tech production capabilities, I think one thing we can be absolutely sure of is that within 10 years everything Taiwan knows will be known widely in China also. There can be no doubting that whatever.

Commissioner DREYER. Thank you.

Chairman D'AMATO. I want to thank the panel for a very full morning. I really appreciate you all coming. You've done such a good job you might be punished and asked back.

(Laughter.)

But we really do appreciate—what we'll do is we will get to you a copy of the transcript, I guess, so you can take a look at it, if you want to add something or if there are some other questions people have, we might forward them to you and stay in touch with you.

Thank you very much.

[Whereupon, at 12:17 p.m., the proceedings in the foregoing matter went off the record.]

(AFTERNOON SESSION, 1:06 P.M., WEDNESDAY, MAY 9, 2001)

PANEL II

Chairman D'AMATO. We'll reconvene our hearing today.

For the benefit of our panelists, Kate Bronfenbrenner from Cornell is a friend of the precursor commission, the Trade Deficit Review Commission, and carried over to the China Commission. Nick Lardy, who I think testified before the Trade Deficit Review Commission, as did Harry Wu from the Laogai Research Foundation. Welcome.

This is a closed briefing. The purpose of it is to have a candid discussion between the panelists and the Commissioners on the work of the Commission and suggestions by the panelists as to the kinds of lines of investigation and inquiry that the Commission can make to fulfill its mandate.

Its mandate primarily is to assess the economic impact of our relationship between the United States and China on basic security interest of the United States. And it's a connection that has not yet been fully understood and fully made.

And this is a totally legislative Commission to report back to the Congress annually on a range of issues associated with this mandate.

So we will proceed in this way. We'll go for 10 to 12 minutes for each of the panelists, and then—in order, in sequence, and then we will open it up for questions and dialogue by the Commissioners.

So we can just go ahead and start. Why don't we just go from left to right. Harry Wu, would you go ahead and—would you like to begin?

STATEMENT OF DR. HARRY WU, EXECUTIVE DIRECTOR AND FOUNDER, LAOGAI RESEARCH FOUNDATION

Dr. WU. Hi, Mr. Chairman. It is my honor to come back and share my view with you.

In August 1999, I went to the far east of Russia, Siberia. My purpose was going to see the labor camps in Magadan, but I wanted to stop in Vladivostok. You know, Vladivostok is the headquarters of the Pacific fleet of Russia, and I saw these submarines and battleships lined up in the port, because the government has no money for their operation.

And later you heard that Chinese purchased two missile destroyers. Each one cost a billion dollars. And the two missile destroyers right now enlist the PLA navy.

And information tells us that this missile destroyer was designed in the former Soviet Union and intended to attack American aircraft carrier. So, fortunately, the Moscow collapsed. But right now, the destroyer serves in China.

My question is: how does this communist country have such a big currency to purchase these battleships? One communist regime, lack of money; and the other one have a lot of money. I think the money is coming from our pocket.

Today there is a $360 billion investment in China. We'll have a big deficit with trade with this country. So that's why we have to care what is the problem over here.

But don't get me wrong, today I am not going to talk about containment or try to isolate China, try to boycott China. It is impossible. And if anyone suggests, you know, we go back to a cold war to contain this most populous country, how to apply the economy sanction—first of all, this is impossible. Secondly, I don't think this is good policy.

But we really have to examine, what is our real China policy? Should we treat this country as a strategic partnership? Should we only engage with them by money? And should we link the human rights with the trade? Should we forget about the prison labor as it relates to our federal law?

Should we think about that—if we don't go and the Western European will occupy the market? And then, what is the security problem to our country? And what is the current situation today in this regime?

I want to use a sentence from the former Soviet Union, Lenin's words. And this is what he said in 1905. It's a pretty good, you know, quotation. This communist leader is quite smart.

Lenin's words, "Those at the top are no longer able to rule the old way. Those at the bottom do not accept being ruled the old way." So the people in the bottom and the top, both sides are seeking to change. So that's why after Mao Tse Tung died, 1976, the Dejadin say, "Okay. I don't care what is the color of the cat. Okay? Whatever, black and white. If the cat can catch a mouse, it's a good cat."

(Laughter.)

So they even violate their own principle. Invite the capitalism back to China. But they are not going to change their idea. They are not going to change the system entirely. And they told you, "Here's the market. Here are the cheap labor forces."

And all of these men and women are in my control. You can make money. I need your money. I need your technology. I want to maintain myself in a stability situation. And then we went into the Chinese trade and market.

Even the terrible thing that happened in 1989 in Tiananman Square, the Taiwanese, Japanese, Hong Kongnese, American, didn't care about this massacre. They still went over there. And then today the people crave a new concept. This really confused me. The concept is if we put more money, more investment in this country, we engage them with more capitalism.

You know, capitalism sooner or later will defeat socialism, so this is the best way to promote the democracy and human rights in this China. I wonder if this is really a good concept. Suppose Ronald Reagan had to make a reexam—you know, something here is wrong. Right?

Why do we call the Soviet Union "Evil Empire" and we try to—I try to, you know, block them. Okay? Even today, you know, we still embargo Cuba. I remember last year I testified before the Senate. I presented a question to Senator McCain, and McCain right away turned the question to Mr. Scowcroft.

I say, "Why we boycott Cuba?" And Scowcroft's answer is, "Well, Cuba is a domestic issue, because we have a big, you know, Cuban community over here.

Well, it seems to me that people want to sell you the idea. We can convince a wolf to become vegetarian. Okay.

In the long term, suppose this is right—happiness is based on privacy, based on private ownership. I mean, this is the opposite of the communism. If the people have more property and access, probably they will, you know, stay away from these totalitarian systems.

But the problem is, first, what happens to this in China? Who are these rich people, wealthy people? Okay. In New York, in Atlanta, in Houston, you can find many Chinese wealthy—wealthy Chinese. Okay.

I talk to them, say, "Well, you have a Mercedes Benz. You have a big account. You have a luxury house. So you are the capitalist." "Yes, I do. I'm a CEO. I'm the manager." Okay.

But I said, "Wait a minute. You also have a title. You are the member of the Communist Party." I said, "What is this? You're supposed to—should be a partarian. Otherwise, how can you become a member of a party?"

And they said, "Well, I know it, but that's the only way I can get the access—obtain the access. If I'm not a member of the party, I have no way to get these things."

So this is the things you can call—these are state, bureaucratic, capitalism systems. Those people today, yes, they want to protect the access, protect their properties. But they have no interest in democracy and freedom. This is not free capitalism at all.

Okay. The second thing I want to put over here today—our investment today in China actually is high risk. Okay? First of all, you know that our investment in China, any investment in China, when it gains a profit, Chinese are not allowed to transfer their profit back to home country. This is their policy.

Commissioner LEWIS. They do not.

Dr. WU. Do not. Okay. You have to remain over there for reproduction. Maybe get something—some way to get out. Legally, there is not.

Okay. The other thing is, do you feel comfortable that capitalist's capital flew into a communist regime? And in their constitution it's very clear we are state-run enterprises and state-controlled economic countries.

Yes, they do—it does—today they do need your investment, because they need the money for maintaining the people in their family, not on the street. Today foreign businesses hire 20 million employees in China. Forty-eight percent—I mean, 50 percent for the export.

You know, export today is a big income. The profit from export is a big income for the government. Okay. It is coming from foreign business. And their businesses—their state enterprises is collapsing—bankruptcy.

Today, Chinese—four major banks, the Industrial and Commercial Bank, Agricultural Bank, Construction Bank. According to

American standards, they're already bankrupt. Sixty, 70 percent of the loan is a bad loan, never comes back.

They are very interesting. Chinese have a very high deposit rate, and the deposits come from the people. And the deposits go to the loans; the loans go to these so-called state enterprises, and money can—never coming back.

If something happens, the government will only have two ways. One is, okay, announce bankruptcy. Second, to change the rate, and that's the leading to a big crisis. Okay.

A country, just like a bird, okay, if you want a bird to fly upward, they need two wings to cooperate together—the economy and politics. The Chinese want it tied up—the political wing. And using only one wing, do you think the bird can fly upward?

And I want to give another, you know, my view. Communist regime today is, just like a big mansion, okay, this mansion in the first three decades, looks pretty ugly from the outside, because domestically they have no cultural revolution, framings, killing, 30 million people die. And international to export, you know, revolution to Philippines to Thailand. They were involved in a war—Korea War. Everybody hates it. It's a terrible, you know, look from our side.

But this mansion is pretty stable, because the majority of Chinese do believe that Mao is our god. We do believe the Soviet Union today is our tomorrow and communism is our only future. All right.

So don't try to, you know, conflict, try to go against this mansion. It's very stable. But today this Chinese mansion looks pretty nice from the outside, new decorations, new painting, because of foreign investment. Okay. Every time you go to Shanghai, you go to the east coast, to most of the major cities, you see a new five-star hotel, and the people seem pretty wealthy.

Okay. They can purchase hamburger, you know, from McDonald's. Michael Jordan becomes more popular in China today. Okay. Many Chinese know Michael Jordan much better than me.

(Laughter.)

But this mansion could collapse in one second, just like the Berlin Wall disappeared. Okay. Because most of the pillars are rotten, damaged. Today the people include the member of the party. They don't believe in communism. They don't trust the Communist Party. Okay.

The communist regime, just like the Titanic, will hit on an iceberg. Okay. The captain can do nothing about it. The engineer can do nothing about it. It depends on how soon it will sink. So that's why you find out so many Chinese want to escape from China.

Earlier this morning you have talked about the capital move out of China. Okay. A part of them is still in. A lot of people moved out. They are interesting things. These people don't want to make any investments, keep their money in China. And the West will say, "Well, there's a wonderful market. Let's go put money over there."

The Chinese actually are confident of their market. They just want to move it out—themselves and the money. But like—you know, on the Titanic, the first class people, and the third class people are told to get out. They see so many boat people, you know, illegally cross the ocean, risk their lives to come to the United States.

So today the Chinese situation is quite critical. Okay. Let me go back a little bit about the spy plane. Currently, you know, the incident about—do you see this? Like last—two years ago we hit the Chinese Embassy in Belgrade. They organized a protest. This time they prevent a protest. Some comment if you want to do it. The police stopped them, because any mass movement happening today in China—they're very scared about it.

Okay. And another indication—I can tell you about the Falun Gong. You have to know, at the beginning Falun Gong was fully supported by the government. The government looks at the Falun Gong as good, because Falun Gung never talks about politics. Falun Gong never talks about unemployment, never talks about democracy, never talks about freedom. Okay. They always say, "We can, you know, do some exercise, practice, and we will overcome everything."

And they said, "Wonderful. That's good." The country's stability—right, it becomes stable. But later they said, "Well, this is the kind of organization that can—in two different directions in one night under one guy's direction." Put it out. It's just sensitive. Everything is so sensitive for them.

Okay. So at this time I want to say China needs the West much more than the West needs China. For one individual company, maybe yes. For example, Boeing cannot get rid of it, because one of nine aircrafts was purchased by China. Otherwise, the Airbus will go for them. Okay.

Entirely for this country, for the West, I don't think it's—if we get rid of China—for what? Nothing. Not important for us.

Chairman D'AMATO. Two minutes.

Dr. WU. Okay. So in my invitation you asked me to talk about prison labor, whatever. You have to know the forced labor production is an integral part of economic systems. The Chinese prison system—even they don't have a budget.

Okay. The police uniform expenses, their salary, whatever, comes from prison production. Okay. It's a profit center. They offer money, offer revenue, and pay tax to the central government.

So the production from forced labor is never going to stop. This is their policy since 1949. And if the products qualify to export, they definitely do it. They never stop. Okay.

Just a couple of months ago there's a case in New Jersey. Do we know that binding clips in sometime ago, one-third of binding clips in the United States——

Chairman D'AMATO. Binder clips?

Dr. WU. Yes, right here. One-third of the American market is processed by forced labor in China. But we don't care, because this is cheap. So who cares? Who is it—human right? Come on. We're talking about what?

In the last 10 years, from the Bush administration to the Clinton administration, signed two agreements with them. And today we got a new letter from the Chinese government responding to American Customs Service. If next time you want to make any investigation, have to agree with me; otherwise, never.

So it's—we really want to implement the law. What should we do? Okay. The products continue to come to the United States, and under our ignorance——

Chairman D'AMATO. I think we'll have a number of questions on that. Can we wrap it up and then we'll move——

Dr. WU. Yes. Thank you.

[The statement follows:]

PREPARED STATEMENT OF HARRY WU

In August 1999, when I visited Vladivastok, the port for the Russian Pacific fleet, I saw numerous battle ships lined up in the port, out of operation because the Russian government lacks the money for their upkeep. Last year the Chinese Navy obtained two Russian-built missile destroyers. The China Business Times ran a front-page picture of the ship, with a caption that read "The bottom line on the Taiwan question."

My experiences lead me to ask you this question now: where did the Chinese Communist government obtain the hard currency to purchase these battle ships?

How can this be possible in the same country that owes many of its employees in its state-owned enterprises many months—equaling millions of dollars—of back pay? Or in the same country that is the largest recipient of aid from the World Bank?

The money source becomes quite clear when you consider the $360 billion foreign investment and trade flowing into and out of China. The current $70 billion trade deficit that United States has with China makes up a large part of this imbalance. This foreign capital is allowing the Chinese government to upgrade their military. It's that simple. Western capitalism is fueling the Chinese Communist vehicle.

No force on earth could return China to isolationism, and any actor in world politics would be foolish to try to isolate that nation of 1.3 billion. But we must still ask why the West, the United States included, has adopted a kowtow culture in its dealings with the Communist Chinese government. Our relations with China are based on the false idea that the stability of the Chinese Communist Party is necessary for successful political and economic relations with China, and for stability in Asia and international peace in general.

Certainly, having China in the World Trade Organization is in the best interests for multinational corporations. In China, Western companies can take advantage of a cheap, hard-working but oppressed labor force because they do not have to worry about giving workers benefits or dealing with strikes. It is actually good for Western business to have a strong Communist Party as a partner in China because the entire government structure operates to serve the Party's interests. So it follows that Western corporations will benefit from allying with the powers-that-be in China.

Recent history gives us a lesson in the destiny of communist regimes. The most important reason for the fall of communism in Europe was that communism, then and now, does not enjoy the support of the people. It breeds instability. Everyday in China, people are making demands like those made at Tiananmen Square in 1989. Whether they are dissidents who fight for freedom of speech, or farmers who are tired of corrupt local officials, there is a broad discontent among the people of China today. Listening to these people would be a way to bring about stability. It is tragic that this regime refuses to recognize the basic fact that democracy is the best way to stability. It is even more tragic that these abuses continue without any serious consequences in the international arena. But what is a scandal is the unquestioned role that international commerce plays in propping up this brutal regime and actually funding its continued dictatorship.

The Chinese communist government maybe can or maybe cannot resist the trend of democracy and freedom with a combination of economic reform and nationalism. But, if this type of regime continues to exist, it will be a huge factor of instability for international peace—instead of the responsible actor that is presented as a certainty by the commercial interests. If anyone is to dare make predications about China's future, they must have a deep understanding of China's recent past.

Communism in China can be divided into two eras—"Maoist" communism from 1949 to 1979, and "Dengist" communism from 1979 to the present. Much has been made of the differences between the system Deng Xiaoping created and the one Mao Zedong left behind. The biggest of these differences is that Mao never allowed a restoration of capitalism—something which Deng permitted in his later years. Mao would have rather seen China's institutions grind to a halt, as they did during the Cultural Revolution, than cede to the requirements of reform through economic pragmatism. But, in essence, the two systems do not differ. At its core, the Chinese communist system of today relies on the same politics of totalitarian despotism and the economics of public ownership that Mao used to impose his will on China.

The present situation in Mainland China can be best summarized with Lenin's words: "Those at the top are no longer able to rule the old way, those at the bottom do not accept being ruled the old way." In my view, the Chinese leadership is facing precisely this crisis.

One can look at the Chinese communist regime like a mansion. Two decades ago, this mansion looked horrible. On the inside, there was the disastrous "Great Leap Forward" and the 30 million deaths from the resulting famine, ceaseless political movements and campaigns, and the Cultural Revolution that inflicted immeasurable and indescribably sufferings to all strata of China's people. Externally, there was "exportation of revolution" in the form of support for North Koreans, the Vietcong and the Khmer Rouge. All this ugliness gave the false impression that the mansion, the communist regime, was losing popular support and was in danger of collapse. Actually, it was relatively stable. Why? Because most people in Mainland China at the time had faith in the communist party and followed Mao Zedong steadfastly. It was a kind of religion and Mao was the new emperor, entrusted with the Mandate of Heaven. Mao himself and the propaganda machine of the CCP had almost completely indoctrinated the Chinese population with the myth that "Communism is China's only future."

Following Mao's death, the Chinese Communist Party faced the "crisis of three distrusts": distrust in the tenets of communism, distrust in the communist party, and distrust in the socialist way. Deng Xiaoping understood that the only way to cope with the conflict between the "hard-dying old practices" and the loss of trust in the Party was to change course; otherwise the communist dynasty would crumble into historical obscurity. We may recall that in Deng's early years in Paris, he boasted that while his comrades were engaged in loud and empty talks about theories of revolution, he would rather "do something practical with his mimeograph." So at the time he became China's post-Mao leader, Deng put forward his often quoted doctrine of "White Cat, Black Cat"; he said, "It doesn't matter if the cat is black or white, the saying goes, as long as it catches mice." So rather than dismantle the communist apparatus, Deng revived it by making incremental changes like releasing farmers from the disastrous people's communes and by introducing foreign capitalism and technology.

Deng knew his history. In the cyclical progression of Chinese history, whenever feudal dynasties faced large-scale peasant insurgencies, widespread calamities, or social turbulence, they would replace "high-pressure policies" with "policies of compromise," by either pardoning prisoners throughout the nation or exempting peasants from taxes for three years to loosen the yoke. The people, granted some temporary breathing room, saw in the emperor a wise ruler once again. In short, Deng designed his policies of reform and openness, not for the people and the nation, but for the survival of the communist power. The present leaders continue Deng's step-by-step economic changes to placate the restless Chinese people, but they are totally unwilling to begin the political reform that would lead to the empowerment of those same Chinese people to organize against the Communist Party.

We must see that the continuation of the communist power is a source of latent disaster. Before this fundamental problem is solved, any economic prosperity and social relaxation lack a stable foundation. It is an extremely dangerous tendency to attribute certain degrees of economic growth and rise in standard of living to Deng and the Communist Party, and to claim that the continued one-party rule is the only possible way for China to progress.

First, this serves the political propaganda need to legitimize the Chinese Communist Party, and helps communism, elsewhere cast aside on our planet, to survive miraculously in China. Second, time and time again, this confuses right and wrong, and sings in refrain the servile view that "emperors create all." To sing in praise of Deng Xiaoping and his successors, another group of dragons hovering over the Chinese people, is to curb the development of democracy and freedom in China. In short, it is the Chinese people, and not their rulers, that must be given credit for the changes that have occurred in China. While the Chinese people have been signaling the need for change from below, the leaders, as expressed in the Chinese Constitution, have continued to insist that "Under the leadership of the Communist Party of China and the guidance of Marxism-Leninism and Mao Zedong Thought, the Chinese people of all nationalities will continue to adhere to the people's democratic dictatorship."

To return to my story of the mansion, this mansion's pillars—the popular support needed to hold up the regime—are essentially rotten, and the timing of its collapse will be as unpredictable as that of the Berlin Wall.

It is the communist party itself that is causing the decay. First, this regime will never grant its people the degree of self-determination and freedom needed for true social stability. The foundation of despotism laid down by Mao remains the state ideology. It is still regularly reinforced and even celebrated by the current rulers of China. While the statues of Lenin and Stalin have been taken down in the former Soviet Union, the giant portrait of Mao still looms over Tiananmen Square.

To the present day, the Chinese government maintains the largest forced labor population in the world within the walls of its Gulag system—the Laogai. In 1960 I was swept up with tens of thousands of others who dared to criticize some aspect of Party policy, and forced to spend nearly twenty years contributing my labor to this machine. Even though ratios of political prisoners in the Laogai have lowered over the years the fundamental principles that it was founded upon remain unchanged. It is a mechanism of forced labor and a tool for maintaining totalitarian control in China.

Western leaders must also remember that according to Chinese national policy, the Laogai remains an integral part of China's economy. Regardless of how small or large of a percentage of GDP is vested in the Laogai, it is this part that is born on the backs of prisoners, with the cost of labor reduced to zero. Over the past decade the Chinese government has successfully rendered useless the two bi-lateral agreements barring the import of forced labor products into the United States. After nine years of incompliance on the part of Chinese officials, the State Department reports that these two agreements are unenforceable. Last year the Chinese Ministry of Justice even went so far as to issue a statement proclaiming, and I quote, "the sovereign right of the Chinese government to investigate claims of forced labor without U.S. interference," and recommending the U.S. Customs Service cease its requests for visitation of prisons suspect of importing their products to the U.S. This letter was released only months before the verdict was issued in a case in New York involving the importation of binder clips that were assembled by Chinese prisoners. In keeping with the inability of U.S. agencies to enforce forced labor legislation, the investigation of this case was initiated by The Laogai Research Foundation. This investigation proved that before the seizure of these binder clips from various U.S. ports, at least one-third of all binder clips available in the United States were the product of Chinese forced labor. There is little doubt that other such examples are readily available but due to the efficiency of Chinese leaders and business at hiding such transactions, U.S. consumers remain unaware.

At root, China's economic reforms have created no "miracle" at all. If there is any miracle, it is in how the regime and its collaborators have won acceptance for the illusion that the West should continue to fuel this socialistic economic boom through an enormous flow of trade, investment, technology, and other forms of aid, some from multilateral agencies underwritten by capitalist nations. The noblest rationale for this strange exercise is that it will—somehow, sometime—serve to transform China's tyrannous system. It is a nice wish. But let's look at the record of the Chinese Communist Party. This Chinese Communist strain of capitalism serves to continue Party rule; it will not, cannot, foster human rights or democracy in China.

Although seemingly going strong as China's economy does year after year, it is really fragile, the danger of economic collapse escalating with each passing day. Western investors are not morally thwarted by the brutal nature of the communist regime that was fully exposed during the Tiananmen Massacre of 1989. On the contrary, Western investments are skyrocketing, reaching a record high of $36 billion at the time I am writing this essay. Needless to say, the Beijing regime needs this "capital transfusion" badly. As a matter of fact, thanks of Western commerce, the Beijing government possesses abundant funds for strengthening its military might and its control of the people. In this sense, the regime's stability depends heavily on Western investment and trade.

But, China's economy is lopsided. First, coastal cities in Eastern China, appearing prosperous due to Western investments and trade, are totally out of line with rural areas. The peasantry who comprise 80 percent of China's astronomical population, live where the issue of land ownership, one of China's ulcers in its clumsy power structure, is far from solved. Local communist bureaucrats and villains are intensifying their ruthless exploitation of peasants who, facing a shortage of funds and a production ecology crippled by the communist system, are ever less motivated in agricultural production. Actually, with the cost of agricultural products rising, with peasants virtually denied access to subsidiaries allotted to them, they are unable to engage in large-scale production. As a result, peasants are flooding into urban areas in mighty streams, hoping to find meager jobs left over by townspeople. The lack of gainful employment for these millions of peasants is breeding social unrest in both the rural areas where some stay and struggle with a subsistence farmer's life against Party oppression or in the urban areas where the local labor markets cannot absorb all those who seek work but face Party disregard.

Second, China's state-owned enterprises are strangling its economic veins. Suppose the central government gets rid of them, the very action would make 14–20 million workers unemployed and thus send forth shock waves throughout the nation. Or, close down all state-owned enterprises, which are highly effective destroyers of social wealth. To be frank, pay normal wages to their in-home employees that would actually be a cheaper way out than keeping the enterprises running. But, with private enterprises replacing state-owned ones and occupying all economic spheres, that would rob the communist regime of its Marxist theoretical and legal basis—public ownership of vital means of production. Mention must be made to the role state-owned enterprises play as the chief channel for communist bureaucrats to appropriate wealth and line their pocket with state-owned funds. This way, by far overshadowing petty moonlighting embezzlers, communist bureaucrats are raking in huge spoils—legally, in all levels.

What an irony communist revolution is turning the other way—unlike early-period idealistic communists who converted private property into state-owned, modern communists are turning state-owned property into their own, and legally, and pipe their spoils overseas. This is why we see sumptuous real estates and businesses owned by communist nouveaux riches—in Hong Kong, in Europe and in America. That is why the Western investors see partnering with the Party as the real motivation in supporting the "Party is China's future" manta.

Third, China's financial system is virtually bankrupt. China's primary commercial banks, the "Big Four", allot 80 percent of their loans to state-owned enterprises and can hardly expect to reclaim them. With no profits to reap, three of the Big Four—China Industrial and Agricultural Bank, China Agricultural Bank and China Construction Bank—have more debts than assets. For various social reasons, the savings rate in China is as high as 40 percent. Deposits from the people equal about $600 billion—comprising 60 percent of bank funds—and is the main source of loans allotted to money-losing state-owned enterprises. This actually chokes potential economic growth and job creation and gives impetus to a huge latent financial crisis. True, the Chinese government claims its foreign-currency reserve of $1.2 trillion and a favorable trade balance of $50 billion can enhance people's faith in the financial system. In reality, people's faith is offset by the government's huge foreign debts and capital outflow. Once bank customers lose their faith in the government system, the government has no choice but to resort to currency depreciation and closing down banks. Both are poor choices which could lead to a huge political crisis.

Fourth, in China today, nearly one half of export opportunities (American dollars earned in external trade are an indispensable part of the Chinese government's revenue) are offered by foreign-invested enterprises. These foreign-invested enterprises create one tenth of job opportunities in a time when unemployment rate in Chinese cities runs are high as 20 percent. This is the bubble economy phenomena people witness in China's coastal cities these days.

The West seems to be in utter need of China's huge market with its 1.3 billion population and cheap laborers controlled by a totalitarian regime. Hence, it wishes to see that regime and society stable, and expects its investments will rake in steady profits. This coincides with the Beijing regime's political slogan "Stability overrides everything".

China, which grows ever more dependant on Western funds and technologies, needs the West more than the West needs China's market. This could have provided leverage for promoting democracy and a free society in China. What a shame human rights were delinked with trade, and China policy was reduced to classical appeasement in one capital after another.

One of the reasons why China suddenly and hypocritically expressed its "urgent desire to join WTO" was that the slowing of foreign investments in 1997–1999 was a terrible blow for China. Reaching an agreement with the United States on WTO issues would be like a cardiac stimulant. To win over certain U.S. political groups' support, Zhu Rongji the premier was sent to the United States. Beating his breast, he vowed that American agricultural products, fruits and grains included, would be given free access to Chinese market. In fact, the Beijing regime was fully aware of serious WTO consequences in China's economy and politics. And, in his internal State Council speech of August 29, 2000 Zhu said: "American fruits and grains into our market? Sheer day-dream!" It can safely be said that Beijing is not anxious to join WTO. Even if one day it does join, China will "play slow-motion Taichi", putting as many roadblocks as possible—to slow down the "WTO vehicle", even to force it into U-turn. How absurd and naive of the West to presume that WTO could make profits by forcing China into the international track, that WTO, coupled with Western investments, could eventually change China's leaders onto a path of freedom.

China's leaders know true economic freedoms or political freedoms is a direct threat to their continued rule. The illusion that money can change the communistic despotic regime is as absurd as the attempt to make the wolf vegetarian.

Judging on politics alone, Western investments are highly risky in China. China's stated ideology is still bent on exterminating capitalism—a life-long goal it will never give up—and continuing down the socialist road. As Deng Xiaoping said, the cat can change its color—white or black, but it's still a mouser. This can be translated as "Today, I need your money and technologies for consolidating my domination. Of course, you can make some money, but I won't give up Communism." Has anybody heard Jiang Zemin or any of his potential successors say he intends to give up communism and to gradually build up a free and democratic society?

Many Western politicians and scholars do not believe that China will become a free democracy in the foreseeable future. This seems to be plausible—judging by China's history, culture, traditions, etc. But this does not mean that the Chinese will not demand freedom and democracy, nor does it mean that communism should exist forever. True, in a nation like China with its huge manpower but used to authoritative politics, nationalism, feudal rule and governed by the communist party, not only will human rights conditions remain deplorable, and its politics increasingly corrupt, but its economy will never be instantly prosperous. Nor will it fulfill its potential without corresponding political reforms like an independent justice system, free media and academic discourse and direct election of accountable officials. Internationally, China will be a factor of instability as it struggles through the contradictions its political leaders have created.

Of course, China's history is written by the Chinese people, but in today's global environment, international political and economic pressure can play an important role. The international community must tell China clearly: we expect to see a peaceful, prosperous, free and democratic China, not a prosperous and stable communist China. Peace and prosperity are possible only when human rights, democracy and freedom are respected.

Chairman D'AMATO. Mr. Lardy?

STATEMENT OF NICHOLAS LARDY, INTERIM DIRECTOR AND SENIOR FELLOW, FOREIGN POLICY STUDIES, THE BROOKINGS INSTITUTION

Mr. LARDY. Thank you very much for inviting me to appear before you today. I want to just quickly review China's trade performance and say something about WTO and the bilateral U.S.-China economic relationship.

Chairman D'AMATO. Talk into your microphone a little bit more.

Mr. LARDY. I think most of the members of the Commission are aware of the fact that China's trade has been growing extremely rapidly. When reforms began more than 20 years ago, China was simply not a significant trading country. They were about the 30th largest trading country in the world. Last year they were number seven.

Their trade has grown more rapidly as a share of world trade than any other country in the post-World War II period. Secondly, of course, they've also attracted massive amounts of foreign investment, foreign-directed investment—that is, investment coming in the form of plant and equipment. The amount currently is something on the order of about $350 billion U.S., which——

Commissioner WALDRON. Is that for all, or just U.S.?

Mr. LARDY. No, that's globally. That's from all sources. China alone accounts for about one-third of all foreign-directed investment in all emerging markets combined.

If you look at it in——

Commissioner LEWIS. Excuse me. You said 350 is the total foreign investment in China?

Mr. LARDY. Yes.

Commissioner LEWIS. Globally.

Mr. LARDY. $350 billion is the total direct investment. I'm not counting——

Commissioner LEWIS. Not U.S.

Mr. LARDY. Not the U.S., no, it's from all sources.

I think China ranks third now as a site—as—number one as an emerging market; it's number three globally as—after the United States and the U.K. as a site for foreign investment.

Now, these two things—the trade growth and the investment—are actually very closely interrelated. The share of exports that's being produced by foreign-invested firms has steadily increased over the last decade and a half. In 1985, one percent of the exports were produced by foreign-invested firms. In 1990, it was 12½ percent. And last year it was 48 percent.

So, basically, half of everything that they're selling into the international market is being produced by international firms. Essentially, China has become the preeminent producer of low-cost, labor-intensive goods.

I think that this is likely to continue. You see more and more companies that are moving their manufacturing to China—a combination of relatively low wages, relatively high productivity workers makes it a very attractive site.

So you see more and more companies, particularly companies in Asia, whether they're in Japan or Hong Kong, Taiwan, South Korea, have moved their production and will continue to move their production.

So I think as long as they remain open to foreign direct investment, and they maintain political stability and are seen as an attractive location for foreign direct investment, China's trade is likely to continue to grow at a multiple of the growth of world trade. Their trade, since the late 1970s, has been growing at about five times the rate of world trade.

I'm not sure it can continue at five times the world rate forever, but it certainly can continue at four, three, or at least twice the rate of the world trade for a number of years. So that its share is going to continue to go up. It could easily be the case that within a decade China might be the second largest trading country in the world, only after the United States.

In other words, the factors are in place that could lead to that result. In any case, I think it's likely that their share will go up and their importance as a trading country will go up.

So that's kind of the background global situation. Let me turn, secondly, to the bilateral trade relationship. I've talked with some of you about this in the past. China has become a very large market for U.S. companies. I think it's now the eighth largest market for U.S. companies.

It's a big market for aircraft, fertilizer, computers, and a lot of other kinds of capital-intensive goods that are produced, and it has become a major source of supply for labor-intensive goods coming into our market, things such as footwear, toys, sporting goods, apparel, and, increasingly, consumer electronics.

So there's a very large two-way trade flow. It is obviously very imbalanced, and I think it's likely to become more imbalanced over time. That is a virtual certainty. But because of the fact that so much other—so many firms from so many other locations are moving their production to China, so we're not buying the goods from Korea or Japan or Hong Kong or Taiwan. It's coming from firms of that nationality that are now being produced—where the products are now being produced in China.

The trade deficit in China is going to continue to go up, even though our exports to China, as I've indicated, have grown quite rapidly. They've tripled, actually a little more than tripled in the decade of the 1990s.

I'd like to turn, third, to say a little bit about WTO compliance. I think this—when China does come into the WTO, I think this will become a significant issue. Obviously, China will never be able to comply fully on day one with everything that they are signing up for in Geneva in the multilateral process. But I would make two points.

I think, first of all, they have made massive efforts over the last two years, particularly since the fall of 1999 when they concluded their bilateral agreement with the United States, they have made massive educational efforts to make various sectors, industries, and so forth, in China aware of what China's WTO obligations are, what the implications of them are, what kind of adjustment will be required on the part of domestic firms.

Many domestic firms, of course, have gotten the message they're going to have to increase their productivity or shrink once China comes into the WTO. So they are laying the groundwork at least for—so that their firms know what's coming and there is some possibility that they will be able to comply.

The second thing I would say on compliance I think is very important and not at all understood, and that is that since China concluded its bilateral agreement with the United States in the fall of 1999, they have made very substantial tariff cuts. They have made the tariff cuts basically that were specified in the bilateral agreement, but the—just let me say what they were.

They have cut tariffs on more than 4,000 tariff lines in January of 2000 and January 2001. That's about 60 percent of the total of all the tariff lines in their tariff schedule, so 60 percent of all import tariffs have been reduced at least marginally.

The average tariff has gone down by more than 10 percent. They have basically implemented the commitments that they made in the November 1999 agreement with the United States, even though they are under absolutely no legal obligation to implement those until they actually come into the WTO.

Remember, when the agreement was assigned, the assumption was that China would come in rather quickly and the tariff schedule cuts would be implemented. But they haven't gotten in for a whole variety of reasons, but they are, nonetheless, unilaterally instituting these tariff cuts.

And it is important to remember that if, at the end of the day, for whatever reason, they don't come in, they are completely free to raise the tariffs back up to what they were before. The key thing about the WTO and one of the reasons I think it's so important is that China, in its WTO commitments to the United States, agreed to bind all of its tariffs—and "bind" is the WTO word—that simply says that China is forgoing the right to ever raise these tariffs at any point in the future.

So it basically—the binding process makes the tariff reductions—or makes the tariff reductions a one-way street. You can never go back. So what they've done in the last two years I think is interesting, because I do think it suggests that the leadership is continuing to use WTO obligations as a lever for promoting domestic reform.

It's telling domestic firms, "You're going to have to be competitive and reduce your costs, or shrink your firms." And we're not going to give you the benefit of the fact that our entry into the WTO has been delayed by a couple of years. We're going to hold your feet to the fire, so they are using it to accelerate the pace of reform domestically.

So just in conclusion, on the compliance issue, I think it will be difficult for China to comply with everything and every detail on day one, but I do think they're making substantial efforts to do so. They certainly are cutting tariffs and taking other steps that suggest a commitment to move ahead and fulfill the obligations that they sign up for once the deal is completed.

I'd like to conclude just with a couple of comments on the whole question of leverage. I know this is kind of at the heart of some of the things that the Commission will be looking at.

I would—maybe in contrast with Mr. Wu, I would argue that this economic relationship, particularly between the United States and China, is one that I would characterize as mutual interdependence. I do not—or I would argue against the idea that China is far more dependent on the relationship than we are.

It is true they are selling more to us than we are selling to them, but we are benefiting from their—and consumers are benefiting from much lower cost items of the type that I mentioned. And so to cut off those imports would impose very substantial costs on U.S. consumers and would not create very many jobs in the United States, because the next lowest cost producer is not in the U.S. for these goods. It's to go back to other places in East Asia and perhaps Southeast Asia.

The other thing I would say on the financial side is that it's very important to keep in mind that even though China has attracted massive amounts of foreign-directed investment, it does not need foreign-directed investment to finance its development. China has the highest savings rate of any country in the world, has had consistently over the past two decades.

Their savings rate is in excess some years of 40 percent. It generally runs 38, 39, 40, 41, 42 percent. You know, that's roughly three times what our savings—our two to three times what the U.S. savings rate is.

So they don't need—I mean, if you look at other countries in Asia that have big capital inflows, those inflows allow them to add three or four, five percentage points to their rate of investment. This is simply not the case in China.

What is has allowed the Chinese to do is to invest abroad at their foreign exchange reserves, and so forth. So that in the pure financing sense, they don't need access. They don't need foreign-directed investment, and they certainly don't need access to international capital markets, simply from a financing point of view.

What they do need, of course, is to some extent they need the technology that is embodied in the foreign direct investment, and what they need on the non-direct investment side—but on the equity side—is they need the improvements in corporate governance that come with selling shares on the market, you know, where you do start to create a system that enforces improvements in corporate governance.

So there are some gains that they get from participating in——

Commissioner BRYEN. Even with 10 percent?

Mr. LARDY. Pardon?

Commissioner BRYEN. Even limiting the amount people can invest as much as they do limit it? Does that make a difference?

Mr. LARDY. Is the question, would limiting the amount——

Commissioner BRYEN. If you can only buy a tiny share and you can't repatriate it anyway, how do you change corporate governance?

Mr. LARDY. Well, I would disagree again with Mr. Wu on the question of whether or not you can repatriate profits. I don't know of any significant American company that is not able to repatriate profits. They have had convertibility on the current account, which means you can repatriate profits, at any time if you have a vote of the board of directors.

So the only companies that may have difficulty in repatriating profits are the foreign partner not being able to take money out.

Chairman D'AMATO. Let's hold our questions until the end. Let him finish. We're almost done.

Commissioner DREYER. But could Nick finish his sentence? I'm interested in——

Chairman D'AMATO. Sure. Yes, he can finish his sentence, of course.

Mr. LARDY. So, I mean, there's a very productive interrelationship in terms of both foreign direct investment and the equity investment, but it's not purely a financing issue. They're getting other things out of it, but their rate of investment is going to be high, given their relatively high rate of savings.

And I personally don't think that cutting China off from U.S. capital markets would have any effect on their rate of growth or any other aspect of their economic performance. Most of the money they're raising, in fact, is in Hong Kong, and U.S. institutions can purchase securities on those markets if they're closed out of the U.S. market.

So I am basically skeptical, I would say, of the idea that somehow we have a great deal of leverage. We certainly have some leverage, but I don't think we have any leverage whatsoever that we could exercise without imposing very substantial costs on ourselves.

Chairman D'AMATO. Thank you.

[The statement follows:]

PREPARED STATEMENT OF NICHOLAS R. LARDY

ISSUES IN CHINA'S WTO ACCESSION [1]

In the course of the 1980s and 1990s China emerged as a major player in the global economy, indeed no other country has ever expanded its role so rapidly. Its foreign trade increased explosively, from about $20 billion in the late 1970s to $475 billion in 2000. After China's inward looking Cultural Revolution decade (1966–1976) drew to a close, China's trade began to grow dramatically faster than world trade. By 2000 its share of total world trade had sextupled as compared with 1977 and as early as 1995 China had become one of the top ten trading countries in the world.[2] Simultaneously China attracted record amounts of foreign direct investment. For much of the decade of the 1990s China was the world's second largest recipient of foreign direct investment, following only the United States. By the end of the 1990s the total stock of foreign direct investment in China accounted for almost a third of the cumulative foreign direct investment in all developing countries. Cumulative foreign investment in China far exceeded the total stock of foreign direct investment in countries such as Mexico and Brazil, which opened their doors to foreign direct investment decades before China.[3]

Less noticed, Chinese firms also have become major investors abroad. As early as the mid-1990s China was the largest outward investor among developing countries and the eighth largest supplier of outward investment among all countries.[4] Finally, China raised significant amounts of capital on international bond and equity markets. Initially most of the funds were raised by the sale of sovereign bonds, but by the latter part of the 1990s major Chinese companies sought listings and raised billions of dollars on overseas equity markets. China Mobile (Hong Kong), PetroChina, Unicom, and Sinopec together raised more than $15 billion through equity sales in New York and Hong Kong in 2000.[5]

Despite this extraordinary performance, China remained in certain respects only shallowly integrated into the world economy.[6] High tariffs and an array of nontariff barriers meant that some critical sectors of the Chinese economy remained relatively insulated from international competition. More generally, the state controlled imports by limiting both the type and number of companies authorized to carry out international transactions; imposing onerous inspection and safety licensing requirements on imports; developing technical standards designed in part to protect domestic industries; discriminating against foreign goods in government procurement, and imposing high local content requirements on foreign and joint-venture firms producing in China. And certain sectors of the economy, such as distribution, telecommunications, and financial services, remained entirely or largely closed to foreign direct investment.

Shallow integration also was reflected in the extraordinarily important role that foreign firms played in China's foreign trade. Foreign firms began to establish operations in China following the passage of a joint venture law in 1979 and the cre-

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[1] This statement has been adapted from sections of: Nicholas Lardy. *Integrating China in the Global Economy*, Brookings Institution Press (Washington, DC: forthcoming).

[2] The World Trade Organization ranked China as the world's 11th largest exporter and 12th largest importer in 1995. Based on the sum of exports plus imports China ranked 11th and Hong Kong ranked 8th. But the WTO's ranking of exporters includes reexports of goods produced in other countries and its ranking of importers is based on gross imports, including both those retained for domestic consumption and those that are reexported. But more than four-fifths of Hong Kong's exports are reexports, either goods produced in China that Hong Kong companies sell to other markets or goods produced in other markets that Hong Kong companies sell to China. When countries are ranked by the criterion of the sum of exports that they produce plus imports that they consume, in 1995 Hong Kong falls out of the top ten and China ranks 10th among the world's trading nations. World Trade Organization, *Annual Report 1996* (Geneva, 1996), p. 24.

[3] World Bank, *World Development Report 1999/2000: Entering the 21st Century* (Washington, 1999), p. 38.

[4] World Bank, *China Engaged: Integration with the Global Economy* (Washington, 1997), p. 26.

[5] PetroChina is China's largest oil producer, Sinopec (China Petroleum and Chemical Corporation) is China's largest petroleum refiner and chemical producer, China Mobile (Hong Kong) is the largest mobile phone operator in China. Prior to May 14, 2000 China Mobil (Hong Kong) was named China Telecom (Hong Kong). The change in the name followed the legal restructuring of the parent, China Telecom, discussed in note 8 of chapter 3. Joe Leahy and Richard McGregor, "Sinopec Joins List of Giant Chinese Privatisations," Financial Times, October 19, 2000, p. 20. Rahul Jacob, " Giving Wings to the Tiger," Financial Times Survey, China, November 13, 2000, p. IV.

[6] Susan L. Shirk, *How China Opened Its Door: The Political Success of the PRC's Foreign Trade and Investment Reforms* (Brookings Institution Press, 1994).

ation of four special economic zones on the southeast coast in 1980. Naturally, the initial contribution of these firms to China's exports was quite modest. Not until 1985 did their share of total exports exceed 1 percent. But, as foreign investment continued to grow, the share of exports produced by foreign-invested firms expanded, exceeding 10 percent by 1990. By 2000 foreign invested firms, which accounted for only about one-eighth of all manufacturing output, were responsible for almost one-half of all of China's exports.[7] But these exports were assembled or processed largely from imported parts and components, so their rapid growth created only a limited demand for inputs produced by domestic firms. Thus to a certain extent a large part of the foreign invested sector could be regarded as something of an enclave, with limited linkages to the domestic economy.

The WTO Decision

Given the rapid growth of the Chinese economy after 1978, the explosive growth of its trade, and its ability to attract record amounts of foreign direct investment, it is not immediately obvious why China's leadership came to view membership in the World Trade Organization as central to the country's economic future. Given the apparent success with what might be called shallow integration, why did the leadership decide to incur the costs of a much deeper opening of the economy to international trade and investment? This question is all the more puzzling because the scope and depth of demands placed on entrants into the formal international trading system have increased substantially since the formal conclusion of the Uruguay Round of trade negotiations in 1994, which expanded the agenda considerably by covering many services, agriculture, intellectual property, and certain aspects of foreign direct investment. Since 1994, the international community has added agreements covering information technology, basic telecommunications services, and financial services. WTO membership now entails liberalization of a much broader range of domestic economic activity, including areas that traditionally have been regarded by most countries as among the most sensitive, than was required of countries entering the WTO's predecessor organization the GATT.

The terms of China's protocol of accession to the World Trade Organization reflect the developments just described and more. China's market access commitments are much more far-reaching than those that governed the accession of countries only a decade ago. And, as a condition for membership, China was required to make protocol commitments that substantially exceed those made by any other member of the World Trade Organization, including those that have joined since 1995. The broader and deeper commitments China has made inevitably will entail substantial short-term economic costs. These costs will be reflected in rising rates of unemployment in sectors that will shrink as they face increased international competition, both from imports and from goods and services provided by foreign-invested firms in China. The efficiency gains from restructuring the economy can be anticipated to be significant but, since they will require the reallocation of both labor and capital, are achievable only in the medium and longer term. Political leaders rarely are willing to impose high short-term economic costs in order to reap benefits in the medium and long term. Why does China appear to be an exception?

The answer to this question perhaps can not be fully known to external observers, but several pieces of the answer appear clear. Perhaps the most important background factor is that the regime, over the first two decades of economic reform, increasingly has staked its legitimacy on its ability to deliver sustained improvements in consumption and living standards of the Chinese people. While China's leaders have hotly debated many of the details of economic reform, there appears to be a nearly unanimous view that economic growth is the sine qua non for staying in power. Appeals to ideology, so characteristic of the Maoist era, are long gone. Appeals to nationalism have increased, but are distinctly secondary to appeals to economic self-interest. Against this background, several factors suggest that the leadership has accepted the stiff demands of the international community in an attempt to continue its ability to deliver rising living standards to the population.

The Chinese leadership has increasingly come to the view that one of the principal benefits of becoming a member of the World Trade Organization is the increased competition it would bring to China's domestic market. Increased competition is seen as an essential additional source of pressure on state-owned banks and

[7] Value-added by foreign manufacturing firms (including those from Hong Kong, Macao, and Taiwan) in 2000 was 533.3 billion of total manufacturing value-added of RMB3,957 billion. National Bureau of Statistics, "Statistical Communique of the People's Republic of China on the 2000 National Economic and Social Development," February 28, 2001 (http://www.stats.gov.cn/english/gb/gb2000e.htm (April 26, 2001).

enterprises, forcing them both to undertake badly needed structural reforms.[8] By the time of his trip to the United States in April 1999, Zhu Rongji was openly articulating the view that China's membership in the World Trade Organization could be a lever for promoting domestic economic reform. At his joint press conference with President Clinton in Washington Premier Zhu stated "the competition arising (from WTO membership) will also promote a more rapid and more healthy development of China's national economy."[9]

More profoundly, it appears that China's top leadership in the wake of the Asian crisis came to believe that there was no viable alternative to the globalization of production and that, indeed, China would benefit from greater participation in the trend. They recognize that globalization means that production of an increasing range of goods is global rather than national. While complex products such as automobiles, aircraft, computers, and telecommunications equipment are assembled in only a few locations, the parts and components for these goods are made in many locations throughout the world, based on comparative advantage. The Chinese have come to realize that their liberal foreign investment regime and low-cost labor markets give them a wonderful opportunity to participate in these cross-border production networks, and that deeper participation in these global networks could provide a new and sustainable base for the continued growth and development of their domestic economy.

But the Chinese leadership has also come to realize that participation in an increasingly globalized economy requires not simply drastically reduced tariffs, but also the development of a market economy. In the words of Long Yongtu, Vice-Minister of Foreign Trade and China's chief global trade negotiator, "Countries with planned economies have never participated in economic globalization. China's economy must become a market economy in order to become part of the global economic system, as well as to effectively participate in the economic globalization process."[10]

These lessons have been reinforced by the fact that economic growth in China, though still strong by developed country standards, has been slowing considerably. China's headline figure for GDP growth declined steadily for seven straight years during the mid to late 1990s. As China's GDP growth has declined, the official numbers have come under closer scrutiny as many observers, both within China and abroad, have begun to suspect that China's GDP growth has been overstated during this period and that real growth in the economy has been markedly slower than the official figures reflect. Added to this skepticism is the fact that China's state-owned enterprise sector, which comprises the backbone of the domestic economy, has become increasingly inefficient and debt-ridden as enterprises are constrained by substantial pension and social welfare obligations, even as they have continued to operate at a loss and produce and accumulate large inventories of unsaleable goods. China was spared the worst effects of the Asian crisis due to its closed foreign exchange policies and large forex reserves, but the crisis served as a wake-up call to the Chinese leadership because many of China's large state-owned firms and financial institutions exhibit the same symptoms as those of Korea and some other nations affected by the crisis. The leadership in Beijing came to realize that economic reform and developing a market economy is a "reform or die" proposition, and that the risk of failure could well be their own economic crisis.

Summary of Commitments

China's commitments to further open its economy in order to gain membership in the World Trade Organization are sweeping. They include significant reductions in tariffs that will bring the average level to under 10 percent by 2005; the introduction of a tariff-rate quota system that brings the tariff rate for key agricultural commodities, such as wheat, almost to zero for a significant volume of imports; the gradual elimination of all quotas and licenses that have restricted the flow of some imports; a substantial reduction in the use of state trading as an instrument to control the volume of imports of agricultural and other key commodities; and the opening of critical service sectors such as telecommunications, distribution, banking, insurance, asset management, and securities to foreign direct investment. In addition, the protocol governing its accession sets forth China's commitment to abide by international standards in the protection of intellectual property and to accept the use

[8] Edward S. Steinfeld, "Beyond the Transition: China's Economy at Century's End," *Current History*, Vol. 98 (September 1999), pp. 271–75.

[9] The White House, Office of the Press Secretary, "Joint Press Conference of the President and Premier Zhu Rongji of the People's Republic of China," April 8, 1999 (http://www.pub.whitehouse.gov/un/uri-res/12...n:pdi://oma.eop.gov-us/1999/4/9/3.text.1 [April 9, 1999]).

[10] Long Yongtu, "China and Economic Globalization," People's Daily, July 10, 2000 (http://www.peopledaily.com.cn [August 1, 2000]).

by its trading partners of a number of unusual mechanisms that could be used to reduce the flow of Chinese goods into foreign markets.

Implications of China's WTO Entry

While the likely immediate economic gains in the form of increased Chinese imports as a result of reduced tariffs and nontariff barriers may have been somewhat oversold, there is little doubt that China's entry into the World Trade Organization is a landmark event for at least three reasons. First, China's membership commits it to comply with the principles and rules of the international trading system. China was far and away the largest trading country outside the system; its participation is essential for the future effectiveness of the World Trade Organization. Second, China's commitments are a lever its reform-oriented leadership can use to complete the transition to a more market-oriented economy. The strategy of relying on increased international competition to induce domestic firms to improve their efficiency is not without both economic costs and political risks. Even if the strategy is successful there inevitably will be high transition costs. Further increases in unemployment, even if only transitory, could lead to more frequent and more intense demonstrations and urban protest. Third, China's commitment to open its markets to increased investment in telecommunications, financial, and distribution services is genuinely revolutionary. This commitment not only offers enormous potential commercial opportunities for foreign firms, but also will contribute to the further transformation of the domestic economy.

Implications for the United States

United States trade negotiators played the lead role in negotiating China's entry into the world economy. This was natural given the large economic stake of the United States in the creation of more open markets globally. China was a particular focus both because of its rapidly increasing role as a global trader and because beginning in 1991 the terms of its entry were seen as providing a template for WTO membership for a number of formerly centrally planned economies. Moreover, as the United States became far and away China's largest export market, the resulting expanding bilateral deficit with China became a major preoccupation of U.S. policy makers.

Trade Expansion

Bilateral trade between China and the United States has grown extremely rapidly since trade relations resumed in 1978. Trade turnover (the sum of exports and imports) grew from $1 billion in 1978 to $116 billion in 2000. However, bilateral trade flows became increasingly imbalanced over the decade of the 1990s. By 2000 the U.S. bilateral deficit reached $84 billion and for the first time exceeded the bilateral deficit with Japan. The growing imbalance frequently is cited as evidence of the closed nature of China's economy. China, it is sometimes said, "has an economic vision that is fundamentally not free-market oriented but mercantilist." [11] Some fear China will displace Japan as our most troublesome trading partner.[12]

This argument is fundamentally flawed for several reasons. Perhaps most importantly the U.S. global trade deficit, which reached an all time record of $330 billion in 1999, primarily reflects the extraordinarily low rate of savings in the United States.[13] Because of meager domestic savings, a large fraction of U.S. domestic investment must be financed by borrowing from abroad. But the rest of the world would be unable to lend to the United States if it did not have a trade surplus with the United States. Policies that open specific markets abroad for U.S. firms, of course, would lead to more U.S. exports to those individual markets. But, at least in the short run, the U.S. global trade deficit would be unaffected. In short, the U.S. global trade deficit is the mirror image of its low savings rate relative to its rate of investment. Until the U.S. savings rate rises or the rate of investment falls, no amount of trade liberalization abroad will reduce significantly the global U.S. trade deficit. Selective trade liberalization abroad only affects the country-by-country distribution of the U.S. global trade deficit, not its overall size.

Second, most of the growing U.S. deficit with China reflects China's rapid displacement of alternative foreign sources of supply, primarily of labor-intensive manufactures. That, in turn, reflects the migration of labor-intensive manufacturing to

[11] Gary Schmitt, "U.S.-China Policy," Project for the New American Century, Memorandum of June 21, 1999.

[12] Amy Borrus and Pete Engardio, "The New Trade Superpower," Business Week, October 16, 1995 (http://www.nexis.com/research/search/doc [October 23, 2000]).

[13] Bureau of the Census and Bureau of Economic Analysis, *US International Trade in Goods and Services—Annual Revision for 1999*, exhibit 13, June 17, 2000 (http://www.census.gov/foreign-trade/Press-Release/99 [September 13, 2000]).

China from other locations in Asia, notably Hong Kong, Taiwan, and Korea. In the 1980s and 1990s, as wages in these countries rose and China increasingly liberalized its foreign direct investment environment, Asian entrepreneurs moved a growing share of their labor-intensive production to China. Thus a very large share of U.S. imports from China are produced in joint venture or wholly foreign-owned factories. In contrast, the U.S. deficit with Japan is primarily the result of the import of much more capital-intensive goods, produced in Japanese-owned factories, which displaces production not in third countries but in the United States.

The third flaw in the argument that the ever growing bilateral trade imbalance reflects a fundamentally closed Chinese economy is that exports of U.S. firms to China have grown extremely rapidly since China's reforms and opening up began in the late 1970s.[14] Since this growth initially was from a very low base, China did not become a significant market for most U.S. firms in the 1980s. In the 1990s U.S. exports to China continued to grow rapidly, almost quadrupling between 1990 and 2000. But since the base for this growth was much larger, by 2000 China had become the eighth largest international market for U.S. firms. Moreover, from 1990 to 2000 exports of U.S. businesses to China grew more rapidly than to any other large export market. The contrast with Japan is striking. Exports to Japan grew only 20 percent between 1990 and 2000, in part because sales to Japan by U.S. firms reached a peak in absolute terms in 1996 and then fell through 1999. The U.S. deficit with Japan is rising in large part because U.S. exports are falling; the deficit with China is rising despite rapid export growth of U.S. exports. The key reason for the latter is the huge buildup of foreign direct investment in labor-intensive export industries in China.

Why China's WTO Accession Matters

The United States has a substantial stake in China's further domestic economic reforms and its deepening integration in the global economy. Most obviously it serves U.S. economic interests. China's commitment to liberalize the terms under which foreign firms can invest in telecommunications, distribution, and financial services creates enormous opportunities since these are areas in which U.S. firms are very competitive on a global basis. China in the 1990s was already the most rapidly growing large foreign market for U.S. goods and services. China's WTO commitments will increase the access of U.S. firms to this market and increase the prospect that the bilateral trade relationship remains robust. Increased access for agricultural products and automobiles is likely to be especially important for the United States. In short, China can continue to contribute to the dramatic growth of U.S. trade, which doubled to $2.5 trillion in the eight years ending in 2000. Trade expansion was an important source of the record rates of growth of output and employment during the 1990s. Equally important, the availability of lower cost imports allowed this growth to occur with an unusually low rate of price inflation. Obviously the United States has and will continue benefit enormously from the shift of production within Asia discussed earlier in this chapter, since imports of these goods help to hold down prices in the United States.

Second, China's deeper integration in the global economy may make China more a constructive participant in a new round of global trade liberalization. China's leadership already has recognized the economic advantages of increased globalization and has even gone so far as to suggest the formation of a free trade area with the Association of Southeast Asian Nations, something that would have been unthinkable even a few years ago.

Third, deeper integration, and the concomitant acceleration of domestic economic reform, also will make it more likely that China will be able to meet the expectations of its population of 1.3 billion for improved living standards. An economically failing China, by contrast, would impose substantial costs on the United States and the rest of the world.

Fourth, the implications of rising living standards based on an increasingly market-oriented economy are overwhelmingly favorable to our long-term interest in the development of a more pluralistic political system in China. As was true in the case of Taiwan from the 1950s onward, a rapidly modernizing economy is likely to generate gradually growing pressure for political change, away from one-party, authoritarian rule. In Taiwan it took almost four decades of rapid economic growth between

[14] In the analysis immediately below the numbers on U.S. exports take into account the reexport of U.S. goods from Hong Kong to China. These goods are recorded by the U.S. Department of Commerce as exports to Hong Kong. The reexport of U.S. goods from Hong Kong to China, net of the margin added by Hong Kong firms, rose from $1.14 billion in 1989 to $5.68 billion in 2000. These numbers represent 20 percent and 34 percent, respectively, of U.S. exports to China in 1989 and 2000.

the time popular elections for county and city officials were introduced in 1950 and the time martial law was lifted and opposition parties legalized. Another decade elapsed before the first national popular election for president. Although China has been conducting popular elections at the village level for more than a decade, at least another decade or two of sustained economic growth probably will be required before a more pluralistic political system begins to emerge.

Finally, China's entry into the World Trade Organization will lead to stronger trade and investment ties between China and Taiwan that may contribute to a gradual reduction of tensions between the two. Given the strong interest of the United States in the peaceful resolution of the Taiwan straits issue, this is a very important potential benefit of China's deepening integration in the global economy. Even prior to each becoming a member of the World Trade Organization, bilateral economic links between China and Taiwan were growing rapidly. In the decade of the 1990s, as China became a more and more important part of the production chain for many Taiwanese firms, more than two-fifths of all Taiwanese foreign direct investment was in the mainland.[15] And trade ties have burgeoned. By 1999 a quarter of Taiwan's exports went to the mainland, making that market almost as important as the United States.[16]

Membership of both China and Taiwan in the World Trade Organization will accelerate these linkages for several reasons. First, membership is almost certain to end Taiwan's long-standing ban on direct shipping and air travel between Taiwan and the mainland. Second, Taiwan will have to eliminate important nontariff barriers on Chinese goods, notably the import ban imposed on a large number of goods of Chinese origin. Finally, Taiwan will ease many restrictions on investment in China that have been in place as part of "go slow, be patient" policy that the Kuomingtang adopted in 1996 to govern economic relations with the mainland.

All of these developments—the opening of direct trade, the elimination of Taiwan's bans on the import of a broad range of Chinese products, and liberalization by the Taiwanese government of restrictions on the outflow of foreign direct investment to China, will contribute to closer bilateral economic relations. These closer bilateral economic relations will likely act as a powerful disincentive to leaders on both sides of the Taiwan Strait against any destabilizing political or military moves which might upset an increasingly interdependent and mutually beneficial economic relationship. The exchanges resulting from a closer economic relationship could also provide a platform of mutual trust and provide contacts for a broader cross-straits dialogue which might further reduce the tensions and anxiety which presently handicap relations across the strait. Given the substantial role that Washington plays in relations between Taipei and Beijing, any reduction in tensions across the strait which resulted from closer economic cooperation would be a huge benefit to U.S. interests in the region, both political and economic.

In conclusion, China's accession to the World Trade Organization is a landmark event, one that has wide ramifications for China, the United States, the WTO, and the world as a whole. It has the potential to transform China's economy, its relations with its neighbors, and perhaps even (someday) its political system. It will impel China to be accountable to an internationally agreed set of rules and bind them to wide-ranging economic and systemic changes in order to meet the commitments they have agreed to undertake as a part of WTO accession. Although China's full compliance with its commitments will be difficult and there are likely to be many disagreements to come about issues related to China's accession agreements, China's WTO entry remains an important step in its move toward greater involvement on the world stage, a move which the U.S. should continue to fully support and encourage.

STATEMENT OF DR. KATE BRONFENBRENNER, DIRECTOR OF LABOR EDUCATION RESEARCH, CORNELL UNIVERSITY

Chairman D'AMATO. Dr. Bronfenbrenner?

Dr. BRONFENBRENNER. Thank you, Commissioner D'Amato, and fellow Commission members.

I've come today to present preliminary findings of our research on the impact of China trade relations on workers' wages and employment.

[15] J.R. Wu, "China Lures Taiwan Techs But Worries Remain," Dow Jones Newswires, August 24, 2000 (http://interactive.wsj.com [August 25, 2000]).

[16] Fred Hu, "One China Is Coming," Asian Wall Street Journal, August 25, 2000 (http://interactive.wsj.com [August 25, 2000]).

At Cornell, I'm the Director of Labor Education Research, and starting in 1988 and continuing to the present I've conducted a series of studies looking at the impact of capital mobility on workers' wages and unions in the U.S.

As you all know, in the debates leading to the recent enactment of legislation granting permanent normal trade relations for China there was a great deal of discussion regarding possible implications the China trade bill might have for the U.S. economy, particularly wages and employment for U.S. workers.

Unfortunately, to date no U.S. government body has the responsibility for collecting comprehensive national data on the wage and employment effects of trade agreements and policies. Thus, we have no established structures or systems to monitor the economic impact of expanding trade and economic ties with China.

Specifically, we have no way of tracking which companies and which industries are shifting production to China, and the workers and jobs and communities impacted by those production shifts.

Because of this deficit of information, this spring your predecessors, the Trade Deficit Review Commission, asked a team of scholars from Cornell University and the University of Massachusetts-Amherst, under my direction, to conduct a pilot study to lay the groundwork for more comprehensive research to monitor and analyze the impact of U.S.-China trade relations on workers and employment in the U.S.

We began this pilot study in February 2001, due to be completed in June, and we will send on to you our final report, much more comprehensive report in June. But in my testimony today I'll provide an overview of both the macro trade and investment data relating to U.S.-China trade relations as well as the preliminary findings from our media tracking data.

The purpose of this study was twofold. The first component involved collecting and analyzing macro data on imports, exports, and foreign direct investment, and those industries and economic sectors that have an active trade and investment reduction relationship with China.

This macro data analysis will lay the groundwork for future more in-depth research, which examines the relationship between international trade, foreign direct investment, and wages and employment and unionization in those industries and sectors.

A preliminary paper written by my fellow researchers at the University of Massachusetts is attached to the written testimony I submitted today.

The second component of our research involves designing and implementing a media tracking system to monitor and analyze media coverage of employment and wage effects of China trade and investment from October 1, 2000, through April 30, 2001. We have chosen to utilize media sources as the best available proxy for government-mandated statistics.

Using online and library sources, we're collecting and tracking print, media stories from U.S. and international media, including Chinese media, on capital mobility, foreign direct investment, wages and employment, and those industries and economic sectors that are involved in either direct or indirect trading production relationships with China.

We're also conducting follow-up online research on companies involved to gain a better understanding of corporate structure and employment patterns.

Data collected from the news stories and the government and corporate research sources are being compiled into an indexed, printed report, as well as a searchable electronic database which we will submit to you along with our final research report.

In this way, the preliminary study will lay the groundwork for future continued tracking of media stories in order to monitor the changes over time and the nature and extent of capital mobility and foreign direct investment, and to broaden and enrich our analysis of the macroeconomic data.

As you heard in the testimony earlier this morning and this afternoon, in the decade prior to establishing the PNTR to China, there was a dramatic escalation in the trade investment relationship between the U.S. and China. Today China is the fourth largest trading partner with the U.S., following Canada, Mexico, and Japan.

In 2000, the U.S. trade deficit with China reached $83.8 billion. It is now $85 billion, as you heard earlier, allowing China to overtake Japan as the country with the largest bilateral trade deficit with the U.S.

During this same period, foreign direct investment by U.S. corporations has increased from only $200 million in 1989 to $7.8 billion in 2000. This parallel growth in the trade and investment relationship has been concentrated in specific industries and economic sectors. Those industries and economic sectors we actually focused on in our media searches.

The U.S. industry is facing the largest volume of imports for China, including electrical machinery and equipment, other machinery other than electrical, apparel and related products, and leather goods. These are also the industries with the highest trade deficits.

U.S. foreign direct investment is concentrated on electrical machines and equipment, petroleum refining and processing, other machinery, and finance. It is worth noting that the largest share of both U.S. trade deficits with China and U.S. foreign direct investment in China has been concentrated to the electrical machines and equipment industry.

Although we're only partway through the data collection process for the media tracking system, our preliminary findings, which are summarized in Table 1 attached to my testimony, suggest there is a direct linkage between increases in trade deficits in foreign direct investment in certain industries and production and employment shifts out of the U.S. and into China and those industries.

The most striking finding in the preliminary media data is that the number of reported production shifts out of the U.S. into China is only slightly lower than the number of reported production shifts from the U.S. to Mexico in that same period.

Similarly, the proportion of production shifts which were reported but have not yet occurred and not been confirmed is also quite comparable between China and Mexico. The relatively small number of production shifts to other Asian and Latin American countries, other than China and Mexico, is also consistent with the macro trade and investment findings.

The total number of jobs reported to have been lost due to production shifts is actually higher for China, 25,326, than it is for Mexico, 23,812. This is true despite the much greater logistical challenges of relocating production to the other side of the world, compared to south of the border, and despite the fact that PNTR was just passed last fall and, as you know, China has yet to be admitted to the WTO.

The relatively high mean number of jobs lost reported in these stories—over 500 from China—suggests that these production shifts represent a significant loss of employment among some of the nation's largest manufacturing employers.

A high percentage of threatened production shifts announced in the media, which have yet to occur or have not been confirmed, appears to be a consequence of several competing trends. The first, it appears that many media sources report the planned relocation but never publish a follow-up story when the actual shift takes place.

Another problem with confirming production shifts is when a plant opens or expands in the destination country, the local media in that country rarely reports on the company or country where the work originated. They celebrate the opening in their country. They don't want to remind people that it came from someplace else.

Another possible contributing factor is many employers may use the threat of production shifts to impress investors and shareholders, and to coerce workers to make concessions on wages, benefits, or work rules, or coerce municipalities to make concessions on taxes, regulations, or zoning requirements.

Although in a short-term study such as this, it is difficult to estimate just how many of these announced production shifts will actually occur, it does appear that some portion were never meant to be more than threats or bargaining leverage.

However, given the equally high percentage of production shifts that we estimate were never reported in the media, they probably balance out the number that are reported that never occur. So we estimate that the number of production shifts listed here actually underestimates—greatly underestimates the actual—the true number of production shifts rather than overestimating them.

We undertook this research very cognizant of the serious challenges inherent in using media sources to reliably and comprehensively track national and international investment and employment trends.

There is no question that this nation is in great need of a federally mandated corporate reporting system to provide a comprehensive understanding of the nature and ramifications of trade and investment relationships with China and other nations.

However, absent any current legislative initiative to mandate corporate reporting of full or partial production and employment shifts out of the U.S., we see this media tracking system as the best available and most practical alternative to a government-mandated and supervised reporting system.

Still, there are enormous challenges involved in developing a reliable and comprehensive system. Although we've made significant progress from just a little more than a decade ago when media searches involved endless hours hunched over microfiche readers and newspaper vertical files, online media searching remains a difficult and time-consuming endeavor.

As we move forward with the research, our research is finding that those searches come up with as many as 500 articles per day, of which five or fewer are actually relevant to the subjects they're looking for. That means for every confirmed case we find, researchers must scan through several hundred different articles.

And we must at all times bear in mind the limitations of our searches and our sources. Only a limited, albeit growing, selection of media sources have online searchable archives.

Two, the local news media are the least likely to have online media archives, but the most likely to report on plant closings and production shifts.

Three, not all production shifts are covered in the media, and we have no reliable way of determining how many are not covered.

Four, media reports range greatly in reliability, veracity, and comprehensiveness of the information reported.

Five, it is extremely difficult to confirm actual production shifts as many more plant closings and production shifts are threatened and we have been actually able to confirm. And in many cases the new production shifted to an entirely different company or subcontractor with an unrelated company name.

And, last, it would take staff and financial resources well beyond the scope of this research endeavor to thoroughly search all available online media data, much of which is kept in expensive fee-for-service and limited access databases.

Despite these challenges we are gaining a clear understanding of just how valuable an ongoing media tracking such as this could be, for scholars, practitioners, and policymakers, interest in the impact of trade policies on workers, their families, and their communities in this country and around the globe.

The database not only provides important insights into the nature and extent of companies that are moving, the number of jobs being lost, and the industries and occupations in which the production shifts are concentrated, it also gives us a baseline to monitor future trends in global trade and investment, and the impacts of changes in trade and investment policies and practices such as the PNTR.

Most important of all, absent government-mandated corporate reporting of production shifts in foreign direct investment, this database will be the only extensive source of comprehensive data on the impact of China trade policies on jobs and workers and communities in the U.S.

To wrap up, it's important that we remember that trade policies such as PNTR have had a much broader ripple effect on workers and communities than simply lost jobs and closed plants. Many Americans are doing better economically than in recent past.

But in the context of corporate mergers, leveraged buyouts, contracting out, the sense of economic insecurity among American workers today has only been heightened by the recent downturn in U.S. economic indicators.

Our media research captures one major source of that economic insecurity and the harsh economic reality which it represents, the hundreds of media stories that come out each week in our nation's newspapers and magazines reporting on plants that have closed and work that has moved to China, Mexico, and around the globe, and the tens of thousands of manufacturing and export-related jobs that are lost.

We've seen in recent months the impact of capital mobility, and the insecurity it breeds go well beyond individual workers whose work has been shifted out of the U.S.

As increasing numbers of workers are displaced from manufacturing and export-related jobs into the service sector and import-related jobs, for many of them it has been a dramatic shift from permanent, unionized, full-time employment with good wages, health benefit and pension benefits and regular hours, to less secure, non-union jobs in the service sector and import-related industries, with lower wages, limited benefits, irregular part-time jobs, and less chance of union representation.

In addition, increased publicity about global capital mobility has contributed to the effectiveness of employer threats of full or partial plant closure when bargaining with individual workers and unions over work rules, wages or benefits, or when campaigning against union-organizing initiatives.

Thus, if we're going to achieve a full understanding of the impact of trade policies on employment, workers, wages, and communities, it's essential we develop a system to monitor and track changes in employment investment that occur in the aftermath of PNTR and other trade agreements.

Our preliminary findings cry out for government-mandated reporting of production shifts out of the U.S., and until such reporting systems exist continued funding of research which tracks the full effects of China trade policy on the U.S. and the global economy.

Given the likelihood that recent changes in U.S. trade policy with China will only increase the trade and investment relationship between the two countries, it becomes all the more important we closely monitor the relationship.

It is for this reason that the media tracking system we have initiated with this project, coupled with the continued analysis of macroeconomic trade and investment, and further quantitative research on employment and wage effects of trade investment policy, are essential if we seek to improve the economic security of workers, families, and communities.

Thank you.

Chairman D'AMATO. Thank you very much, Dr. Bronfenbrenner.

[The statement follows:]

PREPARED STATEMENT OF DR. KATE BRONFENBRENNER

Commissioner D'Amato and Commission members, thank you for this opportunity to present the preliminary findings of our research on the impact of China trade relations on workers, wages, and employment.

I am the Director of Labor Education Research at Cornell University where I am on the faculty of the Extension Division of the School of Industrial and Labor Relations. Starting in 1988 and continuing to the present I have conducted a series of studies specifically designed to gain greater insight into factors contributing to the impact of capital mobility on workers, wages and unions.[1] My current research "The Impact of U.S.-China Trade Relations on Workers, Wages, and Employment" was commissioned in February 2001, by your predecessors, the U.S. Trade Deficit Review Commission.

As you all know, in the debates leading to the recent enactment of legislation granting permanent normal trade relations for China there was a great deal of discussion regarding the possible implications that the China trade bill might have for the U.S. economy, particularly wages and employment for U.S. workers. Unfortunately, to date no government body in the U.S. has had the responsibility for collecting comprehensive national data on the wage and employment effects of trade agreements and policies. Thus, we have no established structures or systems to monitor the economic impact of expanding trade and economic ties with China. Specifically we have no way of tracking which companies in which industries are shifting production to China and the workers, jobs, and communities impacted by those production shifts.

Due to this deficit of information, this spring, your predecessors, the U.S. Trade Deficit Review Commission, asked a team of scholars from Cornell University and the University of Massachusetts Amherst[2] to conduct a pilot study to lay the groundwork for more comprehensive research to monitor and analyze the impact of U.S.-China trade relations on workers, wages, and employment in the U.S.

This pilot study began on February 12, 2001 and is due to be completed by June 1, 2001. In my testimony today I will present an initial overview of macroeconomic trade and investment data relating to U.S.-China trade relations as well as the preliminary findings from our media tracking data. Our final, more comprehensive, report for the project will be submitted to the Commission by June 1, 2001.

The purpose of this preliminary study is twofold. The first component involves collecting and analyzing macro data on imports, exports, and foreign direct investment in those industries and economic sectors that have an active trade, investment, and production relationship with China. This macro data analysis will lay the ground work for future, more in-depth, research which examines the relationship between international trade and foreign direct investment and wages, employment, and unionization in those industries and sectors. A preliminary paper, "The U.S.-China Trade and Foreign Direct Investment Relationship," prepared by the researchers at the UMass Political Economy Research Institute who are working with me on this study, is attached to the written testimony I am submitting today.

The second component of our research involves designing and implementing a media tracking system to monitor and analyze media coverage of employment and wage effects of China trade and investment from October 1, 2000 through April 30, 2001. We have chosen to utilize media sources as the best available proxy for government mandated statistics. Using on-line and library sources, we are collecting and tracking print news stories from U.S. and international media (including Chinese media) on capital mobility, foreign direct investment, wages, and employment in those industries and economic sectors that are involved in either direct or indirect trade and production relationships with China. We are also conducting follow-up on-line research on the companies involved to gain a better understanding of corporate structure and employment patterns. In addition we are using government databases for WARN Act and Trade Adjustment Assistance filings to supplement the media

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[1] See Kate Bronfenbrenner. "Uneasy Terrain: The Impact of Capital Mobility on Workers, Wages, and Union Organizing" Commissioned Research Paper and Supplement to *The U.S. Trade Deficit: Causes, Consequences and Recommendations for Action*, Washington, D.C.: U.S. Trade Deficit Review Commission, November, 2000; "The Effect of Plant Closings and the Threat of Plant Closings on Worker Rights to Organize" Supplement to *Plant Closings and Workers Rights: A Report to the Council of Ministers by the Secretariat of the Commission for Labor Cooperation*, Dallas, TX, Bernan Press: June, 1997. *Organizing to Win: New Research on Union Strategies*. Editor (with Sheldon Friedman, Richard Hurd, Rudy Oswald, and Ron Seeber). Ithaca, N.Y.: ILR Press, January, 1998. "Employer Behavior in Certification Elections and First Contracts: Implications for Labor Law Reform." In Sheldon Friedman, Richard Hurd, Rudy Oswald, and Ronald Seeber, eds., *Restoring the Promise of American Labor Law*. Ithaca NY: ILR Press, 1994, pp. 75–89. Kate Bronfenbrenner and Tom Juravich. "The Impact of Employer Opposition on Union Certification Win Rates: A Private/Public Comparison," Economic Policy Institute Working Paper No. 113, 1995.

[2] Principle investigators for the project include Kate Bronfenbrenner, School of Industrial and Labor Relations, Cornell University (project director); Jerry Epstein and Elissa Braunstein, Political Economy Research Institute, University of Massachusetts Amherst; and Stephanie Luce, and Tom Juravich, Labor Relations and Research Center, University of Massachusetts Amherst. In addition the following individuals are working as research assistants on this project: Jeremy Boyd, James Burke, Michael Davis, Dean Frutiger, Carolyn Gleason, Robert Hickey, Hyunji Kwon, Rattawut Lapcharoensap, Hilary Rhodes, Michael Ristorucci, Anne Sieverding, Miho Watanabe, and Mark Weisenborn.

sources. Data collected from the news stories and other on-line government and corporate research sources is being compiled in an indexed printed report as well as a searchable electronic data base. In this way, the preliminary study will lay the ground work for continued tracking of media stories in order to monitor changes over time in the nature and extent of capital mobility and foreign direct investment and to broaden and enrich our analysis of the macro economic data.

U.S.-China Trade Relations: Preliminary Macro Trade and Investment Data

In the decade prior to the extension of permanent normal trading relations (PNTR) to China in October 2000 there was a dramatic escalation in the trade and investment relationship between the U.S. and China. Today, China is the fourth largest trading partner with the U.S., following Canada, Mexico, and Japan. In 2000, the U.S. trade deficit with China reached $83.8 billion, allowing China to overtake Japan as the country with the largest bilateral trade deficit with the U.S. During this same period, foreign direct investment by U.S. corporations has increased from only $200 million in 1989 to $7.8 billion in 2000.[3]

This parallel growth in the trade and investment relationship has been concentrated in specific industries and economic sectors. The U.S. industries facing the largest volume of imports from China include electrical machinery and equipment, other machinery (except electrical), apparel and related products, and leather goods. These are also the industries with the highest trade deficits: $16.4 billion for electrical machinery and equipment, $10.2 billion for leather goods, $8.2 billion for apparel and related products, and $6.3 billion for other machinery.

U.S. foreign direct investment in China is concentrated in electrical machines and equipment, petroleum refining and processing, other machinery, and finance. It is worth noting that the largest share of both U.S. trade deficits with China and U.S. foreign direct investment in China have been concentrated in the electrical machines and equipment industry.

This growth in trade and investment relations between the U.S. and China has both resulted in, and been supported by, greater government support of the trading relationship. These have included the U.S.-China trade agreement signed in November 1999, the extension of PNTR to China in October 2000, and U.S. government support for China's upcoming entry into the World Trade Organization.

Findings from Media Tracking System

Although we are only partway through the data collection process for the media tracking system, our preliminary findings, summarized in Table 1, suggest that there is direct linkage between increases in trade deficits and foreign direct investment in certain industries and production and employment shifts out of the U.S. and into China in those industries. The most striking finding in the preliminary media data is that the number of reported production shifts out of the U.S. into China is only slightly lower than the number of reported production shifts from U.S. to Mexico for the same time period. Thirty-eight percent of the total reported production shifts were to China, 49 percent to Mexico, 9 percent to other Asian countries, and 4 percent to other Latin American countries. Similarly the proportion of production shifts which were reported, but have not yet occurred or have not yet been confirmed, is also quite comparable between China (65 percent) and Mexico (72 percent). The relatively small number of production shifts to Asian and Latin American countries other than China and Mexico is also consistent with the macro trade and investment findings.

The total number of jobs reported to have been lost due to production shifts is actually higher for China (25,326) than it is for Mexico (23,812). This is true despite the much greater logistical challenges in relocating production to the other side of the world compared to south of the border and despite the fact that the PNTR was just passed last fall and China has yet to be admitted to the WTO. The relatively high mean number of jobs lost, 563.8 for China, 499.7 for other Asian countries, 396.87 for Mexico, and 381.83 for other Latin American countries, suggests that these production shifts represent a significant loss of employment among some of the nation's larger manufacturing employers.

The high percentage of threatened productions shifts announced in the media which have yet to occur or have not yet been confirmed, appears to be a consequence

[3] For all the information in this section see the attached paper "The U.S.-China Trade and Foreign Direct Investment Relationship: A Report for the U.S.-China Security Commission" by Elissa Braunstein, James Burke, and Gerald Epstein.

of several competing trends.[4] The first is that it appears many media sources report the planned relocation but never publish a follow-up story when the actual shift takes place. Another problem with confirming production shifts is that when a plant opens or expands in the destination country the local media in that country rarely reports on the company or country where the work originated.

Another possible contributing factor is that many employers use the threat of production shifts to impress investors and shareholders and to coerce workers to make concessions on wages, benefits, or work rules or coerce municipalities to make concessions on taxes, regulations, or zoning requirements. Although, in a short-term study such as this, it is difficult to estimate just how many of the announced production shifts will actually occur it does appear that some portion of these announcements were never meant to be more than threats or bargaining leverage.[5]

The data also reveal a great deal of regional variation. Shifts of production out of the U.S. into China are most likely to originate in the Southeast (32 percent), West Coast and Mountain States (21 percent) and Southwest (18 percent) and only 13 percent originate in the Northeast and 13 percent in the Midwest. In contrast, only 13 percent of productions shifts to Mexico originate in the West Coast and Mountain States and 10 percent originate in the Southwest, while 21 percent originate in the Midwest, 19 percent in the Northeast, and 34 percent in the Midwest. The overwhelming majority of companies (70 percent or more) shifting production to China, Mexico, and other Asian and Latin American countries are large publicly held multinational corporations.

As would be expected from the macroeconomic data, production shifts to China are highly concentrated in electronics and electrical equipment (38 percent), household goods (11 percent) and toys (8 percent). In addition 22 percent of the production shifts were in chemical production and processing. In contrast to Mexico, none of the production shifts to China reported in the media were in autoparts, apparel, or textiles.

Challenges and Possibilities of the Media Tracking System

We undertook this research fully cognizant of the serious insufficiencies inherent in using media sources to reliably and comprehensively track national and international investment and employment trends. There is no question that this nation is in great need of a federally mandated corporate reporting system to provide a comprehensive understanding of the nature and ramifications of trade and investment relationships with China and other nations. However, absent any current legislative initiative to mandate corporate reporting of full or partial production and employment shifts out of the U.S., we see this media tracking system as the best available and most practicable alternative to a government mandated and supervised reporting system.

Still, there are enormous challenges involved in developing a reliable and comprehensive media tracking system. Although we have made significant progress from just a little more than a decade ago when media searches involved endless hours hunched over microfiche readers and newspaper vertical files, online media searching remains a difficult and time consuming endeavor. As we move forward with the research our researchers are finding that their searches come up with as many as 500 articles per day, of which five or fewer are actually relevant to the subjects they are searching for. This means that for every confirmed case we find, the researchers must scan through several hundred different articles. We must at all times bear in mind the limitations of our searches and our sources, namely that (1) only a limited, albeit growing, selection of media sources has searchable online archives; (2) local news media are the least likely to have online media archives but the most likely to report on plant closings and production shifts; (3) not all production shifts are covered in the media and we have no reliable way of determining how many are not covered; (4) media reports range greatly in the reliability, veracity, and comprehensiveness of the information reported; (5) it is extremely difficult to confirm actual production shifts since many more plant closings and production shifts are threatened than actually take place and in many cases the new production is shifted to an entirely different company or subcontractor with an unrelated company name; and (6) it would take staff and financial resources well beyond the scope of this research endeavor to thoroughly search all available online media data, much of which is kept in expensive fee-for-service and limited access databases.

[4] We expect the proportion of announced production shifts which are unconfirmed to drop considerably in our final report for the study once we have had more time to conduct more in-depth follow-up searches for each announced production shift.

[5] See Bronfenbrenner (2000) or Leonhardt (2001) for additional analysis on employer media threats of plant closings and job loss.

Yet, despite these challenges, we are also gaining a clear understanding of just how valuable an ongoing media tracking system such as this could be for scholars, practitioners, and policy makers interested in the impact of trade policies on workers, their families, and their communities in this country and around the globe. The database not only provides important insights into the nature and extent of the companies that are moving, the number of jobs being lost, and the industries and occupations in which the production shifts are concentrated; it also gives us a baseline to monitor future trends in global trade and investment and the impacts of changes in trade and investment policies and practices such as the PNTR. Most important of all, absent government mandated corporate reporting of production shifts and foreign direct investment, this database will be the only extant source of comprehensive data on the impact of China trade policy on jobs, workers, and communities in the U.S.

Conclusion

In closing, it is important that we remember that trade policies such as PNTR have had a much broader ripple effect on workers and communities than simply lost jobs and closed plants. Yes, many Americans are doing better economically than in the recent past. Yet, in the context of corporate mergers, leveraged buyouts, contracting out, and capital flight, there remains a great sense of economic insecurity among American workers today that has been only heightened by the recent downturn in U.S. economic indicators. Our media research captures one major source of that economic insecurity and the harsh economic reality which it represents—the hundreds of media stories that come out each week in our nation's newspapers and magazines reporting on plants that have closed and work that has moved to China, Mexico and around the globe and the tens of thousands of manufacturing and export related jobs that are lost.

Despite the fact that the media stories we have found in our research capture only a fraction of the total production shifts out of the U.S. into China and other countries, the pervasive nature of these stories has had a powerful effect on the consciousness of American workers. Even at the highpoint of the 1990s economic expansion "Work Trends Surveys" conducted by the John J. Heldrich Center for Workforce Development at Rutgers University and the Center for Survey Research Analysis at the University of Connecticut have found that nearly nine out of every ten Americans reported that they were concerned about job security for workers currently employed and eight out of every ten Americans were concerned about employment prospects for the next generation (Van Horn, 2000). Similar studies conducted by the Chicago-based International Survey Research group found that workers in the late 1990s were three times more insecure about losing their jobs in the current economic boom than they were in the depths of the 1980–81 recession (Belton, 1999).

As we have seen in recent months, the impact of capital mobility and the insecurity it breeds goes well beyond the individual workers whose work has been shifted out of the U.S. As increasing numbers of workers are displaced from manufacturing and export related jobs into service sector and import related jobs, for many of them it is a dramatic shift from permanent full-time employment with good wages, health and pension benefits, regular hours and union representation to less secure non-union jobs in service sector and import related industries with lower wages, limited benefits, and irregular part time hours. In addition, increased publicity about global capital mobility has contributed to the effectiveness of employer threats of full or partial plant closure when bargaining with individual workers or unions over work rules, wages, or benefits or when campaigning against union organizing initiatives (Bronfenbrenner 2000).

Thus, if we are going to achieve a full understanding of the impact of trade policies on employment, workers, wages, and communities, it is essential that we develop a system to monitor and track changes in employment and investment that occur in the aftermath of PNTR and other trade agreements. Our preliminary findings cry out for government mandated reporting of production shifts out of the U.S., and, until such reporting systems exist, continued funding of research which tracks the full effects of China trade on the U.S. and global economy. Given the strong likelihood that recent changes in U.S. trade policy toward China will only increase the trade and investment relationship between the two countries it becomes all the more important that we closely monitor the relationship between trade deficits, foreign direct investment, government trade policies, and shifts of production and employment out of the U.S. and into China. It is for this reason that the media tracking system that we have initiated with this project, coupled with continued analysis of macro economic trade and investment and further qualitative and quantitative research on the employment and wage effects of trade and investment policy, are essential if we seek to protect and improve the economic security of workers, families, and communities in the U.S. and around the globe. Thank you.

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PANEL II DISCUSSION AND QUESTIONS AND ANSWERS

Chairman D'AMATO. Commissioner Mulloy?

Commissioner MULLOY. Thank you, Mr. Chairman.

I have a question. I'd like to direct it to Mr. Lardy. And then afterwards, if the other two witnesses would comment on it.

This goes really to the thrust of our charter, which is to look at the impact of our trade and investment with China on national security interests of the United States. One of our witnesses this morning said that America's stated security policies and economic policies toward China—the important question: are they dovetailing, or are they in conflict?

I think some people—and we had a security briefing last week—would say that if our policies are making China a more technologically sophisticated and a much strengthened economy, and we don't know how they're going to behave, we could be creating a potential problem for ourselves.

Whereas, others would say by bringing China into the WTO, and making it part of the larger global community, we are somehow going to make China less of a national security problem for ourselves.

I would like, Mr. Lardy, for you to comment, what do you think we're doing? Is it a gamble? Is it clear? And which would you recommend we do? And if we do the WTO, are there any modifications you would recommend that we would take on that?

Mr. LARDY. Well, let me just begin by saying I do agree with the premise of your question. I mean, there are great uncertainties about the long-term direction China will move in, so to some extent we are—it is a gamble.

I am betting on the second side of your question; that is, that as they become more integrated into the global economy that that will have a constraining effect on their behavior in other areas, and, secondly, that it will have significant effects on political reform as well.

I don't—you know, I think that if they had not had this involvement of foreign firms and this huge amount of trade over the last decade, they would have made less progress towards becoming a market economy. I think this is increasingly a market-driven economy. Yes, there are elements of state ownership, and there are elements of state control.

But it has really very dramatically transformed over the last decade and particularly over the last two decades. So I think they are moving in the right direction. They are moving in a direction in which people have more choices, not less, where they go to school, what kind of a job they get, and even in some cases, although not all, where they're going to live.

And I think as you have rising incomes, you may have a pattern very similar to what we saw in Taiwan. There will be a demand for more political reform. It started in Taiwan in the early 1950s with low-level village elections in overtime. It moved up, and the system was transformed, even though they were under martial law and had a highly authoritarian system for several decades after 1949.

So I think the best lever for encouraging that kind of change is moving stronger—more strongly in the direction of the market, and I think the way you encourage that is by getting them into the WTO, getting them subject to all of the rules of that system.

China's per capita income, quite frankly, is so low that—and I personally think we have quite a bit of time to figure out whether or not this is going to work. They are not going to be in the position to really threaten us—our security directly for quite a long period of time.

So we will have—I think we have the luxury of time to judge what's happening in terms of the pace of political reform and what their long-term strategic intentions are. I don't think we have to assume today that they are entirely adverse to our interests, and, therefore, we should have no economic relationship with them.

Commissioner MULLOY. Would the other two witnesses comment on the thrust of the question?

Dr. WU. Well, let me say something. First of all, I disagree with Mr. Lardy's quote—using the Taiwan progress as an example. I think we have to know—this system is based on capitalism, just like Taiwan and South Korea—is very different from a system based on communism.

That means, you know, they feel that all of the property is owned by the state with, no private rights, no privacy, no private property at all. I think this is a very different system. It's very difficult to make all kinds of comparisons.

The other thing is, should we care about security? Because the Chinese communist government is here our—share the profit, share the money, and put the money for their, you know, into their power control and to upgrade their military assistance.

And maybe you will argue, say, "Well, I don't think the Chinese are going to launch a missile to Los Angeles." But what about the Korea War? What about the Vietnam War? We were involved with Chinese over there. Okay?

Now, let's go back, talk to WTO, because Mr. Lardy was talking about how they began complying, or something like that. Okay.

Last year, the Chinese suddenly expressed an urgent desire to join the WTO. I heard by Chinese president Jiang Zemin many times, he said, "Don't worry. Why should we be in a hurry? We've already talked about it for 13 years."

And suddenly they urgently want to join the WTO. Why? Because from 1997 to 1999, the foreign investment slowed down. If this kind of problem happened to China, it's really a disaster for the central government.

That's why when they come to the United States, they say, "Okay. I send—I come to the United States." They want you, you know, my—I shall try to give the American people a break. And then even he opened his mouth, he said, "We will agree that American agricultural products, you know, sell it to China," because they want to get some politicians from Ogifio state to agree on the WTO negotiation.

Let me quote for you an internal document from China. On August 29, 2000, in an internal briefing on the State Council to Zhu Rongji, the Chinese Prime Minister, said, "American foods and grains into our market? Sheer daydream."

Commissioner LEWIS. I couldn't hear you.

Dr. WU. Sheer daydream.

Commissioner LEWIS. Daydream.

Dr. WU. Well, they're just anxious to show you that they want to get into the WTO. You know, after the agreement between the United States and China was reached last year, the Hong Kong stock market went up, and it meant the foreign investment is going back to China.

But I want to share with you, okay, the Chinese are going to play the very small motion of a tai chi. They are going to put as many, many roadblocks as possible to slow down WTO vehicle. And they can even turn a U-turn on this WTO issue, because they know that if they really get into WTO their economy system is facing big, big problem.

Now, the other thing I want to—talking about so-called compliance, Chinese makes a lot of promises about economy reform and political reform. And many of them are actually never implemented. Okay.

They promise to stop the forced labor in exports. Okay. They're talking about property rights, talking about environment protection. It's only by words, never implemented. Should we trust them?

Actually, with the trade with China, there are two parts over there. One is ethics, morality, and principle, but actually it's a political issue. Okay. It means, should we do business with an evil empire? With a communist government?

You do business—that's when both sides share the profit. Should we profit them? Our investment actually is like a blood transfusion for this dying system.

Why do we never trade with the Soviet Union if this is a very good idea? But you have to know the human rights issue is not a concern of American politicians, not a concern of American businessmen, and I don't think we have to ask Americans—the human rights problem in China.

But this is good leverage, okay, because China only—if China becomes a free, prosperous, democratic China, this is the most important thing for Chinese and for the United States. Okay.

It is true you can make money from Chinese cheap labor forces. It is true, because 1.3 billion men and women are controlled by one man. Okay. In China, there is no free union. Don't worry about strikes. Okay. The government takes care of business, make the order in your business.

If you have a good relationship with the government, everything is soft. But what is that? Did you feel that—what is a partner? Is it a partner in China? They are communist. You do business with someone totally against your principle. You don't feel that's a problem?

You want to make money. Yes. The Chinese labor force cheap and controlled. Of course it's good for the labor force in Indonesia——

Chairman D'AMATO. One minute.

Dr. WU [continuing]. Compete for the labor force in India.

So I think this problem also relates to another problem I talked about at the beginning—security. Okay. Does the government benefit from our investment? Benefit from our trade? And where are they going to spend the money?

Chairman D'AMATO. Thank you.

Commissioner Robinson?

Dr. BRONFENBRENNER. Can I just respond?

Chairman D'AMATO. Oh, I'm sorry. Dr. Bronfenbrenner?

Dr. BRONFENBRENNER. Just two points. The first is that we need to be careful to assume that open markets necessarily change human rights and labor rights in countries, and that, in fact, there is no guarantee that opening markets in China means there will be less child labor or less prison labor, and that we need to be very careful to analyze that.

The other piece, though, I wanted to point out—right now we haven't been just tracking U.S. production shifts to China, but also production shifts from Latin American and Asian countries.

And that's where we see where the China trade is actually having an impact on possibly lowering the standard of living and living conditions in countries like Korea and Brazil, and other countries who are finding, in the race to the bottom, they are now having good jobs in their countries, manufacturing and production jobs shift to China in the current environment. And I haven't had a chance yet to run those numbers and give them to you, but in our final report we'll look at it.

And I think what we're seeing is that it's not just production leaving the U.S., but we are also seeing that some of what we consider more stable democracies are possibly going to be threatened by trade with China because of shifts of good jobs from those countries to China.

Commissioner LEWIS. Are the Chinese concerned?

Dr. BRONFENBRENNER. Well, workers in those countries are concerned. I'm not sure—Taiwan is a very interesting—you know, it's got two different lines. One is that businesses in Taiwan are very eager to move into China.

At the same time, their government is having tensions with China, and we find enormous efforts to move production, including we saw a lot of electronics—laptop computers, things like that, that they're moving in. It's very difficult, then, to find a newspaper in Beijing saying that the company moved from Taiwan to Beijing. So it's very hard to trace the source of that employment.

Chairman D'AMATO. Commissioner Robinson?

Commissioner ROBINSON. Yes. I just had a few quick related questions for Mr. Lardy. First, as you may know from the deliberations so far of the Commission, no one is talking about trying to restrict or cut off China's access to the U.S. capital markets.

But I was wondering if you would——

Commissioner WALDRON. I'm certainly thinking about that.

(Laughter.)

Commissioner ROBINSON. Well, would you support strengthening SEC disclosure requirements with regard to Chinese enterprises and other emerging market enterprises?

Mr. LARDY. Well, you know, I'm not an expert on securities law. But, you know, I do think that there should be full disclosure, so people—investors can make a judgment on what the risks are. Obviously, emerging markets—companies are generally riskier and people have to have full information to make a judgment about that.

So if our current levels of disclosure and reporting requirements are not high enough, they should be raised.

Commissioner ROBINSON. Would you agree that U.S. pension and other fund managers often purchase the bulk of Chinese enterprises that list in Hong Kong and other world markets?

Mr. LARDY. Well, for some companies that's true. They are the major players, although there is a very substantial retail market in Hong Kong among local investors there. But certainly for the bigger issues like PetroChina, China Mobil, those companies, certainly institutional investors must be the major shareholders.

Commissioner ROBINSON. If that's the case, if all U.S. institutions and persons were prohibited from the purchase of the securities of a specific Chinese entity, for reasons of they're a proliferator, an egregious national security or human rights abuser, for example, do you think that—which would kill the U.S. demand side. It's not a matter of not being able to just enter the U.S. markets, but no U.S. person, legal person, is allowed to purchase that security, which is what OFAC does for a living, as you know.

Would you think that that would have a negative impact or a significant impact on a large Chinese state-owned enterprise, like a PetroChina, for example?

Mr. LARDY. Well, you have to look very carefully at specific cases. Certainly, in general, it might, but for a PetroChina, which is now the single most profitable petroleum company in the world, you know, I suspect they can find enough investors in Europe and other countries in Asia or Latin America, and they might do—a few might do reasonably well, even without any investment from U.S. institutions or individuals.

Commissioner ROBINSON. But it could have higher cost of funds, for example, elevated risk profile, and over time, if they need annual multi-billion dollar sums, as many of these do, that it could limit the availability of the adequate funding itself. I don't want to lead the witness here, but I'm just wondering if——

Mr. LARDY. No, no. For certain cases, it certainly could. I mean, many of these—I mean, quite frankly, some of these companies are—some of these companies have been very attractive, and some of them have not been, shall we say, from an investment point of view. And the latter would be especially hurt if they were cut off.

Commissioner ROBINSON. And, finally, I was just going back to the big picture point. Is it your testimony that if China, as a whole, were denied access to the U.S. capital markets for any, say, significant period of time, due to a dramatic downturn in the bilateral relationship, that it would have little or no impact on Chinese economic growth and development? That was, I think, what you said.

Mr. LARDY. Well, let me refine it a little bit. I certainly think it would probably have little effect on the rate of investment, since they already have a very, very—as I mentioned, 40 percent roughly rate of domestic savings.

So you would not—this isn't an economy where investment is going to decline by several percentage points because they don't attract foreign capital, either through equity markets or through direct investment.

So what we would be looking at, then, is a second order effect, and that is obviously in some industries they can get better technology if they have a foreign partner coming in to develop the industry than if they're going to do it on their own. So you might expect the productivity of investments in some sectors to be less, if it was entirely indigenous as opposed to having some foreign technology.

So that could certainly affect the rate of growth somewhat, but it would not be a major——

Commissioner ROBINSON. But they presumably do need a lot of foreign capital in the years ahead. I mean, your own analysis on the banking crisis and others show vast financial needs that can't be all serviced domestically.

You know our position in the global capital markets. That is, the United States probably occupies, what, 40 or 50 percent of total global capital? I mean, I was just taken by that, because, you know, I've been a very avid reader of your work, and you've done a lot of very fine work as well on the banking system and the like.

And we've had testimony before this Commission that had very substantial capital requirements, notwithstanding the reserves. They need to come to the international markets for the restructuring of the SOEs alone. All I'm saying is that it's just I was struck by the idea that you could have China in some eventuality cut off from the U.S. capital markets.

I've never heard an analyst suggest that this would not have had a very significant impact, or that it was marginalized the way your statement indicated.

Mr. LARDY. Well, let me restate it. I think it is easy to exaggerate. Look at this way. This is now a trillion dollar economy. The rate of investment is about 40 percent, so you're talking about a rate of investment of $400 billion a year. And the all-time peak last year, you know, the—I believe the equity inflows were something on the order of about $20 billion. So that would be $20 billion out of the $400.

It's a relatively small portion, and, in addition, part of what happens is that China builds up its foreign exchange reserves, so that if the $20 billion were not available the investment rate might be just as high, the technology wouldn't be quite as good.

Commissioner ROBINSON. But these are accurate——

Mr. LARDY. I think China's major challenge—you've made a good point—is—is to improve the efficiency with which their very high rate of savings is invested. Arthur had a program the other day at his institute. We talked about the financial system, and it's a very weak financial system, and it's not very efficient at allocating resources to their highest use.

So certainly, to some extent, these big state companies are going for external financing, because the domestic capital market is so small.

Commissioner ROBINSON. Right.

Mr. LARDY. And so if they did the reforms that they need to get their banking system on a sound footing, develop a real capital market as opposed to what one Chinese economist has called a "casino," they probably could get by with a lot less foreign investment than they otherwise might need.

So it's very much dependent I think on the pace of domestic reform on the financial——

Commissioner ROBINSON. But I was thinking company by company versus dealing in aggregate flows. There's a big difference in those two.

Chairman D'AMATO. Thank you.

Commissioner Dreyer?

Commissioner DREYER. This is a question for Harry Wu. You dealt with the where with regard to prison labor—of a book published a couple of years ago called "New Ghosts, Old Ghosts," in which the author makes the point that, in fact, prison labor is not a very efficient form of production, and that its importance in the Chinese economy is declining. Would you agree or disagree with that?

Dr. WU. I know the author very well. He is a Columbia scholar, Jim Seymour. And I totally disagree with what he said, because basically he disagreed—one thing with me is Chinese laogai is not the Soviet-style gulag. So Chinese laogai is a kind of prison system similar to other countries. I don't think this is the thing, you know, that common people agree with.

In that book, his analysis is based on three provinces, three areas—Quinghai, Gansu, and Xinjiang. And these three are very rural areas. The production is very low profile in China, and most of these forced labor products for export is located in the eastern—along the coast.

And most of the production value comes from this area. So I don't think he is using the very good materials to make an analysis on this, and——

Commissioner DREYER. So you would dispute the sample, then, he uses——

Dr. WU. Yes. Just as basically wrong. And we have so much Chinese information—most of these Fourth World products exported to the international market actually come from the east coast, from the Sungyang northeast along the coast to the Guandong, this area.

Commissioner DREYER. And another point Seymour makes is that he thought conditions in the laogai had improved. Would you agree or disagree with that?

Dr. WU. Well, it is true I agree with it. You know, compared with what? Okay. Let me say it this way. For example, I spent 19 years in the Chinese laogai. Some people ask me, say, "Did you ever attempt to escape?" I said, "No, never." Where would I go? Nowhere.

If I show myself in the doorway of my parents' home, they have to right away turn me into the police station. Okay. And today you heard many people escaped. Okay? And during my time in the prison camp, you know, we have nothing to do about it, only, you know, submission and accept the full reform.

And today in China you can bribe the police, reduce the sentence, even, you know, get a medical probation. So this is wonderful, right?

(Laughter.)

But what are they talking about? It is improving or not? What is this?

Commissioner DREYER. Better than before but not very good.

Dr. WU. I just don't know what is the comparison we are talking about.

Commissioner DREYER. Thank you.

Chairman D'AMATO. Thank you.

Commissioner Waldron?

Commissioner WALDRON. Thanks very much.

I'm going to sort of pile on to Nick Lardy, because yours was— it had the most figures in it. And I am very concerned. Obviously, I am skeptical of the idea that laogai is somehow anything but an extremely impressive system, and I am also very concerned about these issues of labor standards, and so forth.

But what I think we're going to end up focusing a lot on is sort of the nature and structure of the Chinese economy, because clearly in the aggregate we can't affect it. I mean, it's too big for us to be able to really sort of push it around. But on the other hand, it seems to me that there are sort of critical nodes, and I thought that Nick's testimony pushed that up.

But I didn't quite understand some things, and you began to answer them when you were answering Roger. You said that China does not need FDI to finance its development, and then you gave the $400 billion investment figure and $20 billion FDI.

But I thought that—isn't it the case that—I mean, also because of its high savings rate, but isn't it the case that almost all of the savings go to state-owned enterprises from the—isn't it the case that the leading banks allocate credit? I mean, that those—those savings that the Chinese are putting into their banks are not, in fact, going into profitable investments, but they are, in effect, subsidies that are going into SOEs?

Mr. LARDY. Well, it is certainly the case that an unfortunately large portion of these funds are misallocated and——

Commissioner WALDRON. Yes.

Mr. LARDY [continuing]. Mentioning the problem of if the banking system could be made more efficient, they would certainly get much better results out of the system.

Commissioner WALDRON. All right. So——

Mr. LARDY. So, yes, in that sense, you could say that since the $20 billion—it's not $20 in FDI. It's about $40 billion in FDI. Last year there was about $20 in equity.

Commissioner WALDRON. Okay.

Mr. LARDY. But the $40 billion in FDI is certainly much more subject to market test than what's being financed out of the domestic banking system, some of which is subject to a market test and a portion of which is not.

Commissioner WALDRON. But, I mean, in a sense, based—and then you made some remarks about how without the $40 billion—well, in a sense, without the $40 billion, wouldn't there be more pressure to allocate these savings, these domestically-generated savings, in an efficient manner?

Mr. LARDY. It's very hard to, you know, know exactly what—you know, this—what would be the case if they didn't——

Commissioner WALDRON. I agree with that.

Mr. LARDY [continuing]. the FDI. I think they're under enormous pressure to improve the efficiency of their domestic banking system because, you know, of the dangers of—you know, the financial risks associated with running an insolvent banking system that, you know, depends on household savings for its financing.

Obviously, it's a huge financial risk, and, thus, it's a huge political risk for the party and for the government in power. So——

Commissioner WALDRON. But it simply makes the risk worse year to year, to take all the savings that come in and put them into the SOE, the state-owned enterprises, right? It constantly makes the problem worse.

Mr. LARDY. It has been going down. And I believe in the last couple of years—I don't have the numbers right at my fingertips—but the share of total lending going to state-owned companies has gone down. It may be the case that last year the absolute amount of lending to state-owned companies went down for the first time, so they are making gradual progress.

Commissioner WALDRON. I was just trying to contrast, say, China—because we normally think—and it is usually the case—that inflows of FDI, whether you're talking about Latin America or Southeast Asian countries or wherever, normally, foreign-directed investment allows the country to have a higher rate of investment than they would if they didn't have—if they didn't have these capital inflows. In other words, there is a net addition to the rate of investment.

In China, there is very little net addition as a result of that.

Well, that's only if you take that $400 billion—well, I mean, I suppose that in every country you count bad investments as well as good investments.

Mr. LARDY. Yes.

Commissioner WALDRON. All right. Okay.

Mr. LARDY. That's right.

Commissioner WALDRON. But it surely tells us something, that—is it correct that FDI counts 48 percent of exports, did you tell us?

Mr. LARDY. Forty-eight percent of all exports are coming out of firms that are either wholly or party owned by foreigners.

Commissioner WALDRON. I mean, it seems to me that is extraordinary testimony to the incredible misallocation of resources in China. In my own, you know, travel there—I am no economist—but I look at things. I look at apartment houses, I look at roads, I look at all kinds of things. I say to myself, is this stuff ever going to make money for anybody?

And I have to say—and you probably have the same experience—that I often end up sort of thinking maybe not.

So, I mean, one could—it seems to me you could make two arguments here. One would be that FDI—that without foreign direct investment there would be no golden thread connecting China's interests to the interests of the world.

In other words, if that 48 percent of exports means that foreign money is disproportionately binding China to the rest of the world, and if it is the case that binding China to the rest of the world is going to favor peace and security, then that would be money well spent.

The other argument, though, would be that somehow having this foreign money available actually reduces the pressure on China to allocate its own resources—for instance, to privatize, something that they—they rigorously avoid privatizing.

We talk a lot about, you know, the non-state or the collective sector, but the actual number of private entrepreneurs in China is very low. Now, you also said that FDI permitted China to make investments overseas, and I was wondering how much Chinese direct investment would you say—how much money has flowed out of China? Do you have a figure for that, Nick?

Mr. LARDY. Well, the key—China is—among emerging markets, China is the biggest investor abroad.

Commissioner WALDRON. Yes.

Mr. LARDY. I mean, this is the universe of countries that does not generally invest a lot in——

Commissioner LEWIS. Can you put a number on that?

Mr. LARDY. The Chinese certainly publish a number on that. And I——

Dr. WU. $100 billion.

Mr. LARDY. Per year or cumulative?

Commissioner WALDRON. Well, it would be interesting to know it by year or cumulatively. $350 billion have gone——

Commissioner LEWIS. How much?

Dr. WU. $100 billion.

Commissioner LEWIS. $100 billion. Is it cumulative or——

Dr. WU. Cumulative.

Commissioner LEWIS [continuing]. Last year?

Dr. WU. Cumulative.

Commissioner LEWIS. Cumulative.

Commissioner WALDRON. I saw figures indicating I think that it was CITIC actually had more—it had invested more abroad than it had inside China.

If you look at the structures of some of these foreign investment and trade corporations, as I say, I am no economist, but it seemed to me that in addition perhaps to allowing—just as they opened the door for foreigners to take their money to buy things in China, they opened the door for Chinese to take their money and buy things abroad. And it seemed to me that there was some sort of a message there.

Mr. LARDY. Right. No, there's a lot of that going on. I don't think it's cumulative, $100 billion. My memory is the number is in the low single digits of billions per year, that we're talking $3 or $4 billion a year in foreign direct investment.

Now, there is a much—but that's what's in the recorded data. Then there is a much larger amount of just unrecorded capital outflow that is not in compliance with their regulations on capital flows, and some of that probably goes into foreign investments abroad.

Commissioner WALDRON. I think just for the purpose of this——

Mr. LARDY. But, you know, a lot of it is going to Hong Kong. There's a huge amount of Chinese investment in property and other kinds of activity just in Hong Kong. That accounts for a big chunk of it.

Commissioner WALDRON. That would be an interesting thing for us to try to find—if there is somebody in the universe of experts who knows about that. I mean, I'd like to thank all of you for your good testimony.

But, Nick, when you made the comment about how we have the luxury of time, because China is at such a low—technologically low level of income, and all the rest, I thought to myself, that's spoken like a true economist.

And it made me think——

(Laughter.)

No. But it made me think of a remark by Dr. Andrew Marshall, who we had here last week. I remember him saying once—and, of course, he's the last man in the Pentagon who remembers Pearl Harbor. And I remember him once saying—(laughter)—he said, " Well," you know Andy talks very, very soft, he says, "Well, you know, in 1941 Japan had seven percent of the GNP of the United States." And then he continued, "But it was—it took us a long time before we were finished with them."

(Laughter.)

And I thought that was a very—it was an interesting comment, because war is rarely in anybody's economic interest. And it's estimated that certainly since the 16th century it's been in nobody's economic interest.

But wars have—they, nevertheless, happen. And there's a different logic there. I hope you're right about the low-income level, but I don't think that we can necessarily bank on it completely.

Mr. LARDY. I'm not offering any guarantees.

Commissioner WALDRON. Okay.

(Laughter.)

Commissioner DREYER. Nick, if I could just say one sentence in follow-on to that. When you said it would be a long time before China can directly confront U.S. militarily, the problem is they can make a heck of a lot of problems for us if they are able to confront us indirectly.

Commissioner LEWIS. Through Iran and Iraq.

Commissioner WALDRON. Well, they could actually confront us directly.

Commissioner BRYEN. We have serious problems, because of proximity and——

Chairman D'AMATO. Commissioner Lewis?

Commissioner LEWIS. I have a couple of factual questions, and then I want to ask all of you a couple of generic questions.

Nick, you said that the 48 percent of exports of China were by foreign-owned firms. Do you have any number for American—exports to the United States by American-owned firms in China?

Mr. LARDY. The short answer is no. The Chinese publish these aggregate data, and they don't break it down. I would suspect that the vast majority of this 48 percent is by either Hong Kong or Taiwanese companies, because those are the companies that have done—moved their labor-intensive production to China—the toys, the footwear, sporting goods, and so forth, increasingly computers and information technology hardware.

And so those companies are predominantly from Hong Kong and Taiwan. So I suspect—you know, most of the American companies that have gone there are much bigger companies that are trying to, you know, sell Coca-Cola or shampoo or Kentucky Fried Chicken or something like that in the domestic market.

Commissioner LEWIS. You're saying most American investments in China are trying to sell in the domestic market rather than selling goods back into the United States?

Mr. LARDY. Yes.

Commissioner LEWIS. I'm surprised to hear that.

Mr. LARDY. In other words, it's mostly the other Asian countries that are using China as an export platform.

Commissioner LEWIS. Okay.

Mr. LARDY. And it's U.S. companies. I mean, General Motors is selling its Buicks throughout China. They haven't exported any of those vehicles, for example.

Commissioner LEWIS. You said that China is the eighth largest market for U.S. goods. I think our total exports to China are $15 billion. So the eighth largest sounds a lot bigger than $15 billion.

Mr. LARDY. Well, there's always this question of how you present the data. First of all, I include in all of my calculations the goods we sell to China that are first exported to Hong Kong, and then are reexported. That's about another $5 billion, or between $5 and $6 billion that the Commerce Department doesn't count.

And we can—we know exactly what those goods are from the data that are published——

Commissioner LEWIS. Okay. Then you said it's the fourth largest trading partner, which sounds very big also. But of that fourth largest, $100 billion is their sales to us.

Mr. LARDY. Right. Exactly.

Commissioner LEWIS. So it's very one-sided trading. It may be the most one-sided trading relationship in the history of the world—$15 versus $100.

Mr. LARDY. Yes. The five to one is very lopsided and it's——

Commissioner LEWIS. It's about seven to one.

Mr. LARDY [continuing]. Going to get worse. It's going to get worse.

Commissioner LEWIS. Okay. Then, the other thing I wanted to ask you——

Commissioner DREYER. Any other good news?

(Laughter.)

Commissioner WALDRON. Maybe it'll be more peaceful as a result.

Commissioner LEWIS. Harry, you said that in 1997 to 1999 foreign investment slowed down. And you think this is one of the reasons why China wanted to join the WTO, to give them stature to be a country in which people will make foreign investments and they'll have access to our capital markets also. That's your view as to why they want to join the WTO.

Dr. WU. Yes. That's why the Chinese sent Prime Minister Zhu Rongji to the United States, to try to convince Americans we are ready to get into the WTO.

Commissioner LEWIS. Okay. Then, I want to ask you another question. Now, I noticed, Nick, before you said China is going towards a market-driven economy. Somebody this morning said a market-oriented democracy. And I don't see China as a market-oriented democracy at all.

I think market-driven economy is probably closer to the truth. Do you see—Kate mentioned this before—do you see the fact that they are a market-driven economy necessarily moves them towards democracy?

Mr. LARDY. Well, I would—certainly not necessarily. But I certainly believe it will contribute further to a more pluralistic political system, and perhaps ultimately even a democratic system.

I think if you look at the other countries in Asia that have made the transition like South Korea and Taiwan, economics was the biggest single-driving factor.

Commissioner LEWIS. Well, I want to ask you about South Korea, for example, which has a very strong union movement. I've never been a member of a union, but it seems to me that any country that has a union movement must, by necessity, be democratic. And I can't think of a single country in which they're arguing that it's not democratic, and there are a lot of countries that don't have unions that have capitalist systems that are not democratic. I'd like you to comment on that one.

Mr. LARDY. Yes. But there are also some systems that are capitalistic and democratic that don't have very many unions, and I think Taiwan would be a good example of that. I don't know the numbers, but given their firm size and their structure, with a lot of relatively—you know, a lot of medium-and smaller-sized firms, and not the big cheabol-type companies like you see in South Korea, unions are not a very important factor, yet they have a democracy and they certainly have a capitalistic system.

Commissioner LEWIS. Kate, would you comment on that?

Dr. BRONFENBRENNER. Taiwan has more unions than you think, and actually has some that are quite active. And they are active in manufacturing, which is the sector that's most threatened with China.

Commissioner LEWIS. The reason I mention this is that part of the fast-track question is whether there will be union, you know, human rights and labor rights.

Dr. BRONFENBRENNER. I think that we have to talk about free independent labor movements.

Commissioner LEWIS. Of course. Of course.

Dr. BRONFENBRENNER. Countries that have government-dominated unions. But I do think that when we look at the industries where production is shifting, those—they tend to be shifting from industries that have the highest union density in the world.

The U.S. is one of the countries with the lowest union density, so that we need to remember that. But in manufacturing, which is where the density is highest.

I want to just respond to something said about U.S.-based companies, are they producing primarily for a Chinese or a U.S. market? We—of course, there is no way to find an absolute answer on that. But based on what I'm finding and the media sourcing, I'm finding something different. What are the U.S. companies that are moving to China, and what are they saying to the media why they're moving to China?

I mean, they range from a fishing rod-reel company that's making their products now in China for the U.S. market.

Commissioner LEWIS. Umbrellas.

Dr. BRONFENBRENNER. Electronics. These are electronic products that are coming back to the U.S. A lot of the petrochemical products are coming here—it's not to sell just to China, and the chemical companies to come back to the U.S.

The one market where we found U.S. companies going to China to sell to the Chinese population was wireless phones. The U.S. wireless companies are going into China to produce wireless phones to sell to the Chinese market, and not just U.S. companies, we found Taiwanese companies and Korean companies that the wireless market—to the point where it seems that every person is at some point going to have a phone based on the number of wireless companies that are moving there.

But they are also moving wireless production to China that they plan to sell the phones back in the U.S. as well. So I am not finding that most production shifts into China serve a Chinese market, but we don't have a good way to answer that question, except by looking at the U.S. companies that are moving and seeing whether those are companies that are also selling products made in China and the U.S.

Commissioner LEWIS. I'd like to ask you all a question. Kate mentioned before that the movement of companies to China is causing dislocations in other democratic countries like Korea. And the unions in those countries and workers are very concerned about this, and you mentioned the words "race to the bottom."

Is there anything that can counteract the view that there really is a race to the bottom as companies move from country to country to country? Isn't there really a race to the bottom?

I'd like all three of you to answer that one.

Mr. LARDY. Well, I certainly don't think so. I think everyone benefits from this trade, and it's a race to the top, quite frankly. If you did away with all this trade, everybody would have a lower income, and——

Commissioner LEWIS. A lower income or a lower standard of living?

Mr. LARDY. Both.

Chairman D'AMATO. I'd like to ask a question.

Commissioner LEWIS. Hold it. Let the other two answer that.

Dr. WU. Let me quote from the Chinese Prime Minister Zhu Rongji when he was talking about market economics. I think this is publicized by the Business Week when a correspondent, you know, asked Zhu Rongji about it. Zhu Rongji said, "Yes, we try to build the market economy system"—but listen—"to the socialist market economy system."

So don't mix in that socialist word. Okay. This is different from your idea, so, oh, Chinese market system—market economy system is building up. No, it's a socialist market.

Commissioner LEWIS. Harry, do you think that there's a race to the bottom in terms of wages that companies are moving from country to country, wherever they can find cheaper labor?

Dr. WU. Yes. Of course they are looking for cheap labor, lower wages, everything. But you have to know, I just want to go back to, who is your partner, business partner, in China? Who is your business partner in China? It is the government—Communist. You don't feel this is a problem?

I just am very curious about that. The people don't want to do business with Soviet Union's government. Okay? And now the Communist government in China is okay. That is something that really confuses me. I don't know. I——

Commissioner LEWIS. The question to you is, why?

Dr. WU. Yes.

Commissioner LEWIS. Kate, how do you feel about the race to the bottom?

Dr. BRONFENBRENNER. Well, I think we have other partners to look at, and I think the recent report that was just issued by the Economic Policy Institute that looked at NAFTA at 7, and found that in Mexico, although it's true that there has been a lot of production increases in China, most of those in Mexico are isolated in the maquilladoras, isolated from the rest of the Mexican economy.

And they have not contributed so much as raising wages for the Mexican population, because the compensation and working conditions for most Mexicans have deteriorated, not improved. And so I think we should look very carefully at the Mexican experience to think about what may be happening in other countries.

When you move away from the elites of those countries, and talk about how the economy is booming, and you talk to people in Korea, and you talk to people in Latin America, and other Asian countries as well, many of the workers question whether, in fact, the boom is trickling down, and whether actually there is small group of people who are benefiting but more and more workers are being forced into an informal sector of day-to-day barter economy.

Chairman D'AMATO. George?

Commissioner LEWIS. George wants to ask a question, but I just wanted to make one comment. I'm sorry.

The New York Times a couple of days ago had an article about the migrant farm workers in Mexico. I don't know if you saw that. And even the president of Mexico has child labor working on his own ranches.

Chairman D'AMATO. Commissioner Becker?

Commissioner BECKER. I almost want to comment on the race to the bottom. When one of the largest corporations in the world makes a statement, public statement, that he would put every plant on a barge, so that he could float it from country to country for the lowest wages, the lowest economic benefits, and the lowest environmental cost——

Commissioner LEWIS. Like General Electric?

Commissioner BECKER [continuing]. And change it——

Commissioner LEWIS. General Electric?

Commissioner BECKER. General Electric made this statement.

Commissioner LEWIS. Well, can I just——

Commissioner BECKER. When they——

Commissioner LEWIS. General Electric is one of the companies that——

Commissioner BECKER. Another question, it's hard for me to resist when you talk about union density in the United States—the United States, I mean, which is the most freedom-loving country in the world, the business institution has never accepted the right of the labor movement to exist as an institution in this country. Has never accepted that.

I mean, that's a—anyway, I have three questions I want to put to each one.

Harry, I've heard you talk before, but it has been many, many years ago. You were in what we refer to as a slave labor camp for 17 years, 20 years.

Dr. WU. Nineteen years.

Commissioner BECKER. Would you mind telling us what——

Dr. WU. Well, nine years in a coal mine, and the other nine years in a farm, in the chemical factories, and brake factories, also in a steel company.

Commissioner BECKER. And what was the last?

Dr. WU. Steel company. Steel.

Commissioner BECKER. Steel. You're a steel worker.

Dr. WU. Yes.

Commissioner BECKER. Okay. I'm a steel worker.

(Laughter.)

Dr. WU. Very different. You got paid; I didn't ever get paid.

Commissioner BECKER. Okay.

Commissioner DREYER. Becker is going to sign you up.

(Laughter.)

Commissioner BECKER. How was it that you were released? What——

Dr. WU. In 1979.

Commissioner BECKER. How did it come about? Why did they——

Dr. WU. I was sentenced to life, and in 1979 Deng Xiao Ping came to power, and they changed the policy, giving certain people like me a kind of rehabilitation.

Commissioner BECKER. Do many of these camps exist over there?

Dr. WU. Of course.

Commissioner LEWIS. And how did you get——

Dr. WU. I came to the United States in 1985 as a visiting scholar of U.C.-Berkeley. Yes, so different——

Commissioner DREYER. And you have actually published a book where they could read all about it, right?

Chairman D'AMATO. Go ahead, George.

Commissioner BECKER. Give me a gavel.

Are there many of these camps over there?

Dr. WU. Yes.

Commissioner BECKER. How many? Can you give us an idea?

Dr. WU. We have published a handbook, around 1,000.

Commissioner BECKER. Around 1,000.

Dr. WU. Yes.

Commissioner BECKER. Is it right for us to refer to these as slave labor camps?

Dr. WU. Oh, yes.

Commissioner BECKER. Are any of these institutionalized business-wise throughout the United States? I understand that it's—let me put it a different way. I understand that some of these slave labor camps are listed by Dun & Bradstreet——

Dr. WU. Yes.

Commissioner BECKER [continuing]. As manufacturing institutions. Is this correct?

Dr. WU. Yes.

Commissioner BECKER. Fabulous.

Dr. WU. Yes. According to Chinese policy, each unit, each facility has two different names.

Commissioner BECKER. Who runs these camps?

Dr. WU. Government.

Commissioner BECKER. The government.

Dr. WU. Yes.

Commissioner BECKER. The military or the——

Dr. WU. Judiciary.

Commissioner BECKER. The who?

Dr. WU. Judiciary, the Minister of Justice. In the judiciary system, they have a name at a prison—at the labor camp, you know, something like that, and also have an enterprise name.

Commissioner LEWIS. How many people are in the old camps?

Dr. WU. How many today? We don't know. Probably approximately five million.

Commissioner BECKER. I was wondering, with the advanced trade—with the trade with the United States, are these camps increasing? Are the numbers of them increasing or going down?

Dr. WU. They are increasing. I can show you one thing right here.

Commissioner BECKER. These are all listed. Do you have these listed?

Dr. WU. This man is—just came to the United States as a businessman. But actually, this is a real job. You can read it. This is a prisons manager.

Commissioner BECKER. If this Commission makes a trip to China, would it be possible for us to go through any of these?

Dr. WU. No, of course not.

(Laughter.)

That's why if I go back to China they will capture me.

Commissioner BECKER. Well, but we're not——

Dr. WU. See the rubber boots. Okay. One of the rubber boots produced by one of the individual labor camps is a prison in Senyung. Fifty-five percent of the rubber boots in China on the market is coming from this——

Commissioner BECKER. But, Harry, if we have the name of a plant that is listed by Dun & Bradstreet as a business enterprise, and we know where it is, can't we ask to see that specific plant?

Dr. WU. Well, they——

Commissioner BECKER. What would they tell us? What do you think they would tell us?

Dr. WU. They sanitized——

Commissioner BECKER. That what?

Dr. WU. They sanitized it. And, for example, let me tell you, there is one prison camp in Yunan Province. The judiciary inside system is number one prison. But the others are Golden Horse, Jimma, just for engine manufacturing. Okay?

These are on the list, and American Customs Service official from Shendu tried to do an investigation. Okay? So he went to the city and asked normal people, saying, "Where is number one prison?" A number of people on the street said, "Over there." He said, "No, this is a company. This is an enterprise." And the people said, "No. This is a prison."

And then he'd come back again and he said, "I'm looking for Jimma in the Golden Horse, manufacturer of diesel engines. Where is the location?" He said, "Over there." And the American said, "No, this is a watch tower by the wire. Everything is like a prison." He said, "No, this is the place."

Commissioner LEWIS. Could we visit that place?

Dr. WU. Of course not. That's why they captured me and sentenced me to 15 years in the jail.

Commissioner LEWIS. What were you sentenced for?

Dr. WU. In the beginning? 19——

Commissioner LEWIS. Because you did what?

Dr. WU. Because I was a 20-year-old student. I was one of the class meeting—I—only two points I made. One is I disagreed with the Soviet invasion of Hungary, 1956. It seemed in violation of international law.

And the second point I made is I—I criticized a member of the party, because if you are the member of a party you have all the privileges. And the common people become second-class citizens. That's all I said. One class meeting was—to 29 students. A couple of days later they said, "Well, Harry Wu is a counterrevolutionary rightist."

Chairman D'AMATO. Commissioner Becker, are you finished?

Commissioner BECKER. Okay. Let me switch just a little bit. On the monitoring, and as something that interests me very much, when the Asian economic crisis hit, steel was being flooded into the United States. We were never able to track this.

The industry was never able to track it. The government couldn't track it. Steel was being stacked up on the levees, on the—at parking lots, down south in Mobile, Alabama. And we never got the full impact of those imports until months and months later. So it created a crisis in and of itself beyond—dimensioned within the steel industry.

And there has been a lot of promise by the government of devising a monitoring system. And I sense one of the difficulties with this is nobody wants to create a huge bureaucracy.

In your studies in that, and examination of this, is there—have you found or can you recommend or will you be able to recommend an easier way to do this? Can we have, for example, an importing license in which they would have to fill out something that could be fed directly into a computer? Is that logical to do that? So we'd have instant knowledge of what's coming in.

Dr. BRONFENBRENNER. I think one of the only ways to do it would be make it some kind of scannable form, so that no one had to transfer the information directly, but it was actually something where if certain boxes are checked, then they would be automatically scanned in. You would need to know the country it came from, the company that produced the good, both the company and the parent company.

It wouldn't have to be a lot of information, but if that information could be on some kind of scanable form that immediately would become data rather than have to go through an entry process.

Commissioner BECKER. Well, the second aspect of that, then, that's—we would hope that something like that could be recommended. But the second aspect is, who is producing the goods? If a company—ABC Company in the United States contracts out for some highly sophisticated equipment to be made, and yet we get an importing material coming into this country, and it's under a Chinese name of a company, and we have no idea whether it's farm implements in there or whether it's electronic gear or that—is this a problem in tracking who actually does what? Because most of these companies are actually contractors, aren't they? Isn't that what they do? They contract this out?

Dr. BRONFENBRENNER. The U.S. companies have become primarily brand names, they often don't produce the goods. The production is done by contractors, and then when it comes into this country it gets the U.S. brand name, which makes it even harder to track.

So there are two directions that I think we have to monitor. One is monitoring goods coming in and making sure that we know the actual source country, source company, and the company the goods are coming into.

The second way that I think we also have to monitor is make a requirement for U.S. companies that are shifting production out of the U.S. to report to the government what kinds of jobs, how many jobs they're shifting, what the product was, and the company they're shifting the work to.

However, I have serious doubts that that kind of legislation is going to come about. I have serious, serious doubts. That's why short of winning this legislation, we have to come up with some kind of proxy for this, and—unfortunately, the media tracking is the only source that we have at this point. I do think we need both to track the goods coming in and figure out where they're coming from and who they're going to, and only if we also track the work going out, will we actually be able to build an information base to understand what has happened.

Commissioner BECKER. The last question I have, and perhaps Mr. Lardy would want to comment on this, but certainly anybody on this—other witnesses that we have talked to all seem to give the impression that they're hoping all of this works out, that this engagement with China is a very tenuous thing and it was described by one as a large rubber band around all of it, and we keep stretching it and stretching it and stretching it, and we hope it doesn't break.

The transparency is a problem, enforcement is a problem, and deceit and deception, obviously, is always a question there. So the question that I would ask is: is this type of economic exchange with China—is this really worth—or does it really make sense if China is going to be a strategic rival of the United States? If it's a true competitor, should we be engaged in this kind of economic exchange with a country like this? Yes, sir?

Dr. WU. Let me make two points. First of all, go back to the—you were talking about tracing the Chinese products. A couple of years ago in the House testimony I remember the Democrat's ranking member, Sam Gejdenson, talking about these Fourth World products.

This hammer is a Diamond brand hammer. We identified the hammer as Diamond brand, made by forced labor. You know, we have pictures, Chinese documents, everything.

But next year we find out there is another five legitimate Chinese factories making the same brand—Diamond brand. Definitely, they are not prison camp at all. So one brand of products has different manufacturers. Only one is a prison camp.

So what can you do? And Sam Gejdenson said, "If we find one hammer—the hammer made by forced labor, we are going to ban the whole category of hammer." It's impossible. The American consumer said, "What are you talking about?" Right?

In China there are no copyrights, whatever. It's controlled, once again, by one government.

Second, I gave another example. I talked to—with the former CEO from Eastman Kodak. Eastman Kodak is a big manufacturer today in China in Xiamen making the film. Eastman Kodak is very well known in the United States because they have a very good benefit policy for the workers.

And I said, "Well, do you know that Chinese workers in your factory in China, if they violate the population control policy"—that means the woman has a second child, there is a violation in China. They will fire her—lose her job. And he said, "Well, I don't know."

Yes. I'm pretty sure he doesn't know. But the American facility—American workers, they will not be fired by Eastman Kodak if they have a second child. The Chinese workers were fired, and he doesn't know.

Yes. Chinese—you know, American business in China, they take a portion of the annual salary income—it's big money—and hand it over to the Chinese government, and the Chinese government organizes a so-called official union in the facility to handle the insurance policy. And the union—the government union fired the female workers, and you violate the population control.

So this is happening today in China. There is very good cooperation over there. Okay? We have a good relationship with the government. They make a good job in business. Okay.

Mr. LARDY. Well, I'm not sure I can add to my earlier answer. I mean, as I said before, I think that China is way behind us in technology and certainly in the military force, and certainly in economics. And I obviously would be against trade with them if they were a strategic competitor in the sense that we thought they were fundamentally—you know, there was going to be a military conflict.

But I don't think the evidence is there yet, and so I certainly don't—I think we ought to follow the other strategy of engagement.

I would like to go back and make one comment related to the foreign firms. Mr. Wu has mentioned several times the nature of the partners. It is increasingly the case—in fact, now in recent years the vast majority of foreign investment going to China is forming wholly foreign-owned companies. There is no Chinese partner whatsoever.

They are 100 percent foreign-owned. This has become the dominant form of foreign direct investment China over the last few years. In the 1980s, it was almost unheard of. There were a few examples in the early 1990s, but now it has become the dominant form of participation by foreign businessmen in China.

They just simply come in and set up a green field facility or they buy something outright, and it's 100 percent wholly foreign-owned, whether it's U.S. or French or Japanese, or whatever.

The other thing I would say is that there would seem to be, based on what Kate said, a difference between the Chinese case and the Mexican case. There has been a very substantial increase in the value added locally in the exporting—in the processing in the exporting plants that foreign investors are involved in.

It used to be the case that this was really something of an enclave and didn't create much demand in the rest of the economy. The rates—the local content was only about 15 percent of the value added even less than a decade ago. It's now up over 30 percent.

So increasingly once foreign firms go in, and they are producing for the export market, after a period of time they do find local sourcing for some of their parts and components, so there is—there is trickle down, if you will.

In other words, it is creating jobs in the rest of the economy. It is raising wages. I mean, not only do these companies pay higher wages than purely indigenous companies, but they are creating demand and jobs in other parts of the economy.

So I'm not quite sure what all the factors are, but, as I say, the rates of value added have more than doubled over the last six or seven years.

Commissioner BECKER. I've been told by American employers that if they own the company outright, if they go into China and they build, all of the product from that factory has to leave China. That it's only on a partnership arrangement in which China has the majority, like a 51 percent, 51/49 percent, can they sell domestically.

This is manufacturers that I deal with that have told me this.

Mr. LARDY. Well, there certainly are cases like that, but it—all of these restrictions are going to go by the board when China comes into the WTO, because they will no longer be able to impose any restriction on where the product of any foreign company is sold.

Chairman D'AMATO. So they will be complying with WTO, in contradiction to every other agreement they've signed.

Mr. LARDY. Yes.

(Laughter.)

On the economic side, I think their record with the United States is—you know, if you go back and look at the market access agreement that they signed in 1992, or even read what USTR has written about it, they basically are in full compliance with that agreement. They weren't in the first year or two. It took them a while to get there, but in recent years they have been in compliance with that agreement.

Chairman D'AMATO. Commissioner Waldron, you had some follow up?

Commissioner WALDRON. Yes. I just had—I want to ask Nick about the Chinese government specifically, because as I understand it Beijing runs a fiscal deficit. And they are increasingly—they are issuing large amounts of bonds, right, into the Chinese market?

But before you comment, I just want to make two quick comments. One is just Harry Wu asked why is it that—of course, it's a rhetorical question, but why is it that we have this embrace of communism in China, whereas we didn't in the Soviet Union?

It seems to me the thing I circulated this morning sort of points it up. Obviously, we started out seeing the Soviet Union as a military rival and a security threat. And, therefore, we wanted to use economics to—we wanted to deny them economic access in order to discipline them.

In the case of China, we saw China as being a positive contributor to American security as an offset to the Soviet Union, and that meant that there was never an incentive in our security calculation to deny economic access to China. Rather, there was a lot of pressure in the 1970s and 1980s to open up the economic exchange as fast as possible in order to foster the security relationship.

And the problem we have now is that the security relationship in a sense has dissolved, I would say with the disappearance of the Soviet Union. But the raison d'etre, from a security point of view, is gone. But the economic relationship is there, sort of moving along.

The other thing I wanted to make a comment——

Commissioner LEWIS. This is driving the relationship.

Commissioner WALDRON. Yes, that's what I'm saying. We have to look at that, because that was never—the thing that I cited here from Matlock's book struck me very much when I read it, which is that in the 1980s there was a decision made in the United States that you hold back on economics until you get some satisfaction on security.

And that meeting was never held when it came to the relationship, the economic relationship with China. The idea was just push forward, push forward, push forward, because security isn't a problem.

The other thing is the question came about Taiwan, were there unions and all the rest, one of the things that struck me very strongly is that the structure of the economy in Taiwan, as Nick pointed out, is very much dominated by small firms, family firms. It's very, very entrepreneurial. Very, very entrepreneurial.

In that sense, it's very, very different from what we're talking about in PRC, where entrepreneurship is discouraged. Now, there are still—the Chinese being the kind of economic heroes that they are, there is still some very impressive entrepreneurship inside China. But it's certainly not fostered by government.

And, therefore, the issue arises of whether our financial—whether our economic relationship is fostering entrepreneurship or whether it's helping the state sector in a sense to resist the need.

But I think that's something that's very—that's a very, very important point to bear in mind, because how you analyze the receiving end in China of the relationship, and what you think the dynamic is, will have a lot of effect on whether you think it's worthwhile or not.

And I wanted to thank Nick for pointing out about the rise in local content, because, I mean, that's—I think the question is, is it like Mexico, or is it like EPZs in Taiwan? This is an important issue.

But could you comment on the fiscal strength or the financial strength of the central government? Why is it that they are running a deficit? Where are they raising the money? How long can they go on doing this? Because, as I understand it, they've said that sort of next year they're going to stop borrowing these hundreds of millions of dollars every year.

Mr. LARDY. Well, I mean, basically, since the beginning of the Asian financial crisis, they have had a fiscal stimulus program. Just prior to the crisis, they were in high rates of inflation and excessive growth, and they were just bringing it down to a soft landing, and then the Asian crisis hit, and aggregate demand—external demand declined, so export growth was not as strong as it had been, and the economy was losing steam.

So they did begin this several years ago. They had a small deficit prior to that. The deficit has gone up, and they are financing it by selling bonds on the domestic market. The total amount of government debt outstanding as a percentage of GDP is still very, very low, but it has——

Commissioner WALDRON. That's if you only include the specific government debt, yes.

Mr. LARDY. Right. You only can include the specific government debt. If you want to add on to that the amount that it's going to cost them to fix up the banking system problems—in other words, some of the bonds being issued by these asset management companies which are implicitly government debt, although not explicitly government debt, if you want to talk about the financing of unfunded pension liabilities, you know, then China's overall fiscal position looks very weak and very fragile, in the sense that they have very, very high levels. If you take the sum of implicit plus explicit government debt, it's quite high.

Commissioner WALDRON. Would it be fair to say that in a sense this stimulus program that you're talking about, for which the government is borrowing money to try to increase demand and stop deflation, and so forth, that that is being carried out to some extent as an alternative to privatization? That there is an attempt to keep the economy somehow pushing ahead?

I mean, you said that the reason they had to do it was that export was—exports were not growing fast enough, even though as you pointed out they're growing at, what, did you say five times the rate of world trade? So they are growing pretty damn fast.

To some extent, is it a political decision to go for this kind of stimulus, and a way of avoiding tackling a tough economic issue?

Mr. LARDY. Well, no, I would say it's largely economic. I mean, there was—I mean, the long-term rate of growth of trade has been very rapid, but there was a period of two to three years where it was relatively slow by Chinese standards.

The amount of this fiscal stimulus on an annual basis is relatively small as a percentage of GDP. It's actually well under one percent of GDP, so we're not talking about big budget deficits of, say, the type that the Japanese have had in the 1990s in an attempt to revive their economic growth. It has been more modest.

But it is economic. It is going into infrastructure. I don't necessarily see it as a tradeoff with entrepreneurship and private activity, because a lot of the money has gone into things that the private sector doesn't do in any economy—you know, bridges, roads, etcetera—has taken——

Commissioner WALDRON. All the things like the new railroad station in Beijing, which is already falling apart, at a cost of——

Mr. LARDY. That predates——

Chairman D'AMATO. We have to move on.

Commissioner Bryen, let's move—we only have a few minutes left, but go ahead. Do you have a question?

Commissioner BRYEN. Yes, I did. What's the average factory wage in China today? In U.S. dollars.

Commissioner DREYER. Is average really meaningful?

Commissioner BRYEN. I want an average number. I asked a question. I'd like to get an answer. What's the average factory wage in U.S. dollars?

Chairman D'AMATO. Does anybody have a guess?

Dr. WU. $400.

Commissioner BRYEN. I want to see how it's contributing to democracy, so—the reason I'm asking the question is I want to know what it is now, what it was 10 years ago, so to speak, and what impact it has on——

Commissioner BECKER. In 1979, doctors were making $40 a month.

Commissioner BRYEN. In 1979.

Commissioner BECKER. Yes.

Commissioner BRYEN. What are they making now?

Commissioner BECKER. I have no idea.

Commissioner BRYEN. $42?

Dr. WU. Today it is like $400 average.

Commissioner BRYEN. $400——

Dr. WU. Average.

Commissioner DREYER. A week? A day?

Dr. WU. I'm sorry, a month. No, I'm sorry, $400 a year.

Chairman D'AMATO. For a factory worker?

Dr. WU. Yes.

Chairman D'AMATO. Factory worker?

Dr. WU. No, average for all Chinese.

Chairman D'AMATO. Oh, average all Chinese.

Commissioner BRYEN. For the whole country.

Dr. WU. Whole country.

Commissioner BRYEN. And the factory worker makes less than that?

Dr. WU. Factory—no, the lower is 80 percent of the population is peasants.

Commissioner BRYEN. So that would be——

Dr. WU. They are probably only—less than $100. Very low.

Commissioner BRYEN. So if we set $500 as sort of the top down, it goes down from there. Has it increased, decreased, or stayed about the same?

Dr. WU. In the urban area, increased.

Commissioner BRYEN. In the urban area.

Dr. WU. In the village, in other areas, decreasing.

Mr. LARDY. Well, but you've got to be careful about the timeframe. If you take from the beginning of economic reform in 1978 up to the present time, the average per capita income, and, thus, the average wage has at least quadrupled. It is true rural incomes have had very little growth in the last two to three years. But if you take the whole sweep of the last 23 or 24 years, per capita incomes have more than quadrupled.

Commissioner BRYEN. Let's accept that. Has that led to democratic reform in the last 25 years? It seems like it went the other way.

Mr. LARDY. Well, I would never use the word "democratic" to describe what China is today.

Commissioner BRYEN. Any liberalization. It seems like——

Mr. LARDY. Citizens can sue the government and do so frequently today. That's something that was unheard of and illegal and impossible in the 1970s.

Commissioner BRYEN. But they can also go to jail for praying or for—go to jail for saying something that the government doesn't like or go to jail because they're in Falun and they——

Commissioner LEWIS. Demonstrating for wages.

Dr. WU. That's very common in China.

Commissioner BRYEN. So I don't see the improvement. The point I'm trying to get at is that we are a bit optimistic to think that, at least in our lifetime, with the current sort of wage that you have there, that this is going to contribute in any direct way to any particular improvement in the governance of China.

Mr. LARDY. Well, it took four decades in Taiwan to move from an authoritarian——

Commissioner BRYEN. Well, what's the average wage in Taiwan? It's about $13,000 or something like that? It's immensely different.

Commissioner BECKER. But this might help you as far as a relationship. A plant that was located in the maquilladoras area in Mexico, that was paying $4 a day, I think 34 or 35 pesos, and the exchange was running about seven to one at the time, is relocating to China because it was $2 a day in China.

Now, that—I won't say that's typical. It may be bad. It may be worse. But this was one example of exactly half of what was being paid in the maquilladoras.

Commissioner BRYEN. I'm only trying to make the point that it seems to me that China is still so vastly unpaying its people, and there is no way for that to rise, and particularly in the dramatic sense.

If we're talking about a difference between $200 and $500, it doesn't impress me very much.

Commissioner LEWIS. Steve, would you yield to me to ask one question to Harry?

Chairman D'AMATO. We have three other Commissioners that——

Commissioner LEWIS. I'm sorry. This is on what he's talking about.

Commissioner BRYEN. I'm trying to get a debate going on this subject, because it seems as if—I mean, I'm not against trade with China, but I'm troubled by the idea that this trade is improving the living standards such that it's going to cause reforms. It seems to me it's not doing anything like that.

Commissioner LEWIS. Well, Harry said before that he's not trying to have a cold war, he's not trying to contain China, but you also said, Harry, that you do not—how do we do business with someone who is totally against our principle? What would be your recommendation for our trading relationship with——

Dr. WU. Well, why don't you just tell the Chinese government "no free lunch." No free lunch. Restraint.

You know, we Chinese have an idiom, okay, there's a pot of hot water. How do you cool down the water? Two ways—one, using a bar—a stick to stir, maybe the cold water—boiling water will cool down. This is temporary. The other way, withdraw the firewood from the bottom of the pot.

So not only put the money, the investment, the business contract on the table, they also put human rights, political reform, political progress also on the table.

We want to see a prosperous, peaceful, and democratic, and free China. But we want to wait. We want to be very patient, but we don't want to see—you still arrest people if they want to say something that they want to say. This is unacceptable.

We want to see the religious freedom. We want to see the Dalai Lama to move back to his own country to see his own people. We want to see the Falun Gong people in—they are put in jail——

Commissioner LEWIS. Okay.

Dr. WU. You want to have a business contract, fine. I think this is the thing they have to, you know, combine together, put together.

Chairman D'AMATO. Commissioner Bryen?

Commissioner BRYEN. Two more questions. What's the percentage of unemployment in China today?

Mr. LARDY. Well, the official figure is—I can tell you what the official figure is, but, quite frankly, it's meaningless, because it only covers urban population. There are tens of millions of people in the countryside who are effectively—you know, their productivity is extremely low, given the shortage of land and they might as well be unemployed. So——

Dr. WU. I can give you a figure. Let me give you the figure. The actual figure—unemployment rate from urban, 20 percent. And countryside, labor force is never counted. Okay. But, actually, there is around 80 to 100 million so-called migrant workers who are in this country looking for a job.

Commissioner BRYEN. Now, is that worse than it was, or better than it was?

Dr. WU. Oh, yes. Yes.

Commissioner BRYEN. Worse?

Dr. WU. Worse.

Commissioner BRYEN. So we have a problem. I mean, in China, there is a growing problem of unemployment and——

Dr. WU. Yes, because the state enterprise is in bankruptcy, laying off the people.

Commissioner BRYEN. So, then, to attract more manufacturing they will probably lower wages and do other things. So it's not a very happy picture, is it?

Dr. WU. No.

Commissioner BECKER. Could I add an element to your thing, if you want a debate going? We talked a little bit about a free trade union movement. We talked—I did, and somebody else raised it—we talked—I call that freedom of association, the right of people to be able to band together, to be able to share in the wealth that they helped create.

And until you empower workers to be able to share in the wealth they helped create, bring collective action, you're not going to build a domestic economy, because the money doesn't go to them. And you can only build a domestic economy if you empower the workers in some way. If you can create wealth amongst the workers, something—so that they can buy, and they can share and participate.

Commissioner BRYEN. Yes, I think you're right. I mean, but the point I'm trying to get to is that it seems like all this trade that we're talking about, instead of improving the situation, the situation is getting worse. You've got more unemployment, more migrant workers, more dislocations, and less freedom.

Chairman D'AMATO. Well, then, you're in the streets of Seattle. You're not in the negotiating——

Commissioner BRYEN. So it seems that the—the idea that people have put forward that this trade is—the trade process is going to somehow make a more democratic and peaceful China may be a bit misplaced.

Commissioner LEWIS. But you have to look at population growth, too, Steve, to see where it's going to affect growth.

Mr. LARDY. And let me just make a comment. I mean, this is an economy that is in a transition from a centrally planned system where everybody had a job and productivity was extremely low, and incomes had very—there was no change in food consumption in China between 1957 and 1977.

We now have been in a transition, and I think we're well along the way towards establishing a market economy. And that's not necessarily a full employment economy. You have variation in wages and some people are more adaptable than others, and so you have unemployment—higher levels of unemployment, but the average person, as I mentioned, is about four to five times better off than when the process started.

So if you're advocating going back to a centrally planned economy with low productivity and everybody has a job and there's no trade, you know, that's certainly an alternative. But I don't think——

Commissioner BRYEN. Well, no, I wasn't advocating that.

Commissioner LEWIS. That——

Chairman D'AMATO. We've got five minutes to go. We're about 10 minutes over.

Commissioner BRYEN. Can I ask my last question?

Chairman D'AMATO. Go ahead, Commissioner Bryen.

Commissioner BRYEN. This has to do with some comments you made earlier about leverage and the question of leverage. There are a lot of people that were looking at the capture of the P–3 and the events that followed that—holding of our people for 11 days, the thought that it was less credit to General Powell and his negotiating abilities than to the negotiating abilities of General Walgreen and Admiral K-Mart.

(Laughter.)

But it brought about the release of our guys and gals. It seems to me that—do you agree with that? Do you think it was economic pressure, the fact that the American people weren't going to buy Chinese products anymore if—given the behavior they saw?

Mr. LARDY. Well, I wouldn't put it—the way I'd put it, I tend to agree with that. I think if they didn't have a huge stake in the economic relationship that we wouldn't have gotten our crew back as fast as we did.

Commissioner BRYEN. So we do have leverage, then.

Mr. LARDY. I would put it the other way around, is that I think the economic relationship creates constraints. And it creates constraints, quite frankly, on both sides. But I certainly think the Chinese side was constrained. They would, you know, face the loss of that economic relationship in the worst case, so, yes—yes.

Dr. BRONFENBRENNER. Just to add to that, it was a very time-sensitive constraint, though, because this was the time before the WTO and when they are seeking out the Olympics. And there is a certain point, once that decision is made, you lose some of that leverage.

If the timing of this was at a time when all of these things were happening at once, and they were very interested, I think that going back to your question before is that we have a lot of people talking about trade—the links between trade and democracy and trade and standard of living, and we actually have very little data.

And, of course, it's extremely difficult to get good data out of China. And I think all of us have to be careful about making sweeping statements based on a lack of data. And what the answer is—if we want to really know what the impact of trade is going to be, we'd better study it very carefully and stop making generalizations that affect, you know, millions and millions of people's lives without getting more data.

Commissioner BRYEN. But what was a spontaneous action of the American people in this particular case had some real impact and did some good.

Chairman D'AMATO. I'm going to limit Commissioners to one quick question each.

Commissioner Robinson?

Commissioner ROBINSON. Yes. I'll make it quick, as much as I can.

Nick, you've done, as I said earlier, a lot of important work on the banking sector, other sectors of the Chinese economy for which I am—for one, am very grateful. Do you personally have a financial background? I'm just curious.

Mr. LARDY. No.

Commissioner ROBINSON. And on to the——

Mr. LARDY. I'll just—I wrote a book on Chinese agriculture quite a number of years ago, and people said, "You must be an agricultural economist." And actually I'm not, so my—then I wrote on banking, and I've written on other things, but I'm not a——

Commissioner ROBINSON. You just play one on TV.

(Laughter.)

And, Harry—seriously, it's been fine work.

Harry, this is the question. Assuming the projection of most analysts I know as well as my own research in this area indicate that China will likely be coming to the U.S. capital markets for tens of billions of dollars annually for the—at least the foreseeable future.

Do you believe that this Commission would be well-served to recommend the strengthening of SEC disclosure requirements, so that American investors can better differentiate between benign commercial Chinese enterprises and those engaged in various forms of actual wrongdoing?

And in rare, select circumstances, consider recommending empowering the President or the Congress to deny access to our markets for specific enterprises that—or an enterprise that's engaged in egregious national security or human rights abuses?

Dr. WU. I would say no, no, and no. Simple. I don't think we have to grant these Chinese companies and get the access on the American market at all. We should not give them any blood transfusions at all.

Chairman D'AMATO. Commissioner Dreyer? Commissioner Mulloy, you have a question?

Commissioner MULLOY. Yes. Mr. Lardy, the question about foreign investment by American companies in China and whether it's there to service the Chinese market or whether it's to be exported back either to the American market or elsewhere, my—you thought it was more to service the domestic market.

The question I have is: is that a judgment based on intuition, or do we have data? And if you do have data, could that be made available to the Commission?

Mr. LARDY. Well, let me respond very quickly. You know, the predominant imports of the United States from China are things like footwear, apparel, toys, sporting goods, and these other labor-intensive commodities. These are—we used to buy most of this from South Korea, Taiwan, and Hong Kong. It's now coming from

China. Most of the companies making it are companies that moved to China to take advantage of the production conditions there.

Now, certainly you can point to certain examples where, yes, American firms are moving to China to produce to come back. But the biggest investments—in the auto industry, for example—and particularly in the services area—in Kentucky Fried Chicken, McDonald's—you know, they have more than 700 restaurants over there, Coca-Cola has a share of the domestic market that is 15 times bigger than its nearest domestic competitor, Procter & Gamble, I mean, the list—Kodak is a very good example.

They have now—five years ago or six years ago they had practically none of the film market. They now have 50 percent of the film market in China, and it's based on production in China.

So if you look—the biggest investments are by American companies that are more capital-intensive and they are not producing labor-intensive products. Yes, you can point to examples where it's coming—where some American companies are moving their production to China to export back here, but I think as a general proposition it is the case that the companies in Asia are the ones doing the labor-intensive production, they're the ones that have moved, they're the ones that are providing the goods that we're importing from China, by and large.

Most of the American companies are more capital-intensive, and they are serving the domestic market.

Chairman D'AMATO. Commissioner Dreyer, you have a quick question?

Commissioner DREYER. Yes. Given the——

Chairman D'AMATO. I'm sorry. Did you want to——

Dr. BRONFENBRENNER. When you look at figures on U.S. FDI into China, you know, it's true that services has grown, but it still is—electronics equipment is way more than any other industry, followed by petrochemical, and then finance.

And I would agree that banking services seems to be something that's serving a Chinese market, but I should say before even finance there is machinery. Services are down lower in the total number of dollars going in. It's true that there are many, many McDonald's or Coca-Colas—but in terms of actual production numbers, that's a smaller number of people in those jobs.

And I think we have to look at the electronics components and machinery and other production. I'm not sure the numbers would bear that out.

Chairman D'AMATO. Commissioner Dreyer?

Commissioner BECKER. Mr. Lardy, do you have a list? Do you have that data? Do you have a list of companies? Is there a list of companies that——

Mr. LARDY. I mean, I've been watching this for 20 years, and I'm just throwing out examples of companies that I remembered. But no, I do not have a list.

Commissioner BECKER. We're beginning to see machine tools coming into the United States now.

Mr. LARDY. But China has been the biggest producer of machine tools in the world for decades. I don't think very many of them are being produced by American companies.

Commissioner BRYEN. Low end.

Mr. LARDY. Yes.

Commissioner BRYEN. Low end.

Mr. LARDY. Yes, absolutely.

Dr. BRONFENBRENNER. But there's been a dramatic increase in U.S. FDI in machine tool companies in China, in petrochemical companies in China. Whether it's U.S. companies that used to produce it in the U.S. now producing it in China, or not they are certainly investing dollars in these industries.

Chairman D'AMATO. Commissioner Dreyer, last question.

Commissioner DREYER. Yes. Given the fact that one important source of investment in the mainland of China has been other Chinese entrepreneurs—that is, non-Chinese citizens who are ethnically Chinese—and given the arrest and detention in the number of people recently, do you see that having any significant effect at all on overseas Chinese willingness to do business with China?

Or is it—this isn't going to happen to me? Or those are mostly scholars? Those are not——

Dr. BRONFENBRENNER. It certainly affected the academic community. It is certainly a big concern among Chinese-born scholars, with good reason.

This is all very soon to see whether that has trickled down into the business community. There has definitely been a reaction within universities. There is word going out to, be careful.

Dr. WU. Let me say it this way. Okay. Making an investment in China, trading with them, that will benefit the American companies and, you know, multiple international companies. That's another problem.

And also, it will benefit the Chinese. You know, today, many Chinese, you know, stand in the intersection of the street and say, "Which way do you want to go?" The left side is the state enterprises company, and it's a foreign company.

Today, in China, finding a job, you know, the first priority is going to be looking for a job in a foreign company, because there is much better payment, much better benefit, everything. And definitely they learn a lot of things from the West.

It is a kind of seeding and, you know, put in the ground—in the soil in this country, and in the future, you know, to—it will blossom, grow, and become a democracy, and something like that. There's no doubt about it. Okay.

But the other—this is one side of the story. Okay. The other side of the story is the government shares the profit. The government is using our money to upgrade their military assistance, become a threat, become a problem, using the monies to gain power and control. And what should we do?

Okay. For example, North Korea—okay—four parties talk, two by two. What is that? South Korea and United States together, North Korea and China. I like to say if today China makes an announcement, "We will withdraw the support to North Korea," tomorrow North Korea will collapse.

North Korea only has one friend in the world—today in the world—China. Okay. So what is this? So we feel this is a communist vehicle in China. That's the way I was thinking about it.

Chairman D'AMATO. Thank you.

Go ahead, Commissioner Becker.

Commissioner BECKER. A very short one, Harry. I hate to let you go, because I know after you leave there's going to be all kinds of things that I'm going to think of.

It's been reported to this Commission, and I've heard it, I've read it in the papers a lot, that the military—the PLA—is virtually separated from the leadership in China, operates independently, almost to the point of like two governments over there. Is this——

Dr. WU. Not true.

Commissioner BECKER. Not true.

Dr. WU. Not true at all. The military is entirely controlled by the party. If you are the chairman of the party, you are the chairman of the military commissions. Without permission from the chairman of the party, the minister can do nothing.

Commissioner LEWIS. So the military is controlled by civilians?

Dr. WU. Controlled by the parties, by the top of the Communist leaders.

Chairman D'AMATO. I want to thank the panelists for their extensive time with us. We appreciate it. We're going to send a transcript around to you to review and edit it, and any additional questions that we might have.

I want to remind the Commissioners that our next public hearing is going to be June 14th from 9:00 to 3:30 here in Washington. June 14th.

[Whereupon, at 3:24 p.m., the proceedings were adjourned.]