

May 30, 2007

The Honorable ROBERT C. BYRD

President Pro Tempore of the Senate, Washington, D.C. 20510

The Honorable NANCY PELOSI

Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR BYRD AND SPEAKER PELOSI:

We are pleased to transmit the record of our February 1-2, 2007 public hearing on “*The U.S.-China Relationship: Economics and Security in Perspective.*” The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, section 635(a)) provides the basis for this hearing, as it requires the Commission to submit an advisory report to the U.S. Congress on “the national security implications and impact of the bilateral trade and economic relationship between the United States and the People’s Republic of China.” In this hearing, the Commission reviewed the overall status of the U.S.-China relationship, and evaluated both the progress that has been made since China’s accession to the World Trade Organization (WTO) in 2001 and the emerging challenges still facing U.S.-China relations.

The testimony offered at the hearing highlighted views that the United States needs to develop a coherent, coordinated policy toward the People’s Republic of China that integrates economic, security, diplomatic, and human rights concerns. Deputy Under Secretary of Defense for Asian and Pacific Security Affairs Richard Lawless testified, “China’s rapid emergence is an important element of today’s strategic environment, of course, one that has significant implications for the United States, the Asia Pacific region, and the world. The uncertainty surrounding China’s rise underscores the importance of the Commission’s charter to identify approaches that best serve U.S. interests in managing the way forward.” Development of a more coordinated framework for approaching China would strengthen the ability of the United States to communicate its interests to China and how it believes China must act to assume a place on the world stage as a mature, responsible world power.

Developing a more coordinated approach will require reexamining the expectations fundamental to the U.S.-China relationship and encouraging a public dialogue among U.S. commercial, security, and diplomatic interests intended to identify conflicts in American behavior toward China, and identification of policy solutions that best serve the economic and security interests of the United States and our people. James Mann, FPI Author-in-Residence at the School for Advanced International Studies at Johns Hopkins University, testified that “[U.S.] policy and public discourse about China are often affected by ideas, assumptions, rationalizations, and phrases that we fail to examine.”

In addition to the economic benefits of expanded trade, the granting of Permanent Normal Trading Relationship (PNTR) status for China six years ago was linked to the social and political belief that economic liberalization inevitably would lead China toward democratic political reforms. However, as Mr. Mann argued, the United States

has not considered fully the possibility that China may not undergo dramatic political change as a result of its economic development and that leadership by the Chinese Communist Party may remain intact. As December 2006 marked the completion of the fifth year after China's accession into the WTO, the United States should review its economic relationship with China and assess the extent to which all the Congress's expectations when it approved PNTR status for China have or have not been realized.

The U.S.-China Economic and Trade Relationship

China's policies of market liberalization have resulted in rapid export-led economic growth prompting increased foreign investment; development of China's manufacturing capabilities; and integration into the global supply chain. China's abundant and inexpensive labor supply has made that country an obvious place for multinational companies to expand their production. However, as Dr. Peter Navarro, Professor of Business at the University of California, Irvine, observed in his testimony, five of eight factors identified as major drivers of China's comparative advantage—i.e., its ability to undercut the prices of global competitors—are considered unfair trading practices. These include its undervalued currency, counterfeiting and piracy, export industry subsidies, and lax health, safety, and environmental regulations. These practices violate China's WTO commitments, especially regarding workers' rights, market access, currency manipulation, subsidies, and the protection of intellectual property rights. These violations and unfair practices also contribute to a growing U.S. trade deficit with China, one that U.S. Census Bureau statistics confirm increased 177 percent in the past six years from \$83.8 billion in 2000 to \$232.5 billion in 2006.

Former Under Secretary of Commerce for International Trade Grant Aldonas argued that, as a result of changes in technology, transportation costs, and communication, China is no longer a low-cost producer, but the country maintains its attractiveness as a location for foreign direct investment because of the massive distortions produced by Beijing's economic policies. These distortions diminish the competitiveness of American workers, benefits, and wages, and as Ms. Thea Lee, Policy Director of the AFL-CIO, testified, even the prospect that American workers will be able to participate in effective collective bargaining as members of unions. Manufacturers increasingly are looking to China for its lower labor costs, and one significant factor is that the Chinese government prevents workers from organizing and negotiating for their wages, benefits, and rights. Dr. Navarro argued that as more American companies offshore their production to China, the American business community will lose its political will to lobby the government against unfair trading practices. It will be increasingly in the interest of businesses operating in China to maintain status quo distortions in order to protect their investments, but, as Mr. Aldonas stated, this is not necessarily in the interest of the United States.

All witnesses agreed that currency reform alone is not the solution to rebalancing the U.S.-China relationship because the deficit and disadvantages are compounded by China's other unfair trading practices. Dr. Navarro noted that revaluation would not produce a one-for-one improvement in the ability of the United States to compete with

the China Price.¹ Rather, coordinated actions in the WTO against unfair industrial subsidies and restrictions on workers' rights are required to produce a comprehensive reshaping of the U.S.-China trade balance and to induce China's greater compliance with its WTO obligations.

The U.S.-China Military and Security Relationship

On January 11, 2007 China fired an anti-satellite weapon at one of its own weather satellites, destroying the satellite and littering space with debris. Deputy Under Secretary Lawless stated that this test and other actions by the Chinese in the past six years illustrate a "more confident and increasingly assertive posture than when the U.S.-China Commission was established in 2000." China increasingly is investing in capabilities designed to thwart U.S. access to the region. Of concern, China's ultimate objectives for its military modernization and assertiveness remain unclear.

Dr. Thomas Ehrhard, Senior Analyst at the Center for Strategic and Budgetary Assessments, testified that the U.S. must actively maintain the existing military balance in Asia. Improvement of China's capabilities requires a combined U.S. strategy of creating a flexible base structure, maintaining long-range forces, and supporting stealthy submarine and aircraft systems. Dr. Ehrhard stated, "Many key measures in the military balance vis-à-vis China are moving in a negative direction from a U.S. point of view, especially in the Taiwan Strait, and that movement is occurring at a pace that may expose this nation and our allies to more destabilizing Chinese actions in the future, generate capacity for coercion by PRC leaders, and present increasing risk of miscalculation owing to an erosion of deterrence." Deputy Under Secretary Lawless concluded that in the absence of improved transparency and broader trust between the two countries, the risk of miscalculating the development of China's military capabilities would increase. .

Mr. Kenneth Allen, Senior Analyst at the CNA Corporation, testified that the issue of transparency in the U.S.-China relationship should be viewed with a 25-year perspective, and that U.S.-China military-to-military exchanges would benefit from formal agreements pledging prior notification of meeting time and place and topics of discussion. Army Col. Charles Hooper, Senior Lecturer at the School of International Graduate Studies at the Naval Postgraduate School, argued that China does not engage in military-to-military exchanges for the purpose of increasing transparency or reducing threat nor does China share information out of a sense of obligation or reciprocity. Thus, it is unlikely the U.S. military will be able to obtain increased access to and conduct meaningful conversation with the PLA's leadership regardless of its investments in military-to-military exchanges. However, all witnesses underscored the importance of continuing to seek dialogue with the Chinese and monitoring the progress of interactions. Moreover, several witnesses highlighted the need to refocus the education and training of

¹ According to Dr. Navarro, "The China Price refers to the fact that Chinese manufacturers can undercut significantly the prices offered by foreign competitors over a mind-bogglingly wide range of products and services. Today, as a result of the China Price, China produces more than 70% of the worlds DVDs and toys; more than half of its bikes, cameras, shoes, and telephones; and more than a third of its air conditioners, color TVs, computer monitors, luggage and microwave ovens." *The Coming China Wars*, New York: FT Press, 2007), p. 2.

U.S. military personnel to incorporate more study of China because of the possibility it may choose a course that will make it an adversary of the United States.

Additionally, creating a new framework for military-to-military exchanges—such as engaging our allies in the region and throughout the world on the subject of the PLA’s modernization or engaging the PLA in security dialogues about third parties or on issues of humanitarian assistance and disaster response—could produce new insight into PLA strategic thought and intention.

The U.S.-China Political and Diplomatic Relationship

Since China’s accession to the WTO, U.S.-China relations have grown increasingly complex as the United States has sought to balance trade promotion with concerns over China’s behavior regarding proliferation, support of rogue governments, and military developments, especially regarding the Taiwan Strait. Acting Deputy Assistant Secretary of State for East Asian and Pacific Affairs John Norris testified, “Our vision is a China that is more open, transparent, and democratic, and a China that will join us in actions that strengthen and support a global system that has provided peace, security, and prosperity to America, China, and the rest of the world. Encouraging China to move in that direction continues to be the foundation of our policy; the question...is how we can most effectively do that.” He noted that while it is encouraging China to choose the path of a mature, responsible stakeholder in the global system, the United States is aware of the possibility that China will not choose this course.

To facilitate the expression of U.S. interests and policy to China, the United States and China have instituted structural mechanisms for diplomatic engagement, such as the Senior Dialogue and the Strategic Economic Dialogue. However, while witnesses agreed that engagement, dialogue, and cooperation with China are needed to improve issues of transparency and governance, Dr. Edward Friedman, Hawkins Chair Professor of Political Science at the University of Wisconsin and Dr. Alan Wachman, Professor of International Politics at The Fletcher School at Tufts University, underscoring James Mann’s point, both highlighted the need to reevaluate how that engagement occurs and whether U.S. expectations and assumptions are, in fact, correct that economic growth in China will lead to political reform.

Witnesses noted throughout the hearing that energy holds immense potential for improved U.S.-China cooperation. Deputy Assistant Secretary of Energy for International Energy Cooperation David Pumphrey testified, “As the two largest energy consumers in the world, the United States and China have a common interest in working together both bilaterally and multilaterally to promote global energy security and a cleaner energy future.” The Department of Energy has actively engaged China on a range of energy issues, including fossil energy, energy efficiency, renewable energy, nuclear energy, and nonproliferation. Moreover, it has worked to incorporate China in dialogue and association with the International Energy Agency, especially as China continues to develop its strategic petroleum reserve.

To improve the depth of U.S.-China cooperation and to improve regional security, given the close relationships the United States maintains in East Asia, Dr. Friedman argued that China must change its diplomatic policies regarding three key regional issues: territorial disputes in the South China Sea and China's relationship with Southeast Asia; territorial disputes in the East China Sea and China's relationship with Japan; and policies toward the people of Taiwan. Moreover, Acting Deputy Assistant Secretary of State Norris acknowledged the importance of involving the diplomatic community in addressing China's recent ASAT test, and suggested the possibility of initiating a dialogue between the Department of State and the Chinese Ministry of Foreign Affairs about the importance of verification in testing of space objects and fair warning, as prescribed by the Outer Space Treaty to which China has acceded but which it has not ratified. Resolution of these issues not only will foster China's reputation as a responsible regional partner, but also will strengthen U.S.-China dialogue by lessening tensions with U.S. allies and allowing engagement to focus on issues of mutual interest.

Despite the areas of potential conflict in U.S.-China diplomacy, Acting Deputy Assistant Secretary Norris and Dr. Shiping Hua, Senior Fellow at the McConnell Center and Professor at the University of Louisville, both agreed that it is in China's interest to play a constructive role in the East Asian region and even globally. Dr. Hua testified that Chinese leaders recognize this and, after three decades of engagement between the United States and China, they realize that constructive engagement with the United States is in China's interest. Acting Deputy Assistant Secretary Norris said, "We must continue to build on the foundations of cooperation that we have established, broadening them and deepening them, while engaging China in a frank and direct manner about those areas in which we believe China's policy or behavior is undercutting our common objectives of peace, security, and prosperity in the region and the world." As expressed by witnesses throughout the hearing, these undercutting policies occur in both the economic and security realm, and the United States needs to design its diplomatic approaches to China so that it pursues American interests in a coordinated way in all three realms of interaction: economic, security, and political.

Recommendations

1. Because understanding China's strategic intentions—both in the economic and security realms—is essential to formulating a responsible and proactive policy toward China that addresses the complexity of U.S. interests and avoids miscalculation and potential conflict, the Commission recommends that Congress take all possible opportunities in parliamentary exchange settings to urge officials of the People's Republic of China to be as forthcoming as possible with the United States and other nations in clearly describing its strategic intent and objectives, and to make prior announcement of significant and possibly controversial actions such as the recent anti-satellite test in order to reduce the potential for miscalculation and prevent the development of anxieties that swell into adversarial inclinations.

2. The Commission recommends that Congress instruct the Administration to reevaluate its assessment of China's currency policies in the Department of Treasury's Annual Report to Congress.
3. The Commission recommends that Congress both applaud the recent actions taken by the Administration to employ WTO mechanisms to seek relief from China's unfair trading practices, and urge the Administration to act more rapidly to employ those mechanisms in future circumstances where China fails to rectify other unfair trading practices.
4. The Commission recommends that Congress direct the Administration to determine the nature of past military-to-military exchanges with China that appear to have produced the greatest enhancement in the U.S.-China relationship and benefits for the United States, to seek agreement from China to expand the frequency and number of exchanges determined to be mutually productive; and to seek a formal agreement from China providing that there will be an exchange of the specific details, agenda, list of participants, and topics for discussion for each military-to-military exchange circulated to all participants at least several weeks in advance of the exchanges.
5. The Commission recommends that Congress urge the Department of Defense to expand its dialogue with the militaries of other nations in the Asia Pacific region about the effects of China's military modernization, actions, and objectives on the regional balance of power, with the purpose of strengthening U.S. partnerships in the region.
6. The Commission recommends that Congress instruct the Administration to create an interagency committee on China to coordinate the formulation and execution of U.S.-China policy, and to facilitate development of a comprehensive U.S. Government policy toward China that incorporates economic, security, and diplomatic considerations and objectives.

The transcript, witness statements, and supporting documents for this hearing can be found on the Commission's website at www.uscc.gov. We hope these will be helpful as the Congress continues its assessment of U.S.-China relations.

Sincerely yours,



Carolyn Bartholomew
Chairman



Daniel Blumenthal
Vice Chairman

cc: Members of Congress and Congressional Staff