TESTIMONY OF KEVIN L. KEARNS, PRESIDENT, U.S. BUSINESS AND INDUSTRY COUNCIL, BEFORE THE U.S.-CHINA SECURITY REVIEW COMMISSION

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Good afternoon. My name is Kevin L. Kearns, and I am President of the United States Business and Industry Council. It is a great privilege to be invited to testify today.

The U.S. Business and Industry Council represents more than 1,000 domestic companies – companies dedicated to producing their goods and services in the United States, where business conditions and genuine free market forces make this strategy sensible. We are also dedicated to ensuring that U.S. government policies encourage the strengthening of the U.S. domestic industrial and technology bases.

The establishment of the U.S.-China Security Review Commission holds the promise of bringing about an urgently needed transformation of America's economic and security policies toward the PRC. USBIC – which has worked for a strong national defense and defense industrial base throughout its seven-decade history – is especially please that the Commission's mandate recognizes that these policies cannot be implemented or examined in isolation from one another. The compartmentalization of economic and security issues has been one of the great failings of America's recent China policies.

To take in order the questions presented in your invitation letter, our Council strongly believes that our current trade and investment policies toward China are undermining U.S. national security. These policies threaten America in several ways. The huge China trade surpluses made inevitable by these policies – nearly $85 billion in 2000 alone – represent an invaluable subsidy for the economy of a country that is clearly unfriendly to the United States, and that regularly challenges U.S. national security interests around the world. Indeed, the forthcoming Pentagon strategic review is widely expected to place China at the top of America's international threat list in all but name.

Because money is fungible, these surpluses clearly free up major resources for the Chinese military. In fact, the $85 billion current annual Chinese trade surplus with the United States is approximately as large as the best estimates of China's current annual level of military spending. And it should not be forgotten that many of the businesses accruing profits through international trade are in fact owned directly by the People's Liberation Army.

In addition, U.S. multinational companies routinely transfer militarily-relevant advanced technology to China through their extensive investment in high-tech manufacturing and research facilities in the PRC.

Another critical development is that the openness of the U.S. market to Chinese goods has crowded out the goods made in developing Asian countries, as well as diverted foreign investment from these countries. The result: We have significantly damaged the economies and societies of countries our security strategy aims to strengthen and defend.

There are strategic, geopolitical consequences from international trade and investment flows. Last month, President Bush wrote to officials of the Asian Development Bank, "I give you my personal pledge that the U.S. market will remain open so that we can continue to contribute to Asian Pacific prosperity." This is the same pledge President Bill Clinton made when Asia was rocked by the 1997 financial crisis.

America had a merchandise trade deficit with Asia of $168 billion in 2000, a figure that has grown by $73 billion since 1997. So what more can the U.S. do? One thing: it can be more selective as to who it helps in Asia by integrating its economic policies with its geopolitical alliances.

The Asian export-led economies are all direct competitors in a U.S. market that cannot support them all. Singapore's Senior Minister Lee Kuan Yew warned in February that China's growing trade "dominance" could put its neighbors out of business. A recent cover story on China in Business Week reported, "China is fast becoming a manufacturing threat to many Asian countries." And a new white paper being prepared by Japan's Ministry of Economy, Trade and Industry (METI) worries that China is becoming "the world production center."

For a White House that considers China as a "strategic competitor" – a correct assessment in our judgement – this cannot be a good trend. Yet, President Bush seems unable to connect the dots between economic gains and national strength – what Beijing calls "comprehensive national power."

The Bush team needs to understand that in commerce as well as in arms, China is in a struggle with America's traditional allies in Asia. The contest is for export markets and capital investment. China and the Rim are all trying to advance up the ladder of more value-added export goods with higher technology; and to attract the money needed for economic growth and improved living standards.

During the Clinton years, China more than doubled its share of the U.S. market, mainly at the expense of its Rim rivals. This performance was based in part on its 1994 devaluation, which helped bring on the 1997 financial crisis that weakened the Rim states. Beijing is attracting not only American and European capital that might have gone to develop Rim economies, but capital from businessmen in Japan, Singapore, South Korea and Taiwan. This further shifts the balance of power in the region.

Slower growth since the 1997 crisis has had a negative impact on defense modernization efforts among many of America's allies. Meanwhile, China's continued economic growth funds its military buildup as foreign investment improves its industries and infrastructure.

In the annual report of India' Ministry of Defense released May 31, it is noted that in South East Asia "the economic crises have also created additional opportunities for extra regional powers to gain increased security leverages in the region....At a strategic level, the military balance between China and the other countries of South East Asia is altering further in China's favour." This is due both the China's military buildup and to the fact that "most of the countries in the region have had to reduce their defence expenditures" due to slower economic growth.

But Beijing's beggar-thy-neighbor strategy could not have worked had Washington not continued granting China "most favored" or "normal trade" status throughout the 1990s. Only trade with allies, friends, or non-belligerents should be considered favored or normal; the privilege should be withheld from a bellicose China.

USBIC and its related Educational Foundation have examined in great detail U.S. corporate investment in China. We believe that the evidence indisputably shows that most of this investment is targeted at least as much at serving the U.S. market as serving China's market – and therefore displaces production here at home. The lopsided ratio of U.S. exports to and imports from China – the widest among any of America's major trade partners – is one strong indication. So is the clear record of U.S. multinationals of engaging economically with China by investing in the PRC rather than exporting to China. As our 2000 report *Factories, Not Jobs* documents, most of these investments by American multinationals are aimed at serving not only the U.S. market, but third country markets as well – meaning that they preempt many direct U.S. exports to these regions.

In addition, several respected scholars have compiled data strongly indicating that most of what America (and other countries) export to China are not goods intended to be consumed in the PRC, but products that contribute to Chinese export activities. For example, researchers at the New York Federal Reserve Bank estimate that only four percent of U.S. exports to China in 199[illegible] were consumer goods, and that only 20 percent of China's total imports reach China's domestic markets. The other 80 percent consists of capital goods and industrial inputs used in the country's vast network of export processing zones – which, of course, support the manufacturing of goods destined for foreign markets. And up to 40 percent of China's total exports are sold to the United States.

Finally, the growing tendency of Chinese companies to sell shares in U.S. financial markets opens up a spigot of money to the Chinese economy that could eventually dwarf the country's net export earnings. The money raised by the PetroChina IPO – although greatly lessened by the activities of a number of American organizations, including my own, dedicated to openness and accountability in foreign securities offerings in U.S. markets – subsidizes the Chinese economy and Chinese military as surely as that generated by the export of machinery.

We hope that the full implications of these trade and investment patterns will be investigated thoroughly by the Commission. In particular, we hope that the Commission will examine the impact of these economic flows on the small and medium-sized manufacturing companies that comprise such a vital but neglected part of America's manufacturing base. These companies, which typically supply U.S. multinationals, have been exposed by U.S. trade policy to predatory competition from Chinese rivals not burdened by labor or environmental regulations, and aided by numerous formal and informal trade barriers and subsidies – including forced technology transfer from American firms. If this predatory competition continues unabated and unaddressed or ineffectively addressed by U.S. policy – as it has been until now, the future of small manufacturers in America is bleak – and the independence of larger American manufacturers could be fatally compromised.

In reference to the enormous size of America's trade deficits with China, the obvious cause is that America's trade barriers are low by any measure, that its market is indeed wide open to Chinese products, and that China's trade barriers remain very high. But this answer also indicates that the U.S. government has failed miserably to secure equitable terms of trade with China, and to promote any U.S. exports other than those that increase the capacity of Chinese manufacturing to compete with American.

Despite China's heavy dependence for growth and economic development on selling to the United States, and despite China's clear technological inferiority, Washington has long acted as if the United States needs China more than China needs the United States. Consequently, China has an almost unbroken record of violating its trade agreements with the United States, and the United States has an almost unbroken record of failing to enforce the treaties it negotiates.

The stated reason for this appeasement of China is the claim that trade, investment and economic growth will bring Beijing peacefully into the mainstream of the international order. Capitalism will breed democracy, and democracy will support peace. Yet, no one dares plot a time table on this, because it is pure speculation. Certainly no national security planning horizon for the next 5-10 years can be based on the expectation that Beijing will not use the new resources (industrial, financial, technological) it develops or acquires to support ambitions hostile to American interests and values.

China has historically gone through periodic upheavals, with wrenching changes and unpredictable results. Many of these upheavals have had large components directed against Western influence. The Beijing regime plays on 150 years of Chinese resentment over "unequal" treaties with outside parties. This lingering sensitivity to that history makes it highly unlikely that China will allow Western powers or corporations to play any large role in its internal markets or decision-making.

Many of those who promote the influence of capitalism on society actually underestimate its strength. Capitalism—the system of production and exchange for profit, is the most "natural" form of economic behavior, seen in various permutations throughout history. The Commercial

Revolution of the 15th century started the long march to today's global economy. Almost every major power in modern times has had a capitalist economy to provide its material underpinnings. Capitalism has shown itself highly adaptive to many forms of government, not just democracy.

The Germany of Kaiser and Fuhrer, Imperial Japan, and apartheid South Africa all had capitalist economies. Only the Soviet Union managed to make it into the first rank of powers without the productivity and creativity of capitalism, but could not compete and eventually collapsed. The Chinese have learned this lesson. But they are not trying to transition from communism to democracy, but from communism to fascism.

What really matters are the ambitions of those in power, and whether it is prudent to give them more resources to carry out their chosen policies. Even a government democratic in form can have ambitions contrary to our own. Nations have long-standing geostrategic interests, and there is no reason why patriotic Chinese in a democratic system might not want to dominate Asia and redress what they perceive as legitimate grievances against the United States. Certainly, they will want to continue the transfer of wealth from the West, as other Asian states have done which use the export-led developmental model.

USBIC believes that the real motive of those corporate interests promoting appeasement of China has nothing to do with advancing political reform. Their top priority is keeping the U.S. market open to the goods they produce in China. In this vein, a desire to make China invulnerable to U.S. national trade laws is surely the prime reason for ardent multinational support for China's entry into the World Trade Organization – a development we strongly oppose at this time.

Although China runs trade surpluses with most of its major trading partners, none of these comes close to its surplus with the United States. In addition, a 1997 USBIC Educational Foundation study titled *Made in China* found that both the European Union and Japan had better trade balances with China in high-value manufactured goods than did the United States.

The trade and investment policies of China's non-U.S. trade partners unavoidably affect U.S. national security. China's surpluses with these countries also subsidize the Chinese economy and in turn the Chinese military. These countries transfer technology to China as well. Japanese firms have traditionally withheld much of their advanced technology from foreign business partners. But recent reports indicate that European companies like the Dutch lithography giant ASM are planning to sell very advanced semiconductor manufacturing equipment to China – possibly equipment more advanced than that proscribed in the Wassenaar agreement. Moreover, the likelihood of Taiwan's semiconductor industry moving most of its advanced production to China greatly expands the possibility of the PRC's securing access to the world's most sophisticated equipment for producing information technology products.

U.S. Trade Representative Robert Zoellick is just completing his first direct talks with China on WTO membership. Serious issues remain to be resolved, especially on agriculture. But we fully expect an agreement to be reached relatively soon. We would highlight two reasons. First, American multinational companies will continue to lobby intensively for U.S. negotiators to close the deal, and their campaign contributions play a large role in American politics. Second, the Chinese must know that the Executive Branch has shown little interest in enforcing trade agreements once they have been negotiated. Therefore, China might show new willingness to compromise.

We believe that the picture of powerful interests in China fighting tooth and nail to oppose WTO admission is greatly exaggerated, and possibly a propaganda product aimed at foreign audiences. This is not to deny that China faces major economic challenges in the future. The leadership has clearly decided to pursue politically risky economic reforms – mainly, privatization of much state-owned industry. But as Beijing has openly acknowledged, these policies would be pursued whether the WTO existed or not. We believe that the Chinese are fully – and justifiably – confident of their ability to resist foreign pressures to speed up or broaden these reforms, and will be able to comfortably control the pace of change in their economy.

USBIC believes that the best policy for handling the problems likely to result from China's admission to the WTO is to withdraw from the organization. We strongly opposed U.S. entry into the WTO, and still consider it a major policy mistake. Outside the WTO, the United States would regain full legal authority to respond to predatory Chinese trade practices through its own trade laws. As we suggested above, the United States has more than enough leverage with China to ensure the success of this unilateral approach. We also believe that similar U.S. leverage exists with our other trading partners, and that unilateralism would achieve similar success on these fronts as well.

We also believe that several other measures are needed to put U.S. economic policy toward China on the right track. The United States should deny China normal trade status until China acts like a normal country economically and on security issues. As observed above, since so much foreign investment in China is aimed at exporting to the United States, the loss of China business by American companies will be limited. Far from jumping into a vacuum created by a lower U.S. corporate profile in China, foreign competitors will undoubtedly reduce their own presence in China as well in favor of other developing country export platforms.

A new unilateral economic policy toward China should require Beijing to abide strictly by the terms of all bilateral agreements signed with the United States, and impose strong, swift penalties for noncompliance. The United States should just as strictly enforce all of its national trade laws in economic dealings with the Chinese (as well as with other countries. In order to monitor China's record, the United States will need to significantly increase the resources and personnel devoted to this mission. Monitoring and enforcing existing trade treaties and trade laws should be at least as high a priority of U.S. trade policy as negotiating new deals. Unfortunately, this is not presently the case.

The United States should end the various subsidies it provides for China trade and investment via the Export-Import Bank and the Overseas Private Investment Corporation. If U.S. multinational companies do indeed regard China as such a vitally important current and future market, they and their private sector financiers should be willing to bear all of the risk of doing business in t he PRC. In particular, the U.S. taxpayer should not be subsidizing investments in and exports to China that simply strengthen China's export base and help displace domestic production. Where U.S. companies can demonstrate that they have lost sales of consumption goods to China because of foreign export subsidies, Washington should restrict that country's exports to the United States until the subsidies are ended. The result would be to require foreign governments to chose between doing business with China and with the United States – a competition the United States would win hands down.

Washington should also severely restrict China's access to U.S. capital markets. No Chinese firms with formal ties to any level of Chinese government should be permitted to sell bonds or shares in the United States. Given the pervasiveness of Chinese government intervention in the economy, so-called private Chinese firms must be scrutinized thoroughly before being permitted into the American financial system, and open, transparent, U.S.-style standards of corporate governance and accounting should be mandatory. The performance of these companies, too, must be continuously and effectively monitored, since transparent business practices are rare in the PRC.

The transfer of militarily relevant technologies to China could pose a major national security threat to the United States. USBIC is deeply concerned that Washington does not have an adequate picture of the China activities of U.S. high tech companies. We recommend that the U.S. government undertake a comprehensive study of these activities to secure the information to develop effective export controls. Special attention should be paid to deemed exports involving research, development, and technical training.

Because multilateral export controls are almost always more effective than unilateral controls, the United States should at long last throw real diplomatic muscle behind efforts to create a tough, effective multilateral export control system for China. The United States is indeed the world's indispensable nation, and should no longer simply accept the lowest common denominator of what often free-riding allies are prepared to do.

And the United States should oppose further multilateral aid and loans tgo China. China does indeed still suffer massive poverty. At the same time, it runs a sizeable current account surplus and therefore is a capital exporter. Ending multilateral aid flows will force China to use more of its own resources to foster economic development. And if denial of access to multilateral support sharpens the guns vs butter dilemma faced by China, so much the better for the United States and China's neighbors. Unfortunately, the United States lacks the voting power in international financial institutions to ensure this result. If these agencies continue to extend aid to China over U.S. opposition, Washington should reduce its contributions by an equivalent amount.

These policy recommendations do not exhaust the list of measures needed to transform U.S. economic and commercial policy toward China, and we would be happy to work with the Commission to identify other desirable course of action.

Thank you again for the opportunity to appear before the Commission.