HEARING ON KEY ECONOMIC STRATEGIES FOR LEVELING THE U.S.-CHINA PLAYING FIELD: TRADE, INVESTMENT, AND TECHNOLOGY

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED EIGHTEENTH CONGRESS
SECOND SESSION

THURSDAY, MAY 23, 2024

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U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

WASHINGTON: 2024

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The Commission's full charter and statutory mandate are available online at: https://www.uscc.gov/charter.

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HEARING ON KEY ECONOMIC STRATEGIES FOR LEVELING THE U.S.-CHINA PLAYING FIELD: TRADE, INVESTMENT, AND TECHNOLOGY

THURSDAY, MAY 23, 2024

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, DC

The Commission met in Room 406 of Dirksen Senate Office Building, Washington, DC and via videoconference at 9:00 a.m., Commissioner Leland Miller and Commissioner Michael Wessel (Hearing Co-Chairs) presiding.

OPENING STATEMENT OF COMMISSIONER LELAND R. MILLER HEARING CO-CHAIR

COMMISSIONER MILLER: Good morning, and welcome to the fifth hearing of the U.S.-China Economic and Security Review Commission's 2024 annual report cycle. Thank you all for joining us today, thank you to our witnesses for sharing your expertise and for the work you have put into your testimonies.

I would like to also thank the Senate Committee on Environment and Public Works for allowing us to use their hearing room, and the Senate Recording Studio for their assistance live-streaming this event.

Finally, I would like to remind everyone attending here in person, and those listening online, that the testimonies from our witnesses are available on the Commission's website. A transcript of this hearing will also be posted on the website.

For most of the last three decades, the U.S. government has allowed, and in some cases encouraged, our businesses to engage openly, not just with our allies and partners, but also our competitors and adversaries. Today we are rethinking this notion.

The China we helped integrate into the global trading system a quarter-century ago is not the same China as we face now. And the lens with which we view this relationship should reflect this reality.

China's economy is roughly five times larger than when it entered the WTO, and years of corporate espionage, unfair trade practices, and industrial policy have helped shaped it into an economic competitor, technological peer, and military challenger.

Today our hearing will explore how the United States has, in recent years, begun to evolve its economic approach to China, the effectiveness of these policies in terms of trade, investment, and technology, and the key challenges for further integration and implementation.

Over the past two administrations, the United States had established a diverse array of economic tools and partnerships to address this new landscape. Since 2018, the United States has imposed tariffs on more than 330 billion of its imports from China.

For the first time in nearly two decades, China has fallen from its perch as the top exporter to the United States. Still, critical technologies, investments, and know-how continue to flow to China.

In October 2022, the United States took a significant step in slowing this flow with new controls related to semi-conductors and other advanced technologies. In 2023, a framework was laid out for assessing potentially worrisome outbound investments into China.

Yet on both counts, U.S. policy makers still lack consensus on the scope, areas of coverage, and enforcement tools related to these new mechanisms.

This highlights three critical questions for us today. First, what areas of trade, investment and technology should the U.S. government prioritize in addressing our economic competition with China?

Second, how can such actions be integrated into a cohesive and unified economic security strategy?

And third, how can such an integrated strategy be developed alongside and in coordination with key allies and partners in order to ensure its efficacy and longevity?

I look forward to hearing from our witnesses on these issues and on the actionable steps Congress can take to address these serious challenges. I will now turn the floor over to my colleague and co-chair for this hearing, Commissioner Mike Wessel.

OPENING STATEMENT OF COMMISSIONER LELAND R. MILLER
HEARING CO-CHAIR

Hearing on "Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology"

May 23, 2024

Opening Statement of Commissioner Leland Miller

Good morning, and welcome to the fifth hearing of the U.S.-China Economic and Security Review Commission's 2024 Annual Report cycle. Thank you all for joining us today. Thank you to our witnesses for sharing your expertise and for the work you have put into your testimonies. I would also like to thank the Senate Committee on Environment and Public Works for allowing us to use their hearing room and the Senate Recording Studio for their assistance livestreaming this event. Finally, I would like to remind everyone attending here in person, and those listening online, that the testimonies from our witnesses are available on the Commission's website. A transcript of this hearing will also be posted to the website.

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OPENING STATEMENT OF COMMISSIONER MICHAEL R. WESSEL
HEARING CO-CHAIR

COMMISSIONER WESSEL: Thank you, Commissioner Miller, good morning. I'd like to thank everyone for joining us and thank our witnesses for the time and effort they have put into their testimonies.

I'd first like to acknowledge our new Commissioner, Mike Kuiken, who is already blending in, Leland Miller for, I believe this is your first hearing in which you are a co-chair, and our new executive director, Mike Castellano, a lot of new additions in the last couple of weeks. And the promotion of Chris Fioravante, one of our long-time anchors on the Commission, who we are deeply appreciative of the role that he had played for so many years in not only keeping the trains running but keeping us on track, each of us.

Today's hearing takes place amid on-going shifts in the architecture of the U.S. economic approach to the People's Republic of China. As has been recognized by the current and past administrations, there is no singular policy lever that is sufficient to meet the significant challenges posed by China to U.S. jobs, businesses, and innovation.

Policy makers have deployed a range of measures to advance U.S. economic and national security objectives. Today, we want to discuss whether these policies are working and what additional steps and tools are needed, if any.

The consensus view of the U.S.-China relationship has changed significantly over the life of this commission. Looking back is not our objective. Looking forward is.

The tide has started to turn so that policy makers are appropriately focused on ways to enhance supply chain resiliency, ensure fair and inclusive trade, invest in U.S. technological competitiveness, and slow the flow of capital to companies involved in China's military modernization and that undermine our economic and national security.

This Commission last examined ways to more effectively leverage the U.S. trade policy tool kit in 2022 when it recommended Congress consider suspending China's permanent normal trade relations treatment in light of China's long-standing distortive trade practices and non-compliance with its WTO commitments.

Two years since, the implications of maintaining the status quo have only grown clearer. Recent administrations have utilized U.S. authorities on export controls and investment restrictions in expansive and sometimes novel ways. But there are still questions on whether existing statutes are well suited to the challenges we face.

As witnesses will discuss today, gaps in this framework may undermine the intent of our policies. The proposed outbound investment screening mechanism being developed by this administration, which was recommended by this Commission in 2021, promises to fill one such gap.

The mechanism aims to ensure that sectors denied access to U.S. technology cannot meanwhile benefit from major U.S. venture capital funds.

My co-chair emphasized the importance of coordination. Our allies and partners now have similar concerns and are developing various tools to handle them, sometimes independently and with concern for maintaining a balanced approach given interwoven economic ties with China.

This suggests careful and coordinated prioritization of key U.S. objectives will be required in order to continue to see progress in this direction. But for me, I don't want our

country to wait for laggards to come along or to diminish the ambition of our approach. Others need to catch up.

I would like to remind our audience that witness testimonies and the hearing transcript are available on our website, www.uscc.gov. Our next hearing on China's preparations for great power conflict will take place on June 13th.

Let me now introduce Panel I. Our first panel will assess the efficacy of trade and tariff measures in leveling the playing field for U.S. firms and workers, and the extent to which they have encouraged U.S. and foreign firms to develop more robust supply chains.

We'll start with Mr. Jamieson Greer, partner in the international trade team at King and Spalding. Mr. Greer's testimony will evaluate the impact of the existing tariff measures on the U.S.-China balance of trade.

Next, we'll hear from Dr. Mary Lovely, Anthony M. Solomon Senior Fellow at the Peterson Institute for International Economics. Dr. Lovely will discuss the limits of tariffs and propose additional measures the United States can deploy to build supply chain resiliency. And welcome back.

Finally, we'll hear from Dr. Davin Chor, Associate Professor of Business Administration and Globalization Chair at the Tuck School of Business at Dartmouth. Dr. Chor will examine how global supply chains have shifted in response to the tariff measures and the impact this has had on the U.S. and Chinese economies.

Thank you very much for your testimony. The Commission is looking forward to your remarks. I ask that all of our witnesses please keep their remarks to seven minutes. And, Mr. Greer, we'll begin with you.

PREPARED STATEMENT OF COMMISSIONER MICHAEL R. WESSEL
HEARING CO-CHAIR

Hearing on "Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology"

May 23, 2024

Opening Statement of Commissioner Michael Wessel

Thank you, Commissioner Miller. Good morning. I would like to thank everyone for joining us and thank our witnesses for the time and effort they have put into their testimonies.

Today's hearing takes place amid ongoing shifts in the architecture of the U.S. economic approach to the People's Republic of China. As has been recognized by the current and past administration, there is no singular policy lever that is sufficient to meet the significant challenges posed by China to U.S. jobs, businesses, and innovation. Policymakers have deployed a range of measures to advance U.S. economic and national security objectives. Today we want to discuss whether these policies are working and what additional steps and tools are needed, if any.

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OPENING STATEMENT OF JAMIESON GREER, INTERNATIONAL TRADE PARTNER, KING & SPALDING

MR. GREER: Commissioner Wessel, Commissioner Miller, the other Commissioners, and staff, thank you so much for inviting me to this hearing today.

I'm not here today on behalf of my firm or any client, and I'm speaking only for myself. Developing and executing a strategy to address China's non-market practices is one of the key challenges of our time. Throughout most of my career as an attorney, both in the public sector and private sector, I've focused on this problem.

As an attorney now, I have a variety of clients that are particularly sensitive to the competition we have with China. And so, I get a first chair view of what's happening on the ground amongst the companies and the workers.

A discussion on how to combat China's non-market economic practices begs the question of the extent of the problem, and the seriousness of the problem, and the threat that's posed. And depending on your answer to this question, that will, I think, direct your policy preferences and recommendations.

There are some folks who think that China's economy is in a bad way, it could buckle under its own pressure due to a number of factors. Some folks think that importing cheap, subsidized Chinese goods is good for the United States, despite any other costs that there might be.

And certainly, if this is the view you take, then it may be that strong trade measures or other measures might appear, you know, useless or even harmful. However, that's not my view, and the sum of my experience.

Without going into great detail into the harmful Chinese policies which are well documented elsewhere, including by this Commission, I will simply say that I'm gravely concerned, not only with Chinese efforts to dominate global markets in some of the most important technologies and advanced manufactured goods, but also with the Chinese government's use of trade investment to support its state-owned enterprises, its military, and meant to drive an economy that appears to be gearing up for conflict with the United States and others.

This very clear and public posture by China strongly informs my views on the appropriate policies to address these challenges and, I think, introduces factors other than economic efficiencies into how we should face the China challenge. And so, I think we have to have strong measures as a result.

To talk about recommendations, I think it first makes some sense to talk about where we've been with respect to trade policy, and some of those outcomes, in order to talk about where we should go.

And in my mind, I split this into two buckets, and it's really kind of 1992 to 2016. And even within there, there's kind of 2000 to 2016. And then there's post 2016 where we see, I think, a pretty clear break in U.S. trade policy towards China.

In the '90s as this group knows, China benefitted from most favored nation tariffs, however, it had to be annually re-authorized by the President under the conditions of the Jackson-Vanik amendment.

Following years of lobbying by a variety of interests, Congress went ahead and granted permanent normal trade relations to China and cleared a pathway for its entry into the World Trade Organization starting in 2001.

And we have a lot of data about what happened since that time. And what we can see is that China really leveraged its newfound permanent preferential access to its markets to ultimately undermine the U.S. economy and its workers.

The bilateral trade deficit from China increased from $84 billion in 2000 to $347 billion in 2016. That's trading goods. China's share of global manufacturing GDP increased from approximately six percent in 2000 to about 24 percent in 2016.

During that same period, the U.S. share of global manufacturing GDP dropped from 26 percent to 17 percent. So, China's increase in manufacturing came at the expense of the United States and other G7 allies.

During that time, U.S. manufacturing shed five million jobs, about 54,000 factories closed, and between 2000 and 2016 U.S. real median household income remained relatively flat. It grew by about $3,000, which is about five percent over 16 years, while global GDP doubled during that period.

So, there are a lot of factors that go into those macroeconomic indicators that I talked about. But it's clear from this experiment that openness to China and the bilateral trade deficit became completely out of whack.

The Chinese global share of manufacturing increased at our expense, and U.S. enforcement during this time was limited, right. We had a handful of WTO cases that had limited value, and we had private parties bringing traditional trade remedy cases, which were important but didn't get at systemic issues.

Now, since that time, due to popular dissatisfaction with some of the outcomes of globalization, we have seen, really on a bipartisan basis and across all kinds of constituencies, a realization that we cannot rely on China. We can't have this kind of interconnected economy with a competitor that might wish us harm.

So, during the Trump administration, there were a number of measures that were taken. Tariffs were imposed pursuant to Section 301. Tariffs were imposed on steel and aluminum pursuant to Section 232. Export controls were enhanced and strengthened.

CFIUS and investment screening became more rigorous. We worked with Congress also to increase CFIUS' remit and effectiveness. The administration started the process of stripping forced labor laws and the like.

And these tools were largely picked up and expanded upon by the Biden administration. In many cases, we heard mention of the continuation of export controls. We've seen a turn to using more explicit industrial policy by teaming with Congress to pass bills like the CHIPS Act and the Inflation Reduction Act.

Now since 2016, we've seen manufacturing and employment go back up. It's gone up by about 600,000 jobs since 2016. U.S. real median household income before the pandemic had gone, 2016 to 2019, from $70,800 to $78,000. I mean, just a huge amount compared to that relatively flat amount that happened from 2000 to 2016.

GDP in the U.S. grew from $19 trillion to about $27 trillion since 2016. And among the G7, the U.S. has built the highest GDP growth rate while also having the strongest trade measures against China. Our bilateral trade deficit with China has fallen during that time. The Section 301 program has driven quite a bit of that, and it's helped reorder some of our supply chains.

There's obviously work to do on some of these things, but I think you can see that despite, well, I think because we have these strong trade measures we may be able to strong, and maybe others would say despite that.

I'll talk more about recommendations later, because I see my time is finishing up. But we clearly need to continue on this trajectory. We've seen the Biden administration in recent days expand the 301 tariffs on items of particular concern. There should continue to be attention paid to this, and consideration of increased tariff usage should be on the table.

We should continue to consider export controls and how that should look when we talk about having a high yard and a small fence. Maybe the fence shouldn't be so small. When we talk about outbound investment, maybe we need to think about additional sectors.

And with respect to Congress, I think Congress is the one that needs to be putting into place that outbound investment scheme to give it the durability and certainty it should have.

And of course PNTR, I think Congress should look into revoking PNTR, creating a new column for China, and doing it in a phased way that makes sense for the United States. Thank you.

COMMISSIONER WESSEL: Perfect, on the spot, I meant, in terms of time. I'm not commenting on the comments. But we'll do that in a moment.

Dr. Lovely?

PREPARED STATEMENT OF JAMIESON GREER, INTERNATIONAL TRADE PARTNER, KING & SPALDING

TESTIMONY BEFORE THE U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Hearing: "Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology"

May 23, 2024

Jamieson L. Greer

I am here today to discuss the very serious dependencies and imbalances in U.S.-China trade relations and how to manage these risks.[1, 2] I will also review historic and recent U.S. trade and investment policies toward China and their impacts. Finally, I will highlight a few areas where Congress can act to strengthen the U.S. economy, protect American workers, reinvigorate the country's industrial base, and protect national security. These objectives should form the core of the U.S. approach to an increasingly ambitious and confrontational PRC.

I. The U.S.-China Trade and Investment Landscape Before 2017

For many years following the normalization of diplomatic relations between the United States and the PRC, bilateral trade flows were minimal. China benefitted from most-favored nation ("MFN") tariffs for imports into the United States, but this status had to be reauthorized annually by the President. This was a condition of the Jackson-Vanik Amendment passed by Congress restricting trade with "nonmarket economies," which were largely communist countries.[3] Annual renewal of MFN tariffs for China became more contentious after the 1989 events at Tiananmen Square, so there was little certainty that investing in China to produce goods for export to the United States was a durable business model.[4]

Bilateral U.S.-China trade began growing more substantially in the mid-1990s. China, with certain allies in Congress and the U.S. business community, lobbied for and eventually obtained admission to the World Trade Organization ("WTO") and legislation providing it with permanent MFN status (*i.e.*, "permanent normal trade relations" ("PNTR")). Advocacy for granting MFN status to China was premised on a number of arguments, including its proponents' assertions that taking this step would decrease the U.S. trade deficit with China and provide U.S. companies with a way to ensure fair treatment in the Chinese market.[5]

Neither prediction was accurate. Between 2012 and 2016 – over a decade after China's admission to the WTO – U.S. companies operating in China named "inconsistent regulatory interpretation and unclear laws" among the top two concerns for doing

[1] I am appearing today in my personal capacity and not on behalf of any current or former employer or client.
[2] References to "China" are references to the People's Republic of China ("PRC") or instrumentalities thereof.
[3] *See The Jackson-Vanik Amendment and Permanent Normal Trade Relations*, Congressional Research Service (Dec. 20, 2023), *available at* https://crsreports.congress.gov/product/pdf/IF/IF12556#:~:text=In%201974%2C%20the%20Jackson%2DVanik,free%20emigration%20of%20its%20citizens.
[4] Robert E. Lighthizer, *Testimony Before the U.S.-China Economic and Security Review Commission: Evaluating China's Role in the World Trade Organization Over the Past Decade*, June 9, 2010, at 1-2, *available at* https://www.uscc.gov/sites/default/files/6.9.10Lighthizer.pdf.
[5] *Id*. at 3-7.

business in the country.[6] And the trade deficit from China increased from $83.8 billion in 2000 to $346.8 billion in 2016.

Despite the hopeful engagement of this period, the Office of the U.S. Trade Representative repeatedly found that China failed to abide by its WTO commitments. In its 2016 report on China's compliance with WTO obligations, USTR observed that "a wide range of Chinese policies and practices continued to generate significant concerns among U.S. stakeholders, as did the continuing abuse of administrative processes by Chinese government officials."[7] Efforts to hold China accountable under WTO dispute mechanisms were largely unfruitful.[8] China doubled down on its non-market economic practices, providing subsidies and pursuing programs to develop national champions to displace U.S. and other Western companies.

Before 2016, the U.S. government typically relied on traditional trade measures and policy tools such as antidumping and countervailing duty ("AD/CVD") laws – which are self-initiated by private parties – and relatively narrow export controls to manage these risks of Chinese trade. However, U.S. trade policy generally was trending the opposite direction: many in the United States were pushing for a bilateral investment treaty with China, and Obama-era export control reform loosened controls on many items on the U.S. Munitions List and the Export Administration Regulations.

U.S. trade policy toward China prior to 2016 ultimately was very harmful. As discussed in more detail in Section III.A below, the economic data from this period demonstrate how trade with China had a negative impact on U.S. manufacturing and our industrial base. Although this policy of openness allowed some companies to increase exports to China and others to lower their production costs, this came at a high price: the United States' manufacturing base and employment declined, the country became very dependent on China for critical inputs, and China leveraged the economic benefit of the relationship to undermine U.S. global leadership.

II. The U.S.-China Trade and Investment Landscape After 2017

In 2017, after many years of pursuing trade and investment policies toward China that harmed U.S. economic and national security, the U.S. government embarked on a new approach toward China. The Trump Administration rejected the previous strategy of engaging in interminable "dialogues" with Chinese officials where macroeconomic issues were discussed and the United States accepted the PRC's framing of issues. Instead, the U.S. government adopted an enforcement posture toward China to level the

[6] 2016 China Business Climate Survey Report, AmCham China (2016), at 18, *available at* http://www.iberchina.org/files/2016/amchan_china_climate_2016.pdf.
[7] 2016 Report to Congress On China's WTO Compliance, USTR (Jan. 2017), at 4, *available at* https://ustr.gov/sites/default/files/2016-China-Report-to-Congress.pdf.
[8] *Id*. at 40-41.

playing field and potentially create an environment where negotiations for improved terms of trade were possible. Some of the more significant measures pursued by the Trump Administration included the following:

- Section 301 Action. The Trump Administration completed an investigation under Section 301 of the Trade Act of 1974 ("Section 301") regarding forced technology transfer by China. The 2018 report by the Office of the U.S. Trade Representative ("USTR"), "Technology: Protecting America's Competitive Edge" ("Section 301 Report"), identified several ways that China effectuates forced technology transfer. These include foreign ownership restrictions and administrative Review and licensing processes, discriminatory licensing restrictions, strategic outbound investment, and intrusion into U.S. commercial computer networks and cyber-enabled theft of intellectual property and sensitive commercial information.[9] China also achieves forced technology transfer through pretextual national security or cybersecurity measures, inadequate intellectual property protection, talent acquisition programs, and abuse of anti-monopoly and standardization laws.[10] In response to these findings, USTR recommended (1) the imposition of tariffs as a responsive action in the absence of a change to these policies and practices, (2) the commencement of a WTO dispute settlement proceeding with respect to intellectual licensing practices, (3) enhancing investment screening for transactions involving Chinese investors, and (4) enhancing export controls to further limit the acquisition of sensitive technology. USTR carried out the first two recommendations under its statutory authorities by imposing a 25 percent tariff on $40 billion worth of Chinese imports and initiating a WTO dispute. Following repeated retaliation by the PRC, USTR ultimately increased the product coverage of the tariffs to apply to $250 billion in imports from China. For the latter two recommendations, the Treasury Department and Commerce Department, respectively, worked with Congress to implement enhanced CFIUS and export control authorities consistent with relevant legislation passed with bipartisan support.

- Phase One Agreement. The Trump Administration also concluded a Phase One trade agreement with China pursuant to which the Chinese government agreed to modify its practices related to forced technology transfer, intellectual property rights and enforcement, agricultural import regulations, currency practices, and financial services market access. The PRC also agreed to expand its purchases of U.S. goods according to a two-year schedule, and to continue increasing imports

[9] Section 301 Report at 5 and 177-180.
[10] *Id*. at 180-182; Jamieson Greer, Written Testimony Before the U.S. House of Representatives Judiciary Committee, Subcommittee on Courts, Intellectual Property, and the Internet (Mar. 8, 2023), *available at* https://judiciary.house.gov/sites/evo-subsites/republicans-judiciary.house.gov/files/evo-media-document/greer-testimony.pdf.

thereafter. Finally, the PRC agreed that the United States could keep the Section 301 tariffs in place and agreed to establish a dispute settlement process that provided the United States with broad authority to enforce the agreement, including in a unilateral way, if warranted.

- Section 232 Action. The Trump Administration imposed additional duties on steel and aluminum under Section 232 of the Trade Expansion Act of 1962. Pursuant to this action, the Commerce Department conducted a review and found that steel and aluminum imports into the United States threatened to impair the national security. Specifically, Commerce found that an import surge threatened to severely harm the domestic industries producing steel and aluminum, and that such harm would negatively impact national security. The remedy imposed under Section 232 was global, but covered Chinese steel and aluminum as well as products from third countries that, in many cases, were shipped to the United States due to displacement by Chinese steel and aluminum in those third country markets.

- Export Controls. The Trump Administration also expanded export controls on China by pioneering a novel combination of the Entity List (*i.e.*, prohibition on the export of U.S. items to a listed entity) and the foreign direct product rule ("FDPR") (*i.e.*, extension of export controls to items made abroad using certain U.S. inputs). The U.S. Commerce Department ("Commerce") applied this approach to Huawei and several of its foreign subsidiaries. Commerce added several other Chinese companies in the semiconductor supply chain to the Entity List as well. In addition, the U.S. government began treating Hong Kong as part of China for purposes of export control regulations.

- Investment Controls. CFIUS took a much more aggressive posture on Chinese investment, aided by passage of the Foreign Investment Risk Review Modernization Act of 2018. The Trump Administration also identified a number of "Communist Chinese Military Companies" and prohibited U.S. persons from trading in the public securities of such companies and their subsidiaries.

- Technology Competition. The Trump Administration prevented and discouraged the widespread adoption of Huawei information technology equipment in the United States. U.S. officials also worked with foreign governments to discourage the spread of Huawei information technology in third countries.

- Forced Labor. The Trump Administration increased enforcement of forced labor laws, including issuing a number of Withhold Release Orders to prohibit the import of goods from companies found to use forced labor in their supply chains. China was one target country in these efforts.

- Information and Communications Technology and Services ("ICTS") Supply Chain Rule. President Trump issued an executive order empowering the Secretary of Commerce to review and mitigate ICTS transactions that pose a risk to national security. This broad authority could prevent a wide variety of covered transactions involving China, such as imports, installations, and supply agreements.

This approach and related measures garnered substantial bipartisan support, and many aspects of these policies have been continued by the Biden Administration. Indeed, in some cases, the Biden Administration has even expanded upon Trump Administration policies:

- Section 301 Action. The Biden Administration retained the Section 301 tariffs and declined to re-open an exclusion process. The Biden Administration also increased tariffs on a narrow set of goods subsequent to the statutory four-year review (*e.g.*, electric vehicles ("EVs") and EV batteries). However, the Biden Administration failed to enforce China's failure to fully comply with the Phase One Agreement.
- Section 232 Action. The Biden Administration retained the Section 232 tariffs on steel and aluminum, including on products from China. It also increased tariffs on Chinese steel and aluminum as a result of the Section 301 review process. However, the Biden Administration conducted limited enforcement of Section 232 tariffs on steel and aluminum imports from third countries, which in some cases are displaced to the U.S. market by overcapacity from China and other countries.
- Export Controls. The Biden Administration expanded export controls on China, using the Entity List and the FDPR to limit China's access to sensitive technology. The Biden Administration's October 2022 export control rules restricted Chinese entities' ability to obtain advanced semiconductor technology and production equipment.
- Investment Controls. The Biden Administration has made liberal use of "non-notified transaction" authority to seek out and investigate Chinese investment in the United States that did not undergo CFIUS review. In addition, the Biden Administration issued a proposed rule to control outbound investment from the United States into China with respect to a small handful of critical industries: semiconductors, artificial intelligence, and quantum computing.
- ICTS Rule. The Biden Administration maintained President Trumps executive order on the ICTS supply chain and recently initiated a rulemaking to explore any national security risk posed by connected vehicles. It is transparent that this

proposed rule largely is directed at Chinese EVs, and if implemented, likely would result in restrictions on the sale or use of Chinese EVs in the United States.

- Domestic Investment. Congress passed the Bipartisan Infrastructure Law, the Inflation Reduction Act, and the CHIPS and Science Act, all of which provide grants, loans, guarantees, or tax incentives to increase domestic manufacturing in relation to the construction of public infrastructure or certain manufacturing and energy facilities.

In sum, U.S. policy toward China has shifted to a much more pragmatic and active approach since 2017. This new strategy is much more in line with objectives such as growing the manufacturing base, increasing employment opportunities for the working class, and protecting American technology and national security.

III. Effects of Recent U.S. Trade and Investment Policies Toward China

Substantial information and data are available regarding the effect of U.S. trade and investment policies toward China. These data show that China benefitted greatly from U.S. trade and investment policies, while the United States suffered substantial negative impacts. The period between China's admission to the WTO and receipt of permanent normal trade relations ("PNTR"), in particular, reflects the results of U.S. policy toward China. However, beginning with a concrete shift in policies toward China in 2017, certain of these trends began to reverse course. Both periods are discussed below.

A. From PNTR to 2016

With respect to pre-2017 policies, U.S. economic openness toward China was a key driver in substantially increasing that country's GDP. China took full advantage of this openness by leveraging state-directed capital investments and subsidies, industrial overcapacity, abysmal labor and environmental standards, forced technology transfer, and countless protectionist measures. At the same time, U.S. industries and workers experienced the "China Shock" and its follow-on effects, a phenomenon whereby regions sensitive to increased import competition suffered from job losses. This dynamic, in turn, has contributed to the extremely large and persistent U.S. trade deficit with China.

A number of data points illustrate the results of U.S. policymakers' decision to open our economy to China despite China's continued failure to open its economy to U.S. companies. The trends below of course are not entirely attributable to the U.S.-China trade relationship, but certainly are manifestations of the vast imbalance and shift in manufacturing and investment to China from the United States.

- U.S. goods imports from China increased from $100 billion in 2000 to $462.4 billion in 2016.[11] This increase was driven by a variety of categories, dominated by (1) Computer & Electronic Products, (2) Miscellaneous Manufactures, (3) Electrical Equipment, Appliances & Components, and (4) Machinery, except Electrical.[12]
- U.S. goods exports to China increased from $16.2 billion in 2000 to $115.6 billion in 2016.[13] This increase was driven by goods categories such as Transportation Equipment, 2) Agricultural Products, 3) Computer & Electronic Products, and 4) Chemicals.[14]
- The U.S. trade deficit in goods with China ballooned from $83.8 billion in 2000 to $346.8 billion in 2016.[15]
- China's GDP rose from approximately $1.2 trillion in 2000 to approximately $11.2 trillion in 2016 – a feat that took the United States over 30 years to accomplish.[16]
- China's global share of global manufacturing GDP increased from approximately 6 percent in 2000 to about 24 percent in 2016. During that same period, the U.S. share of global manufacturing GDP dropped from about 26 percent in 2000 to about 17 percent in 2016.[17] China's increase in manufacturing has come at the expense of the United States (and other G7 countries).
- U.S. manufacturing employment fell from (on average) 17.3 million jobs in 1999 to 12.3 million jobs in 2016, for a net loss of 5 million jobs.[18]

[11] U.S. Import and Export Merchandise Trade Statistics, U.S. Census Bureau: Economic Indicators Division USA Trade Online, available at https://usatrade.census.gov/ (*accessed* May 15, 2024).
[12] TradeStats Express – U.S. Trade by Partner (Countries and Regions), International Trade Administration, available at https://www.trade.gov/data-visualization/tradestats-express-us-trade-partner-countries-and-regions (*accessed* May 15, 2024).
[13] U.S. Import and Export Merchandise Trade Statistics, U.S. Census Bureau: Economic Indicators Division USA Trade Online, available at https://usatrade.census.gov/ (*accessed* May 15, 2024).
[14] TradeStats Express – U.S. Trade by Partner (Countries and Regions), International Trade Administration, available at https://www.trade.gov/data-visualization/tradestats-express-us-trade-partner-countries-and-regions (*accessed* May 15, 2024).
[15] U.S. Import and Export Merchandise Trade Statistics, U.S. Census Bureau: Economic Indicators Division USA Trade Online, available at https://usatrade.census.gov/ (*accessed* May 15, 2024).
[16] World Bank, Gross Domestic Product for China [MKTGDPCNA646NWDB], retrieved from FRED, Federal Reserve Bank of St. Louis, available at https://fred.stlouisfed.org/series/MKTGDPCNA646NWDB (*accessed* May 15, 2024).
[17] Richard Baldwin, "China is the world's sole manufacturing superpower: A line sketch of the rise," CEPR (Jan. 17, 2024) (citing OECD data), *available at* https://cepr.org/voxeu/columns/china-worlds-sole-manufacturing-superpower-line-sketch-rise.
[18] U.S. Bureau of Labor Statistics, All Employees, Manufacturing [MANEMP], retrieved from FRED, Federal Reserve Bank of St. Louis available at https://fred.stlouisfed.org/series/MANEMP (*accessed* May 14, 2024).

- Approximately 54,000 factories closed in the United States between 2001 (397,522 annual average) and 2016 (343,687 annual average).[19]
- Between 2000 and 2016, U.S. real median household income remained relatively flat, growing from $67,470 to $70,840[20] – an increase of about 5 percent over 16 years – while global GDP more than doubled over that period.[21]

During the period of the United States' aggressive economic engagement with China, it appears that economic benefits to the U.S. economy generally were far outstripped by the enormous gains realized by China.

B. From 2017 to the Present

As described above, in 2017, the United States began to change its economic relationship with China by imposing measures to manage the downsides of trade and investment. However, U.S. trade measures on China have not slowed the U.S. economy. To the contrary, these measures have been instrumental in improving U.S. competitiveness and diversifying supply chains in a healthy way. This is apparent from macroeconomic data as well as data relevant to specific trade measures.

- Manufacturing employment rose from 12.3 million jobs in 2016 to 12.8 million jobs right before the pandemic for a gain of about 500,000 manufacturing jobs between 2016 and 2019. Today, four years later, that number is hovering around 12.9 million jobs.
- U.S. real median household income increased from $70,840 in 2016 to $78,250 by the end of 2019 and prior to the COVID-19 pandemic.[22] This reflects a gain of about $7,500 to U.S. households during the period of the imposition of strong trade measures against China. Since 2019, U.S. real median household income has declined somewhat to $74,580, although it remains above pre-2016 levels.
- GDP in the United States grew from $18.8 trillion in 2016 to $27.4 trillion in 2023, reflecting an increase of $8.6 trillion.[23] Among the G7, the United States

Number of Establishments in Private NAICS 31-33 Manufacturing for All establishment sizes in U.S. TOTAL, NSA, U.S. Bureau of Labor Statistics, available at https://www.bls.gov/iag/tgs/iag31-33.htm (*accessed* May 15, 2024).

[19] Number of Establishments in Private NAICS 31-33 Manufacturing for All establishment sizes in U.S. TOTAL, NSA, U.S. Bureau of Labor Statistics, *available at* https://www.bls.gov/iag/tgs/iag31-33.htm (*accessed* May 15, 2024).

[20] Real Median Household Income in the United States, Federal Reserve Bank of St. Louis – Economic Data, *available at* https://fred.stlouisfed.org/series/MEHOINUSA672N (*accessed* May 16, 2024).

[21] GDP (current US$), World Bank ($33.9 trillion GDP in 2000 versus $76.52 trillion GDP in 2016), *available at* https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?end=2016&start=2000 (*accessed* May 16, 2024).

[22] Real Median Household Income in the United States, Federal Reserve Bank of St. Louis – Economic Data, *available at* https://fred.stlouisfed.org/series/MEHOINUSA672N (*accessed* May 16, 2024).

[23] Gross Domestic Product, Federal Reserve Bank of St. Louis – Economic Data, *available at* https://fred.stlouisfed.org/series/GDPA (*accessed* May 16, 2024).

has both the highest GDP growth rate and the strongest trade measures against China.[24]

- The U.S. trade deficit with China fell from $375 billion in 2017 to $279 billion in 2023 – a 25.6 percent decline.[25] Notably, this reflects not only decreased imports from China, but also increased exports from the United States. U.S. imports from China fell from $505 billion in 2017 to $427 billion in 2023, while U.S. exports to China increased from $130 billion in 2017 to $148 billion in 2023. For 2024, the trade deficit with China is tracking to annualize at $243 billion, which would be the lowest level since 2009. Thus, the shift in U.S. trade policy toward China has been accompanied by a marked improvement in the terms of trade between the United States and China.

- The Section 301 tariff program has been an important driver of this trend and has reduced U.S. reliance on China. As noted above, the Section 301 tariffs were complemented in January 2020 by a "Phase One" trade agreement with China, which permitted the United States to maintain tariffs on Chinese imports while committing China to make a number of structural changes with respect to agricultural regulations, intellectual property rights and enforcement, financial services access, and other matters. The Phase One agreement also required China to substantially increase its purchases of goods from the United States. The combination of the Section 301 tariffs and the Phase One agreement combined to improve the terms of trade between the United States and China. A Wall Street Journal analysis observed that "[t]he increase in shipments to China was led by products such as soybeans, crude oil, cotton and corn—all covered by the purchase agreements under the so-called Phase One trade pact implemented a year ago under Mr. Trump."[26]

    - One very concrete example of the success of the Section 301 tariffs is the domestic market for EVs. In 2018, the United States imported very few EVs from China. Nevertheless, anticipating an eventual surge in production and export of EVs from China, the Trump Administration imposed a 25 percent tariff on imported Chinese EVs as part of the Section 301 action, on top of the 2.5 percent MFN duty rate. The Biden Administration just announced an increase of the Section 301 tariff on Chinese EVs to 100 percent. As Chinese exports of EVs rapidly increased

[24] Neil Irwin, "U.S. Winning World Economic War," Axios (Jan. 31, 2024), *available at* https://www.axios.com/2024/01/31/us-economy-2024-gdp-g7-nations.
[25] "Trade in Goods With China," U.S. Census Bureau, *available at* https://www.census.gov/foreign-trade/balance/c5700.html.
[26] Yuka Hayashi, "U.S. Trade Balance With China Improves, but Sources of Tension Linger," Wall Street Journal (Feb. 5, 2021), *available at* https://www.wsj.com/articles/u-s-trade-deficit-narrowed-in-december-as-exports-outpaced-imports-11612532757?mod=article_inline.

over the past few years – reaching 4.1 million units in 2023[27] valued at $34.1 billion[28] – the U.S. market was largely insulated by the cumulative 27.5 percent tariff on such vehicles. U.S. imports of Chinese EVs in 2023 were valued at only $358 million.[29] By contrast, the European Union began to be inundated with Chinese EVs, accounting for 40 percent of Chinese EV exports.[30] Protecting the U.S. EV market from distortive Chinese imports has proven critical to providing breathing space for the U.S. industry.

- The Section 301 tariffs have also proven effective in decreasing U.S. dependence on critical technology products. The Section 301 tariffs were focused on products that fall within the PRC's "Made in China 2025" strategy.[31] The U.S. International Trade Commission ("ITC") found that U.S. imports of items subject to the Section 301 tariffs declined substantially, falling from $345.4 billion in 2017 to $265.1 billion in 2021.[32]
- The ITC report also found that for the ten U.S. industries most affected by the Section 301 program, the tariffs "increased the value of domestic production by between 1.2 percent for Computer Equipment and 7.5 percent for Household and Institutional Furniture and Kitchen Cabinets in 2021."[33] In other words, the ten most affected sectors all benefitted from increased domestic production value. In the aggregate across all products covered by the Section 301 tariffs, the ITC observed a net positive increase in the value of domestic production of such products.[34]

[27] Ken Moritsugu, "Chinese auto exports rose 64% in 2023, with strong push by EVs, as makers expanded overseas," Associated Press (Jan. 11, 2024), *available at* https://apnews.com/article/china-auto-exports-ev-hybrid-7d553c31597125d6702b6691a8542cb1.
[28] Joseph Webster, "China has become an electric vehicle export behemoth. How should the US and EU respond?," Atlantic Council (Feb. 29, 2024), *available at* https://www.atlanticcouncil.org/blogs/new-atlanticist/china-has-become-an-electric-vehicle-export-behemoth-how-should-the-us-and-eu-respond/.
[29] *Id*.
[30] *Id*.
[31] Robert Lighthizer, *No Trade Is Free: Changing Course, Taking On China, and Helping America's Workers* (2023) at 148 ("The proposed list of products was based on extensive interagency economic analysis and targeted products benefiting from China's industrial plans such as the Made in China 2025 plan.").
[32] "Economic Impact of Section 232 and 301 Tariffs on U.S. Industries," U.S. International Trade Commission Pub. 5405 (May 2023) at 137, *available at* https://www.usitc.gov/publications/332/pub5405.pdf; *see also* Chad Bown, "Four years into the trade war, are the US and China decoupling?," Peterson Institute for International Economics (Oct. 20, 2022), *available at* https://www.piie.com/blogs/realtime-economics/four-years-trade-war-are-us-and-china-decoupling ("As expected, the trade war has had the largest impact on imports from China of products hit with the highest US tariffs. US imports from China of goods currently facing a 25 percent duty (Lists 1, 2, and 3) remain 22 percent below pre-trade war levels (figure 2). . . . US imports from China of products currently subject to 7.5 percent tariffs (List 4A) remain 3 percent below levels in August 2019 (right before imposition of tariffs on those products)").
[33] *Id*. at 147.
[34] *Id*. at 149.

- At the same time, the Section 301 tariffs appear to have had no material impact on inflation. The Section 301 tariffs were imposed between July 2018 and September 2019.[35] Inflation was very low during that time period and the following years. In fact, the U.S. inflation rate dropped from 2.44 percent to 1.81 percent from 2018 to 2019, and dropped again to 1.23 percent in 2020.[36] Inflation did not begin its steep increase until after that, which some economists attribute to "volatility of energy prices, backlogs of work orders for goods and service caused by supply chain issues due to COVID-19, and price changes in the auto-related industries"[37] – but not the Section 301 tariffs.[38]
- I would also note that some observers have dismissed the effect of the Section 301 tariffs by noting that in certain instances, Chinese companies have moved elements of their production operations to other countries. This likely is true. However, even incremental movement of supply chains out of China are preferable to the *status quo ante*. From a more practical perspective, this indicates that the Section 301 remedy may need to be modified to prevent third-country workarounds by extending the effect of the measures to imports from Chinese headquartered companies or adjusting the rule of origin for goods subject to the Section 301 tariffs.
- The Section 301 tariffs slowed down China's exploitation of the United States' otherwise open economy. The Wall Street Journal has reported that "[t]he economic cost to Beijing of Trump's tariffs, retained by Biden, is real. Chinese companies slapped with tariffs exported less to the U.S., reduced hiring, spent less on research and development and were less likely to start new ventures, according to research from economists at Peking University, Fudan University and other leading Chinese universities. Overall, the damage to China's gross domestic product from the trade war was three times as high as the hit to the U.S., according to some Chinese economists."[39]

[35] "China Section 301-Tariff Actions and Exclusion Process," Office of the U.S. Trade Representative (May 14, 2024), *available at* https://ustr.gov/issue-areas/enforcement/section-301-investigations/tariff-actions.
[36] "Inflation, consumer prices for the United States," Federal Reserve Bank of St. Louis, *available at* https://fred.stlouisfed.org/graph/?g=lXs0 (*accessed* May 14, 2024).
[37] "What caused inflation to spike after 2020?," U.S. Bureau of Labor Statistics Monthly Labor Review (Jan. 2023), *available at* https://www.bls.gov/opub/mlr/2023/beyond-bls/what-caused-inflation-to-spike-after-2020.htm.
[38] One vocal critic of Section 301 tariffs estimated that they only contributed between 0.3 and 0.5 percent to the 7 percent spike in inflation in 2021. Ed Gresser, "Trade Fact of the Week: Estimates of 'Section 301' Contribution to U.S. Inflation Rate; Rane of Estimates: 0.3% to 1.3%?," Progressive Policy Institute (Apr. 27, 2022), *available at* https://www.progressivepolicy.org/blogs/trade-fact-of-the-week-estimates-of-section-301-contribution-to-u-s-inflation-rate-range-of-estimates-0-3-to-1-3/.
[39] Lingling Wei, "Beijing Braces for a Rematch of Trump vs. China," Wall Street Journal (May 1, 2024), *available at* https://www.wsj.com/world/china/trump-china-rematch-beijing-0b0a9c6e?mod=Searchresults_pos2&page=1.

- The Section 232 tariffs have also been effective in deterring imports of steel from China as well as imports of other foreign steel displaced into this market by Chinese exports to third country markets.
    - In the years leading up to the Section 232 action, U.S. steel production and employment was under substantial threat from import surges. Monthly new orders for domestic manufacturers had fallen to their lowest levels since the Great Recession.[40] The Section 232 tariff regime played a central role in the industry's ability to withstand the flood of steel imports generated by non-economic production capacity outside the United States. Thus, the survival of the U.S. steel industry is, on its own, indicative of the efficacity of the Section 232 tariffs.
    - In 2016, U.S. imports of steel products from China totaled approximately 800,000 MT. By the end of 2020, such imports fell to 350,000 MT. Imports from China increased again in subsequent years, but have remained below 600,000 MT. These numbers on direct imports from China are relatively low given the extensive AD/CVD orders on Chinese steel products.
    - The broader import data on steel may be more representative of the effectiveness of the Section 232 tariffs given the effect of Chinese overcapacity on third country markets. In 2017, the first year of the Trump Administration, there were 34.7 million MT of steel imports into the United States. By 2019, that fell by 27 percent to 25.4 million MT – a drop of 10 million MT. (In 2020, that number dropped to 20 million MT, although demand factors likely were at play due to the COVID-19 pandemic.) In 2021, imports increased to 28.6 million MT and have remained roughly at that level throughout his term. There were 25.6 million MT of imports last year, and we are on track for 27.2 million MT on an annualized basis.[41]
    - Finally, it should be noted that the Biden Administration's recent decision to increase Section 301 duties on Chinese steel products should further reduce imports of such products.[42]

[40] Manufacturers' New Orders: Iron and Steel Mills and Ferroalloy and Steel Product Manufacturing, Federal Reserve Bank of St. Louis, *available at* https://fred.stlouisfed.org/series/A31ANO (*accessed* May 16, 2024).
[41] U.S. Steel Import Monitor, U.S. Department of Commerce, *available at* https://www.trade.gov/data-visualization/us-steel-import-monitor (*accessed* May 14, 2024).
[42] "Memorandum on Actions by the United States Related to the Statutory 4-Year Review of the Section 301 Investigation of China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation," The White House (May 14, 2024), *available at* https://www.whitehouse.gov/briefing-room/presidential-actions/2024/05/14/memorandum-on-actions-by-the-united-states-related-to-the-statutory-4-year-review-of-the-section-301-investigation-of-chinas-acts-policies-and-practices-related-to-technology-transfer-intellectua/.

- Robust use of CFIUS authorities has deterred Chinese investment in key sectors and geographic locations in the United States. 2016 and 2017 were record years for Chinese foreign direct investment in the United States, totaling $48.4 billion and $36.8 billion, respectively.[43] However, these figures declined markedly in ensuring years, falling to less than $5 billion in 2022.[44] This trend is also reflected in CFIUS data, which show a decline in notices filed with the committee for Chinese purchases of U.S. assets from 2018 to 2021, with a resurgence in notices involving China in 2022 and 2023.[45] In light of the declining Chinese investment in the United States, this recent increase in CFIUS filings likely reflects investors' increased awareness of the sensitivity of such investment, the growing use of CFIUS' authority to investigate "non-notified" transactions, and efforts by investors to obtain the certainty of CFIUS clearance.

In sum, the implementation of robust U.S. trade measures to manage trade and investment with China have not slowed down or undermined the U.S. economy. Rather, such measures have strengthened the resilience of the U.S. economy and incentivized production in the United States. Numerous factors are at play in U.S. economic expansion over the past few years, and disentangling our supply chains from China have certainly been part of that dynamic.

IV. Proposals for U.S. Trade and Investment Policies Toward China

Designing and implementing optimal policy prescriptions for the U.S.-China economic relationship depend on fully appreciating the extent of the challenge posed by China for the United States. Those who assess that China does not pose a significant economic or security threat will have different views on appropriate trade policy toward China.

Speaking for myself, I view China's stated ambitions and observed actions as a generational challenge for the United States. Trade and investment with China not only have failed to live up to expectations, but they have also actively harmed U.S. economic and national security interests. China itself has focused on decoupling for many years, importing from the United States only what it really needs and seeking to dominate its domestic and international markets, particularly in strategic sectors. Indeed, China repeatedly has implemented its "playbook" of excluding foreign companies from their domestic market, creating overcapacity, and flooding global markets with its goods.

[43] *See* The U.S.-China Investment Hub, Rhodium Group, *available at* https://www.us-china-investment.org/fdi-data.
[44] "Vanishing Act: The Shrinking Footprint of Chinese Companies in the US," Rhodium Group (Sept. 7, 2023), *available at* https://rhg.com/research/vanishing-act-the-shrinking-footprint-of-chinese-companies-in-the-us/.
[45] *See, e.g.*, "Committee on Foreign Investment in the United States: Annual Report to Congress, CY 2020," at 35, *available at* https://home.treasury.gov/system/files/206/CFIUS-Public-Annual-Report-CY-2020.pdf; "Committee on Foreign Investment in the United States: Annual Report to Congress, CY 2022," at 39, *available at* https://home.treasury.gov/system/files/206/CFIUS%20-%20Annual%20Report%20to%20Congress%20CY%202022_0.pdf.

China has done this in sectors such as steel, solar cells and modules, chemicals, consumer goods, and electronics, and now it is seeking to achieve the same in sectors such as pharmaceuticals, semiconductors, automobiles, and aircraft. Moreover, trade and investment with China remain very difficult for American businesses trying to participate in the Chinese market. In the most recent business climate survey by the American Chamber of Commerce in China, one-third of the survey participants still invested in China reported "experiencing unfair treatment compared to local competitors."[46]

These unfair trading practices by China have resulted in decades of U.S. trade deficits in goods and has negatively impacted our industrial base. This is particularly concerning China's increased militarism – its buildup of conventional and strategic capabilities combined with its assertion of authority in the South China Sea and aggressive territorial claims in Taiwan, the Philippines, India, Japan, and elsewhere. China is also engaged in a long-standing pattern of undermining human rights, basic freedoms, and democracy, and it uses its economic power to pursue these goals.

It is very important for the American people – and our allies – that the United States have a robust manufacturing base. I believe the stakes of losing this competition with China are very high. As a result, strong action on a number of fronts – including international trade – is essential to protect the economic and national security of the country. This does not mean the United States should attempt to harm the Chinese people or constrain Chinese growth for its own sake. Nor does it mean that all U.S.-China trade should be cut off. Rather, the focus should be on ensuring economic opportunity and mobility for American workers and their families, defending against Chinese unfair trading practices, and preventing Chinese military or technological dominance. The United States should implement a trade policy that includes these objectives. Below, I briefly outline a handful of recommendations on trade policy for consideration by Congress.

- PNTR. Congress should begin the process of revoking PNTR with China and creating a new tariff column with elevated tariffs applicable to Chinese goods. This is consistent with recommendations from the United States House Select Committee on Strategic Competition between the United States and the Chinese Communist Party.[47] As part of this, Congress should empower the President to

[46] Giulia Interesse, "AmCham China Business Climate Survey 2024: Key Takeaways," China Briefing (Feb. 7, 2024), *available at* https://www.china-briefing.com/news/amcham-china-business-climate-survey-2024-key-takeaways/.
[47] "Reset, Prevent, Build: A Strategy to Win America's Economic Competition with the Chinese Communist Party," United States House Select Committee on Strategic Competition between the United States and the Chinese Communist Party (Dec. 12, 2023), at 14, *available at* https://selectcommitteeontheccp.house.gov/sites/evo-subsites/selectcommitteeontheccp.house.gov/files/evo-media-document/reset-prevent-build-scc-report.pdf.

modify tariffs on China where appropriate for economic and national security purposes.

- Customs Rules. Congress should pass legislation prohibiting preferential duty treatment under free trade agreements with third countries or other preference programs where (1) Chinese content in relevant imports exceeds a *de minimis* level and (2) the goods were produced by a Chinese company or its subsidiary or branch in the third country.

- Counteracting Economic Coercion. Congress should pass legislation to reduce the vulnerability of U.S. companies to economic coercion or retaliation by China. For example, such legislation could provide that revenue from tariffs on Chinese goods be disbursed to workers and companies harmed by Chinese retaliation. Further, Congress could authorize action by the President against companies from third countries that take advantage of Chinese retaliation against the United States by backfilling into the Chinese market.

- Outbound Investment Controls. Congress should pass legislation establishing review of outbound U.S. investment into China in a broad variety of sectors that have economic and strategic significance. This regime should empower the Executive Branch to take action to prevent or otherwise mitigate such investment where it would harm the economic or national security of the United States.

- Support for Critical Manufacturing and Research and Development. Congress should assess whether additional sectors should receive incentives along the lines of those in the CHIPS and Science Act or Inflation Reduction Act. Incentives should be considered for pharmaceuticals, robotics, medical devices, aircraft, automotive, energy products, telecommunications, electronics, and other sectors.

- Trade Remedy Laws. Congress should enhance trade remedy laws to ensure enforcement for the benefit of domestic manufacturers. Where courts or agencies have failed to protect domestic industries, Congress should improve the existing legal regime to deter repeat offenders, crack down on duty evasion, and account for market distortions that give foreign producers an edge over U.S. producers. Previously introduced bills such as the Leveling the Playing Field Act are a step in the right direction.

- Export Controls. Congress should require the appropriate agencies to enhance export controls on China with respect to a broader range of critical industries, such as aircraft, transportation equipment, and legacy semiconductor manufacturing equipment.

- Sanctions. Congress should pass legislation directing the U.S. Treasury Department to establish a China-specific sanctions program based on policies and practices related to international security, human rights, and other issues.

- Government Procurement. Congress should build upon previous efforts to restrict the use of government funds, loans, or grants to obtain goods and services from Chinese companies.

It should be noted that political will to enforce U.S. trade laws is the basis for any effective strategy to manage threats posed by China. There are a number of existing international trade and national security statutes and authorities that give the President substantial power to deal with the China challenge. But if a President is not committed to fundamentally changing the U.S. trade relationship with China, no amount of existing or new tools will make a difference.

Any policies enacted to rise to the challenge posed by China will have costs and benefits. Thus, the measures described above should be accompanied by competitive policies in adjacent issues areas such as energy, fiscal, and monetary policy. This can help U.S. companies and workers become more competitive and facilitate the United States' economic disentanglement from China. There is no silver bullet, and in some cases the effort to pursue strategic decoupling from China will cause short-term pain. However, the cost of doing nothing or underestimating the threat posed by China is far greater. Implementing these suggested policies will better equip the United States to grow its industrial base, provide meaningful employment for Americans, and establish secure and reliable supply chains.

OPENING STATEMENT OF MARY LOVELY, ANTHONY M. SOLOMON SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

DR. LOVELY: Thank you, Commissioner Miller, Commissioner Wessel, and members of the Commission, thank you for inviting me to testify today. My testimony focuses on trade policy.

The objective of U.S. trade policy toward China has shifted over the past two decades from seeking to bring China into compliance with its treaty obligations, to a protracted trade war, to now strategic decoupling.

The U.S. has reduced both its imports from and exports to China since the onset of the 2018-19 trade war. A review of recent research finds that decoupling from China has been costly for U.S. consumers and producers.

Analysis of the four waves of trade war tariffs finds that they fall heavily on producer inputs, that they tax imports that have no obvious relationship to the cause for the original action, and that they omit exports that have unfairly benefitted from the practices identified by the investigation.

Import taxes fall more heavily on low income families than on the wealthy, therefore the structure of the trade war tariffs raises basic questions about their efficacy and the fairness of their design.

Tariffs on China have allowed third-countries to increase their share of U.S. imports. Recent analysis of the trade patterns of these countries finds that they have raised the share of their imports from China in pace with their gains in the U.S. market. Countries replacing China tend to be deeply integrated into China's supply chains and are experiencing faster import growth from China.

Congress and the administration can reform U.S. trade policy to better serve U.S. strategic goals with China. I have four recommendations.

First, I believe it's necessary to clarify and communicate U.S. strategic intent with respect to trade with China. The U.S. has consistently communicated to China and the rest of the world the intent and the extent of the export controls placed on semi-conductor exports in October 2022.

This clarity provides a firm basis for technology companies as they comply with U.S. rules and as they formulate plans for future capital expenditures. The targeted design of export controls also eases coordination with partners abroad whose participation is key to any policy's effectiveness and in our relationship with the Chinese government.

U.S. trade policy objectives with respect to China do not exhibit the same level of strategic clarity. We have deployed many tools to reduce trade in many sectors. While U.S. officials repeatedly state that the U.S. is not attempting to decouple from China, there has been little clarity on exactly which objectives, vis-à-vis China, American trade policy is meant to achieve.

This ambiguity creates uncertainty for our friends and allies and hinders the private investment that is needed to adjust supply chains in strategically important activities. U.S. policy will be more effective if it reflects clearly communicated strategic intent with respect to the bi-lateral relationship.

My second recommendation is to reform the existing Section 301 tariffs to target Chinese technology related practices. In contrast to export controls, U.S. trade policy objectives have not been clearly linked to the trade policy instruments we deploy.

The recently released review of Section 301 tariffs finds that China has not eliminated its unfair technology transfer practices. In other words, the report finds that Section 301 tariffs levied in 2018-19 have not been effective in achieving their stated aim.

Nevertheless, rather than reforming U.S. policies to target trade that has benefitted from forced technology transfer, the U.S. continues to levy the same set of tariffs.

The Commission should recommend that the U.S. trade representative advise the President on ways to relieve the burden of Section 301 tariffs on U.S. consumers and businesses by removing taxes on imports with no strategic value. Tariff relief can center on final consumer goods and on intermediate inputs in machinery that falls outside the scope of the Section 301 violations.

As I've discussed recently in a working paper with Kim Clausing, tariffs are a regressive tax that places an uneven burden on working families. Continuation of tariffs that tax working families for no strategic gains should be removed.

At the same time, the coverage and rate of tariffs on goods that reflect forced use or theft of U.S. technology should be increased. The U.S. should expect China also to reduce the scope of its tariffs on U.S. exports in kind.

My third recommendation is to clarify U.S. intentions to reduce Chinese content in global supply chains. U.S. market share for third countries has increased as the China share has fallen. In addition to high labor, environmental, and decarbonization standards, there is a growing demand for these countries to decouple from China.

The claim is that the presence of Chinese investment or Chinese value added in third country exports transfers unfair practices and depresses the price at which their exports enter the United States. Such concerns have led to demands for aggressively countering suspected duty circumvention, adjusting countervailing and anti-duty procedures, and for stricter rules of origin in trade agreements.

Such concerns seek to extend U.S. jurisdiction to the foreign value-added content of our trading partners' exports. While it is desirable to ensure that import prices are not distorted by Chinese non-market practices and transnational subsidies, there is an obvious tradeoff between the need to create new locations for production and attempts to fully remove China from the supply chains of other countries.

Many friends and allies do not wish to decouple from China, and uncertainty about the U.S. position slows investment into countries that could replace China in value chains. The U.S. should clarify its position on Chinese content in third country exports, recognizing that tracing and eliminating such content is counterproductive in the quest to diversify global supply chains.

My last recommendation is that the Commission should recommend restoration of Congressional oversight over U.S. trade policy by limiting executive discretion under Section 301.

The U.S. Section 301 statute does not require the executive to disclose to Congress the scope of products being investigated and, thus, does not contain how much, or the type of trade that might be affected by tariffs, nor for how long the tariffs might be imposed. These decisions are at the discretion of the executive.

This extensive power to tax usurps powers reserved by Article 1, Section 8 of the Constitution for the U.S. Congress. It sidesteps constraints built by Congress into safeguards, anti-dumping, and countervailing duty investigations.

While the use of an existing platform for new tariff heights is expedient, it makes a mockery of the U.S. administrative protection system erected by Congress, alerts our friends and

allies to the capriciousness of U.S. trade law, and injects additional growth regarding uncertainty into the U.S. economy.

Congress should restrain executive discretion in 301 cases by limited the scope and timing of remedies. Thank you.

COMMISSIONER WESSEL: Thank you, and spot on on time as well. Dr. Chor?

PREPARED STATEMENT OF MARY LOVELY, ANTHONY M. SOLOMON SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Hearing On "Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology"

Prepared statement by
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Before the
U.S.-China Economic and Security Review Commission
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Commissioner Miller, Commissioner Wessel, and members of the Commission, thank you for inviting me to testify today. I appreciate the opportunity to appear before you to testify about US trade policy and its effectiveness in addressing China's nonmarket practices. In this testimony, I describe and evaluate US trade policy toward China, omitting discussion of export controls and investment restrictions. This omission does not imply that such efforts are unrelated to economic resilience, only that they are grounded in national security concerns and, thus, more appropriate for discussion in that context.

The objective of US trade policy toward China has shifted over the past two decades, from seeking to bring China into compliance with its treaty obligations to a protracted trade war to strategic decoupling. Detailed bilateral trade data shows that the US has reduced both its imports from and exports to China since the onset of the 2018-19 trade war. A review of recent research on these developments finds that decoupling from China has been costly for US consumers and producers.

The recent Biden administration decision to maintain existing Section 301 tariffs on China necessitates an inspection of the structure of these taxes. Analysis of the four waves of trade-war tariffs finds that they fall heavily on producer inputs, that they tax imports that have no obvious relation to the cause for action, and that they omit exports that may have unfairly benefited from the practices identified by the investigation. This pattern of levies raises basic questions about the efficiency and fairness of their design.

Tariffs on China has allowed a set of third countries to increase their share of US imports. Recent analysis of their trade patterns finds that they have raised the share of their imports from China in pace with gains in the American market. Countries replacing China tend to be deeply integrated into China's supply chains and are experiencing faster import growth from China, especially in strategic industries.

This review leads me to offer four recommendations to the Commission. My first recommendation is that the US clarify and communicate its strategic intent with respect to trade with China. Secondly, I argue that Section 301 tariffs should be reformed to target Chinese technology related practices. Thirdly, I argue for greater clarity concerning US intentions to reduce Chinese content in global supply chains. Finally, I argue for limiting executive discretion as currently exercised under Section 301.

The Shifting Objectives of US Trade Policy Toward China

After its accession to the World Trade Organization (WTO) in 2001 and prior to 2017, US trade policy sought primarily to bring China into compliance with its international treaty obligations while defending US producers from unfair trade practices. Through a sequence of bilateral efforts, including the Strategic Economic Dialogue initiated by the George W. Bush administration and the US-China Strategic and Economic Dialogue, initiated by the Barack Obama administration, the US maintained high-level consultations with the Chinese government on economic and financial issues. These forums covered cross-cutting issues, including climate change, energy security, bilateral investment, technology transfer, and trade imbalances.

During this period, US imports from China rose quickly, increasing fourfold, from $102 billion in 2001 to $427 billion in 2023. In the process, China became America's top import source, (a status lost only in 2023) and a dominant supplier in many individual products. According to Bown (2021), after a five-year grace period during which China phased in its WTO accession commitments, the United States brought 20 formal WTO disputes against China between 2006 and January 19, 2017. Over that period, the United States filed only 12 disputes total against all other WTO members.[1] Of those cases brought by the US against China, Bown and Keynes (2020) note that 18 reflected systemic issues, those in which the concern is violation of national treatment or discrimination between foreign producers and domestic producers. The US has brought more systemic cases against China than any other WTO member, far more than the second most active complainant, the European Union, which joined the US on 5 systemic cases against China (Bown and Keynes, Figure 6).

While tackling systemic issues at the WTO, the US also deployed trade remedy tools available under various trade statutes. Bown (2019) finds that between 2001 and 2017, the United States launched 130 antidumping and 69 countervailing duty investigations of imports from China, resulting in 103 and 55 restrictions imposed, respectively. He also finds that the average US antidumping duty in force against China in 2018 was 151.5 percent, and the average US countervailing duty was 72.4. By his count, 8.6 percent of US imports from China were subject to antidumping or countervailing duties in 2018.

In recent testimony before this Commission, Elizabeth J. Drake (2024) describes the application of antidumping orders and countervailing duty orders on Chinese exports compared to their total use. She notes that in fourteen of the twenty years from 2000 to 2019, new antidumping and countervailing duty orders on imports from China accounted for half or more of new orders imposed each year. While noting areas where further action is needed to counter circumvention and evasion, she argues that these duties have proved effective in disciplining surges of unfairly traded imports from China.

[1] According to the US-China Economic and Security Review Commission (2017), by the start of the trade war, the US had brought 21 cases against China to the WTO, with US claims upheld partly or in whole in those cases brought to a decision.

Over time, the frequent use of domestic trade remedies brought complaints against the US by other members of the WTO. US officials became increasingly disillusioned by the WTO's repeated rulings against American use of trade remedies. The chief US complaint was that the Appellate Body had added to or diminished the rights and obligations laid out under the WTO agreement, especially in cases challenging anti-dumping, countervailing, and safeguard measures (Bown and Keynes, 2020). This frustration culminated in 2016 with the Obama administration's decision to block appointment of a new judge to complete the three-member roster. In late 2017, with two spots on the Appellate Body roster unfilled, the Trump administration made clear that it would block all future candidates until its complaints had been resolved.

As this brief overview of US trade policy indicates, until the Trump administration, US actions toward China centered on its compliance with WTO obligations created by its 2001 accession and related agreements as well as pursual of domestic remedies for unfair foreign trade practices. Other important economic issues, such as exchange rate manipulation and intellectual property protections, were addressed in bilateral talks, but did not drive US trade policy.

The failure of China to liberalize investment rules in sectors deemed important for American companies, particularly financial services, and its treatment of US foreign affiliates were discussed in bilateral dialogues throughout the Bush and Obama administrations. However, the trade tools used during this period, namely domestic unfair trade remedies and WTO complaints, were deemed insufficient to address US concerns about Chinese practices limiting US export sales and foreign affiliate activities inside its home market. In 2017, the Trump administration initiated a complaint under Section 301 of the Trade Act of 1974, alleging that Chinese acts, policies, and practices burdened US exports, investment, and use of intellectual property. The subsequent investigation examined Chinese practices related to technology transfer, intellectual property, and innovation. The findings, issued on March 22, 2018, asserted that China's use of foreign equity restrictions forced technology transfer within Sino-American joint ventures, that its use of discriminatory technology licensing restrictions prevented US firms from fully benefiting from their own property, that Chinese firms undertook outbound investment to acquire foreign technology and engaged in cyber-enabled theft of intellectual property.

The United States imposed the first trade war tariffs on July 6, 2018, levying 25 percent duties on $34 billion of imported products (now known as List 1 products). China responded with 25 percent tariffs on $34 billion of US exports.[2] Escalation continued throughout the summer of 2018. The United States and China followed with duties on $16 billion of imports in August 23 (known as List 2 products). In September, the United States imposed 10 percent tariffs on an additional $200 billion of imports, rising to 25 percent in June 2019 (known as List 3 products). The last round of tariffs was imposed by the US in September 2019, with a levy of 15 percent on another $100 billion of imports (known as List 4A products). China levied new tariffs on US exports in retaliation for these last two rounds.[3]

[2] Chad P. Bown (2021) provides a detailed timeline of the sequential trade war tariff hikes.

[3] List 4 tariffs were ultimately split into two parts, known as List 4A (%101 billion) and List 4B ($151 billion). As detailed by Bown (2021), List 4A included some clothing and footwear and the imposition of tariffs was delayed

Plans for additional tariff hikes were shelved when the US announced agreement with China on a "phase one" deal in January 2020. By February 2020, as listed in table 1, the US had placed average duties of around 20 percent on two-thirds of imports from China while China levied an average tariff of 21 percent on 58 percent of imports from the United States.

While the Section 301 investigation focused on Chinese practices related to US intellectual property, reasons given by the Trump administration for the trade-war tariffs went far beyond the findings of the formal investigation. At various times, members of the administration pointed to the bilateral trade imbalance, industrial subsidies, non-tariff export barriers, and various domestic distortions in output and input markets as justification for the aggressive remedies applied to Chinese imports. The Phase 1 agreement perhaps best reflects the weight given by the Trump administration to these various factors. It includes chapters addressing intellectual property protection, technology transfer, trade in food and agricultural products, new access in China for financial services, exchange rates and transparency, and a government-to-government enforcement mechanism. Announcements of the agreement emphasized the Chinese commitment to purchase an additional $200 billion of US goods and services in 2020 and 2021.

The Biden administration inherited the trade-war tariffs when it came into office in January 2021. As a candidate, Biden criticized them as a burden on Americans and promised to remove them if elected. With the Covid-19 pandemic, however, came a focus on economic security and resilience that provided a new rationale for the tariffs already in place. Citing China's unfair trade practices and forced technology transfers, President Biden announced on May 14, 2024 that the Trump trade war tariffs would remain in place.[4] In addition, the President levied new tariffs on imports from China of steel and aluminum, semiconductors, electric vehicles, batteries, critical minerals, solar cells, ship-to-shore cranes, and medical products. Almost immediately, China signaled it will retaliate against new trade barriers as the Ministry of Commerce announced the launch of an anti-dumping probe into imports of polyoxymethylene copolymer, a thermoplastic widely used in the consumer electronics and automotive industries, from the EU, the US, Japan and Taiwan.[5]

The Biden administration has offered three main economic (exclusive of national security) arguments to support its view that China's role in US supply chains must be reduced to increase

until September 1, 2019, after back-to-school shopping was done. List 4B contained imports of consumer electronics and toys and ne tariffs on this bundle was delayed until December, after shipments for the Christmas season would be on shore. With the completion of the Phase One agreement in December, however, List 4B tariffs were cancelled.

[4] See The White House. 2024. Fact Sheet: President Biden takes action to protect American workers and businesses from China's unfair trade practices. May 14. https://www.whitehouse.gov/briefing-room/statements-releases/2024/05/14/fact-sheet-president-biden-takes-action-to-protect-american-workers-and-businesses-from-chinas-unfair-trade-practices/

[5] Anti-dumping investigation reported by Eleanor Olcott and Paola Tamma, "China retaliates against the US and EU with anti-dumping probe," Financial Times, May 19, 2024.

economic resilience. The first concern is that China's dominating presence in global markets is itself a source of economic risk. China now accounts for about 17 percent of the world's manufactured good exports, with its share of some individual products exceeding three-quarters of the world total.[6] Secondly, despite China's compliance with most WTO dispute settlement rulings, US officials frequently state that China abuses the norms of the international trading system in ways that reduce the resilience of partner economies.[7] Because of the important role played by the state, both through state-owned enterprises and by state purchasing behavior and regulatory action, Fang (2023) argues that China's economy is increasingly directed by nonmarket practices rather than market forces, and that foreign firms in sectors with such state dominance are unable to compete against Chinese firms, both at home and abroad, based on underlying capabilities and market conditions. A third argument sees the Chinese government itself as a source of supply shocks. Concern about the concentration of production in China has grown along with its propensity to use trade as an instrument of economic statecraft. In recent years, a growing number of US partners have been on the receiving end of China's leveraging trade to further its political goals.

The objectives of US trade policy toward China have been transformed by both the US-China trade war and the pandemic's elevation of economic resilience as a policy goal. Bown (2021) argues that the Trump administration fundamentally changed US trade policy toward China. In particular, he notes that contrary to prior efforts to change Chinese policies the administration "did not bring any meaningful WTO disputes against China, nor did it make any policy progress addressing China's subsidies, even with the US-China phase one agreement" (p. 2). The Biden administration has maintained a similar posture toward trade with China, while adding significant restraints on semiconductors and semiconductor manufacturing equipment and services based on national security concerns. Fundamentally, US trade since the onset of the trade war has shifted away from attempts to change Chinese behavior through dialogue, defensive trade remedies, and dispute settlement to one aimed at reducing the level of bilateral economic integration.

[6] Trade shares based on author's calculation using information on trade flows from the CEPII BACI dataset. China is defined to include Mainland China, Hong Kong, and Macao. See Gaulier and Zignago (2010) for details on the dataset.

[7] A recent example of US views on the impact of China's economic policies on other economies is the statement released by the Office of the US Trade Representative following a WTO dispute settlement panel's rejection of China's argument that US Section 232 tariffs on steel and aluminum imports are permissible under WTO rules. United States Trade Representative spokesperson Sam Miche (2023) writes that "the United States condemns China's refusal to correct its severe and persistent nonmarket excess capacity for steel and aluminum that is at the heart of a global crisis that led to the U.S. Section 232 national security actions." The statement fails to note that a WTO panel found that US Section 203 tariffs on steel and aluminum could not be justified on national security grounds and were therefore impermissible under the terms of the General Agreement on Tariffs and Trade 1944. More details on that ruling can be found at "Dispute Settlement 544: United States—Certain Measures on Steel and Aluminium Products," World Trade Organization, panel report under appeal on January 26, 2023, https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds544_e.htm.

The Impact of the Trade War on Consumers, Jobs, and Trade Flows

The trade war has been costly for US consumers and businesses. To date, US Customs and Border Protection has collected $215 billion in tariff revenue from imports taxed by the trade war, an amount largely borne by American consumers and businesses.[8] In theory large countries may experience some "terms of trade" benefits from tariffs (since reduced demand from a sufficiently large buyer may reduce the price exporters are able to charge for their products). In practice, no study of recent rounds of Trumpian tariffs has found any evidence that US tariffs result in lower prices for US importers. On the contrary, study after study has shown that new tariffs levied by the US since 2017 have instead been fully "passed through" to American buyers.[9]

As reviewed in Meng, Russ, and Singh (2024), the literature has consistently found that tariffs are regressive taxes in the United States, with no notable exceptions. Clausing and Lovely (2024) distribute import taxes across income groups, using the U.S. Treasury method for assessing the distribution of excise taxes. Tariffs are a regressive tax on consumption, reducing the after-tax income of the lowest quintile of households 4 times more than that of the top quintile.

Russ and Cox (2020a, 2020b) demonstrate job loss from the tariffs due to harmful effects on producer input prices. Their findings echo other careful work by researchers that has failed to find beneficial effects for workers from these waves of protection, and more often found serious harms. For example, Flaaen and Pierce (2024) find that the post 2018 tariffs were associated with reduced manufacturing employment, in part due to the complexities of supply chains, competitiveness, and retaliation.

US export competitiveness is harmed by tariffs on intermediate inputs, which increase firms' costs. Handley, Kamal, and Monarch (forthcoming) directly link US firms' performance to their exposure to the 2018-2019 tariff increases. The products most exposed to US tariff increases had lower exports; the resulting decline in exports is equivalent to what would be caused by a foreign tariff of about 3 percent. In terms of US export competitiveness, tariffs on inputs used by US manufacturers and other businesses are clearly an own goal.

Trade war tariffs did affect the volume of trade between the U.S. and China, most clearly in flows of newly taxed goods. According to an influential academic study of the trade war that used advanced econometric methods, the value of newly taxed US imports fell by an estimated 32 percent.[10] The drop in US imports from China is visible even in simple graphs, as seen in Figure 1. Starting as soon as the first trade-war tariffs were levied, US imports departed from their prior trend, falling sharply and then recovering somewhat during the pandemic. The trend in US imports from China has fallen since mid-2022 as precipitously as in the early months of

[8] Customs and Border reports revenue collected on imports from China under Section 301 separately. See "Trade Statistics," US Customs and Border Protection, accessed May 19, 2024. https://www.cbp.gov/newsroom/stats/trade.

[9] See, e.g., Fajgelbaum et al. (2020), Fajgelbaum and Khandelwal (2022), Amiti, Redding, and Weinstein (2019, 2020), Cavallo et al. (2021), Flaan Hortaçsu, and Tintelnot (2020), and Houde and Wang (2023).

[10] The reduction in US import value from trade-war tariffs is estimated by Fajgelbaum, Goldberg, Kennedy, and Khandelwal (2020). A discussion of economic studies of the trade war appears in Fajgelbaum and Khandelwal (2022).

the trade war with a recent leveling out at about 80 percent of their June 2018 value. In contrast, US import purchases from the rest of the world have returned to a level above what one would expect based on pre-trade-war trends.

Figure 2 provides a more detailed look at how US imports from China have moved since June 2018. Imports of goods subject to tariffs of 11-25 percent, those on Lists 1, 2, and 3, have not exceeded 80 percent of their pre-trade-war levels since the onset of the trade war and they remain at 60 percent of their June 2018 value. In contrast, US imports of the same set of goods from other countries soared after April 2021 and remain about 40 percent higher than their June 2018 value. A similar pattern is seen for imports on List 4A, which are subject to a 15 percent tariff, although the decline in imports of these products relative to their June 2018 value is less pronounced than for those on other lists. Like imports on Lists 1, 2, and 3, imports from the rest of world rose rapidly in spring 2021 and remain elevated. It is noteworthy that imports from China of products not subject to any trade-war duties soared during the pandemic period but began a steep decline once the crisis was past, while imports of the same goods from other countries remain elevated. These trends indicate that tariffs have depressed US imports from China relative to other trading partners.[11]

After falling in 2019 and 2020 from its 2018 high, the nominal value of US imports from China grew during the pandemic years of 2021 and 2022, as seen in Figure 3. In particular, the value of goods not subject to trade-war tariffs rose above $200 billion for the first time in 2021. However, in 2023 the nominal value of US imports from China fell for all three categories of goods, shrinking back to 2020 levels. This shrinkage may reflect a permanent reduction in bilateral trade, or it may reflect factors peculiar to 2023, such as the rapid loosening of Covid-19 restrictions and the subsequent spread of the virus throughout the population. Only time will tell.

US exports reacted strongly to the imposition of tariffs by China in retaliation for American actions. As seen in Figure 4, the total value of US exports fell sharply during the trade war, remained depressed for almost two years and reaching the June 2018 value only in March 2021. American farm exports were targeted by Chinese retaliatory tariffs, but exports of planes and helicopters also fell sharply in 2019 and 2020.

Trade war tariffs are scattershot, not strategic

The Trump administration deployed tariffs as a "crowbar" to force China to change practices it saw as harmful to American interests. As seen in the Phase One agreement, the administration also wanted to raise purchases of US exports to ameliorate some of the commercial damage done by China's retaliatory tariffs and in an ill-fated attempt to reduce the bilateral trade imbalance. Product groupings for each round were set to meet the former President's demand for new taxes on bundles of a specifically stated value. With each new round of tariffs, the administration stated the value of goods to which the new tariffs would be applied, as well as the threatened tariff rate. The process behind the identification of these products bore no resemblance to processes used for other forms of administered protection in the US.

[11] Price changes cause movements in trade flows that may obfuscate changes in import quantities. However, the US does not import much energy or food from China, two product groupings that have experienced significant price swings in recent years.

The issue now, as the Biden administration has decided to maintain the Section 301 tariffs, is that these tariffs were not chosen to send a strategic message to China, to strategically decouple from China, or to otherwise serve the long-term goal of increasing the resilience of the US economy. There are three features of the bundle of imports currently being taxed that suggests it can be reformed to better service US strategic concerns.

First, the tariffs fall heavily on sectors that are not knowledge intensive. They do not hit sectors where China may have profited from forced or stolen technology transfer. Thus, they do not send China (and the world) a clear message about what the US wants or can accept in the intellectual policy policies of its partners. Lovely and Liang (2018a) analyze the List 1 products and find that the bulk of the trade flows taxed in this round were in knowledge-based activities but covered only about one-third of exports of computers and electronic products. The set of products targeted in List 2 consists of less knowledge-intensive goods. Lovely and Liang (2018b) find that List 2 greatly expanded coverage of apparel and accessories while hitting technology sectors lightly.

As Figure 5 shows, once all 4 tariff rounds were complete, labor-intensive and resource intensive manufactures imported from China face an average tariff of 12 percent. Low-skill and medium-skill technology intensive manufactured goods imports each face an average tariff of 18 percent, while high-skill technology-intensive manufactures face an average tariff of 15 percent. More granular examples make the issue readily apparent. Eighty-eight percent of clothing and textiles imports and 100 percent of hide and skins imports are subject to trade-war duties even though they contain very little intellectual property for Chinese manufacturers to steal.[12] What strategic purpose do tariffs on labor-intensive manufactures serve?

Secondly, some IP-intensive products were not hit with new tariffs during the trade war. Overall, 49 percent of trade in electronics and electrical machinery was not subject to Section 301 tariffs (Bown, 2021). Notably, laptops, monitors, video game consoles, and smart phones have been spared, despite their obvious link to strategic competition in technology sectors. As chronicled by Bown, "the United States periodically created new tariff codes when the administration wanted to exclude certain products from its trade war duties that were lumped with others in the official US tariff schedule. The most prominent was the desire to exclude tens of billions of dollars of smartwatches (e.g., Fitbit and Apple Watch) from the List 3 tariffs in September 2019." The political economy of their exclusion is not difficult to figure out, but the action left largely untouched some firms that benefitted heavily from offshoring production to China. This feature of Section 301 tariffs raises basic questions of fairness. Clausing and Lovely (2024) show that tariffs are a regressive tax that falls more heavily on less affluent Americans. How can it be fair that tariffs are levied on products sold at Walmart, but not on fancy computers sold at specialty stores?

Third, trade-war tariffs hit intermediate goods very hard. To investigate the extent to which Section 301 tariffs land on capital and intermediate goods purchased by US-based producers, targeted tariff lines can be viewed through the lens of the United Nations' broad economic categories (BEC).[13] The BEC groups transportable goods according to their main end use,

[12] Shares of taxed import value by sector drawn from Figure 2 in Bown (2021).

[13] We use the United Nations' concordance to take the HTS data into the BEC classifications, https://unstats.un.org/unsd/trade/classifications/correspondence-tables.asp.

separating consumer goods from other products. At the end of the tariff escalation, as seen in Figure 6, 93 percent of US imports from China of intermediate inputs faced new tariffs. By contrast, 69 percent of imported final consumer goods, and 47 percent of imported capital equipment were taxed.

Tariffs on intermediate inputs hurt US manufacturers and, as discussed above, have led to a decrease in export competitiveness and American job losses. Tariffs on intermediate inputs have led to a robust exemption process, so that manufacturers who would otherwise by hurt by tariffs can request relief. The exemption process is opaque and it creates administrative, fairness and governance problems.

Are global supply chains moving away from China?

The 2018-19 trade war undoubtedly reduced the US reliance on China both as an import source and an export destination. In its place, the US increased its trade with other exporters, notably Vietnam, Taiwan, and Mexico. Lovely, Xu, and Zhang (2021) employ detailed trade data to find that the trade war raised the US market share of those countries that were already exporting similar products to the US. Alfaro and Chor (2023) also see a "reallocation" of global supply chains, finding that while direct US sourcing from China has decreased, the import shares of low-wage locations (principally Vietnam) and nearshoring/friendshoring alternatives (notably Mexico) have increased.

This reorganization of supply chains is also affecting the composition of US imports from China, as they are driven by the availability of alternative low-wage location and investment decisions by multinational firms. As shown in Figure 7, China has lost US market share in all four degrees of manufacturing exports, as categorized by UNCTAD, with the decreases largely taking place since 2017.[14] The largest declines in market share between 2013 and 2023 have occurred in relatively labor-intensive activities.[15] These declines can be seen in the shares for labor-intensive and resource-intensive activities, where the share of US imports from China declined by 18 percentage points (the first columns in Figure 7) and the high-skill and technology-intensive manufactures, where the share of US imports from China declined by 13 percentage points (the last columns in Figure 7). That China would be losing ground in the first of these categories is not surprising, given rising costs in China and improving conditions for production in alternative low-middle income countries. That China has lost in the high-skill, high-tech product category needs a bit more explanation. This category is dominated by electronics, and it contains many intermediate steps that can be performed with lower-wage workers skilled in labor-intensive segments of the global industry, such as cell phone assembly.

While bilateral trade with China appears to be diminishing, there is little evidence that China's place in global supply chains is being dislodged. The evidence shows that (a) China maintains its dominant share of global manufactured goods exports; and (b) third countries have raised the

[14] The manufacturing sectors assigned to each category are listed in Table 2.

[15] The longer time frame used for this figure reflects the fact that US tariffs are not the only reason for a lower China share of US imports, although they certainly appear to have accelerated these trends. Some labor-intensive production has been slowly relocating in response to changing underlying cost fundamentals, a trend that was visible before the trade war.

share of their imports from China in pace with their share of the American market; and (c) it is likely that some transshipment of exports from China to third countries is occurring.

That China maintains its share of global manufactured good exports may be surprising to some, given the fall in its American market share. Chinese imports fell from 21.6 percent of US total import value in 2017 to 14 percent in 2023. Nevertheless, China has been able to quickly reroute its exports, and as seen in Figure 8, its share of global exports reached 27 percent in 2021 and 2022 (the more recent year for which global data is available.)

Third countries have raised the share of their imports from China in pace with their share of the American market. Freund, Mattoo, Mulabdic, and Ruta (2023) show that countries replacing China tend to be deeply integrated into China's supply chains and are experiencing faster import growth from China, especially in strategic industries.

Additional evidence that possible "friendshoring" locations are more deeply integrating with China comes from Dahlman and Lovely (2023), who show that almost all middle-income countries in the Indo-Pacific region have increased their reliance on Chinese intermediate goods imports since 2010.[16] Countries experiencing increased sales to the US are being supported by both inward foreign investment and increases in intermediate goods imports from China. The upshot is that as the US relies more on alternative trading partners, it continues to rely on China because of the intermediate goods these countries use to produce the goods they ship to America.

An additional explanation for China's ability to maintain its weight in global supply chains may be rerouting of exports to third countries for transshipment to the US. The level of such transshipment is not known, but it is consistent with trends in Southeast and South Asian imports from China that track trends in these countries' exports to the US.

Recommendations for the Commission

There are several steps that Congress and the Administration can take to reform US trade policy to better serve US strategic goals in its relationship with China. My assessment of alternative actions reflects two features of the global economy that constrain US policy. First, as noted repeatedly by Treasury Secretary Janet Yellen, the Chinese economy is too large and too intertwined with the global economy for the US to decouple from China. Therefore, I prioritize policies that acknowledge China's continuing presence in global supply chains, while reducing the harm of Chinese practices on the US economy. Secondly, I prioritize policies that reduce the current level of uncertainty in US-China commercial relations. Commercial policy toward China implicitly and explicitly relies on the private sector to decide how to alter supply chains given tariff levels, export controls, and other restrictions. Trade policies that embody greater clarity in the US position on its relationship with China will reduce the uncertainty that dampens the international flow of capital and diminishes global growth prospects.

1. **Clarify and communicate US strategic intent with respect to trade with China.**

[16] China is the most important trade partner for almost all countries joining the US in IPEF negotiations. Indeed, 11 of these 13 countries are already members of the Association of Southeast Asian Nations–led Regional Comprehensive Economic Partnership (RCEP), which binds them to China through a preferential trade agreement. Importantly, generous rules of origin contained in RCEP encourage development of supply relations among its members.

The United States has consistently communicated to China and the rest of the world the intent and extent of the export controls placed on semiconductor exports beginning in October 2022. This clarity provides a firm basis for technology companies as they adjust their business operations to comply with US rules and formulate plans for future capital expenditures. In these ways, a clearly stated US policy objectives reduces the long-term costs of decoupling from China in this sector.

The targeted design of export controls also eases coordination with partners abroad, whose participation is key to the policy's effectiveness, and in our relations with the Chinese government. Strategic clarity validates official US claims that export controls are a form of "derisking" and not "decoupling." In the words of US National Security Advisor Jake Sullivan, "Our export controls will remain narrowly focused on technology that could tilt the military balance. We are simply ensuring that U.S. and allied technology is not used against us. We are not cutting off trade."[17]

US trade policy objectives with respect to China and US trade policy tools do not exhibit the same level of strategic clarity. We have deployed many tools to reduce trade in many sectors. As described above, Section 301 duties hit all types of products and have been justified by many different complaints against China. While US officials repeatedly state that the US is not attempting to decouple from China, there has been little clarity on what objectives vis-à-vis China that American trade policy is meant to achieve. This ambiguity creates uncertainty for friends and allies and hinders private investment in new locations in activities designated as strategically important. US policy will be more effective if it reflects clearly communicated strategic intent with respect to the bilateral economic relationship.

2. **Reform existing Section 301 tariffs to target Chinese technology related practices.**

In contrast to export controls, US trade policy objectives have not been clearly linked to the trade policy instruments we currently deploy. The recently released review of the Section 301 tariffs found that China had not eliminated its technology transfer related practices and that the country persists in attempts to acquire foreign technology through cyber intrusions and cyber theft. In other words, the report finds that Section 301 tariffs levied in 2018-19 have simply not been effective in achieving their stated aim. Nevertheless, rather than reforming US policies to target trade that has benefited from forced technology transfer, the US continues to levy the same set of tariffs on Chinese exports to the US, albeit with some new exclusions for machinery imports.

The Commission should recommend that the US Trade Representative advise the President to relieve the burden of Section 301 tariffs by removing taxes on imports with no strategic value. Tariff relief can center on final consumer goods and on intermediate inputs and machinery that fall outside the scope of Section 301 violations. As discussed in Clausing and Lovely (2024), tariffs are a regressive tax that places an uneven burden on working Americans. Continuation of tariffs that tax working families for no strategic gains should be removed.

[17] Quote taken from *Remarks by National Security Advisor Jake Sullivan on Renewing American Economic Leadership at the Brookings Institution*, April 27, 2023. https://www.whitehouse.gov/briefing-room/speeches-remarks/2023/04/27/remarks-by-national-security-advisor-jake-sullivan-on-renewing-american-economic-leadership-at-the-brookings-institution/

At the same time, the coverage and rate of tariffs on goods that reflect forced use or theft of US technology should be increased. If the objective is to reduce sales of Chinese firms that have profited from ill-gotten technology, coverage of high-technology imports should be increased. Because much of this trade occurs within the global value chains of multinational technology firms,[18] higher tariffs on these products will undoubtedly have costs for American consumers and firms. These burdens should be acknowledged as the cost of protecting US interests in these sectors.

The US should expect China to also reduce the scope of its tariff on US exports, at least on a proportionate basis. Further, because China reduced average tariffs on exports from other partners since 2017, the US should expect that the tariff facing many American exporters will fall to a lower level than that levied before the trade war.

3. **Clarify US intentions to reduce Chinese content in global supply chains**

As described above, third countries have raised their share of American imports as the China share has fallen. The US now seeks to ensure that these emerging exporters meet an ambitious set of standards related to labor conditions, environmental standards, and decarbonization. The difficulty of building a high-standard network as an alternative to China is exemplified by the limited progress made to date in negotiations on the Indo-Pacific Economic Framework.

In addition to labor, environmental and decarbonization conditions, there is growing demand for these countries to also decouple from China. The claim is that the presence of Chinese investment or Chinese value added in third-country exports to the United States is suspect. Chinese presence in supply chains may transfer unfair practices to third-country production, depressing the price at which such exports enter the US.[19] Such concerns have led to demands that US trade policy promote third-country decoupling by aggressively countering suspected duty circumvention, adjusting CV and AD procedures to permit consideration of transnational subsidies embodied in input and equipment form China, or by renegotiating rules of origin in trade agreements.

Such concerns seek to extend US jurisdiction to the foreign value-added content of our trading partners' exports. While it is desirable to ensure that import prices are not distorted by China's non-market policies and transnational subsidies, there is an obvious tradeoff between the need to create new locations for production and attempts to remove China from the supply chains of other countries. While many nations want to bolster defenses against Chinese coercion and aggression, it is doubtful that they share the US view that China can or should be excluded from supply chains. Chinese foreign investment is already flowing into East and Southeast Asia and eastern Europe. Integration with China is not limited to middle-income countries, however. Japan exports almost as much to China as it does to the United States and imports almost twice as much. Much of this bilateral trade feeds Japan's onshore production.

[18] Lovely and Huang (2018) provides a detailed description of foreign participation in China's high-technology manufacturing industries.

[19] Drake (2024) provides a clear discussion of these concerns.

Uncertainty about the US position on this issue likely slows investment into countries that could serve as alternative sites for production for the American market. The US should clarify its position on Chinese content in third-country exports, recognizing that tracing and eliminating such content may be counterproductive in the quest to diversify global supply chains.

4. **Restore Congressional oversight of US trade policy by limiting executive discretion exercised under Section 301.**

The US Section 301 statute does not require the executive to disclose to Congress the scope of products being investigated and thus did not constrain how much, or the type of, trade that might be affected by tariffs, let alone what level or for how long the tariffs might be imposed. These decisions are at almost complete discretion of the executive —discretion President Trump took full advantage of during the trade war and which President Biden used to place additional tariffs on US imports of Chinese steel and aluminum, semiconductors, electric vehicles, batteries, critical minerals, solar cells, ship-to-shore cranes, and medical supplies. This extensive power to tax usurps powers reserved by Article 1, Section 8 of the Constitution for the US Congress. It sidesteps constraints built by Congress into safeguards, antidumping, and countervailing duties investigations. While the use of an existing platform for new tariff hikes is expedient, it makes a mockery of the US administered protection system erected by Congress, alerts our friends and allies to the capriciousness of US trade laws, and injects additional growth-retarding uncertainty into the global economy.

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Tables

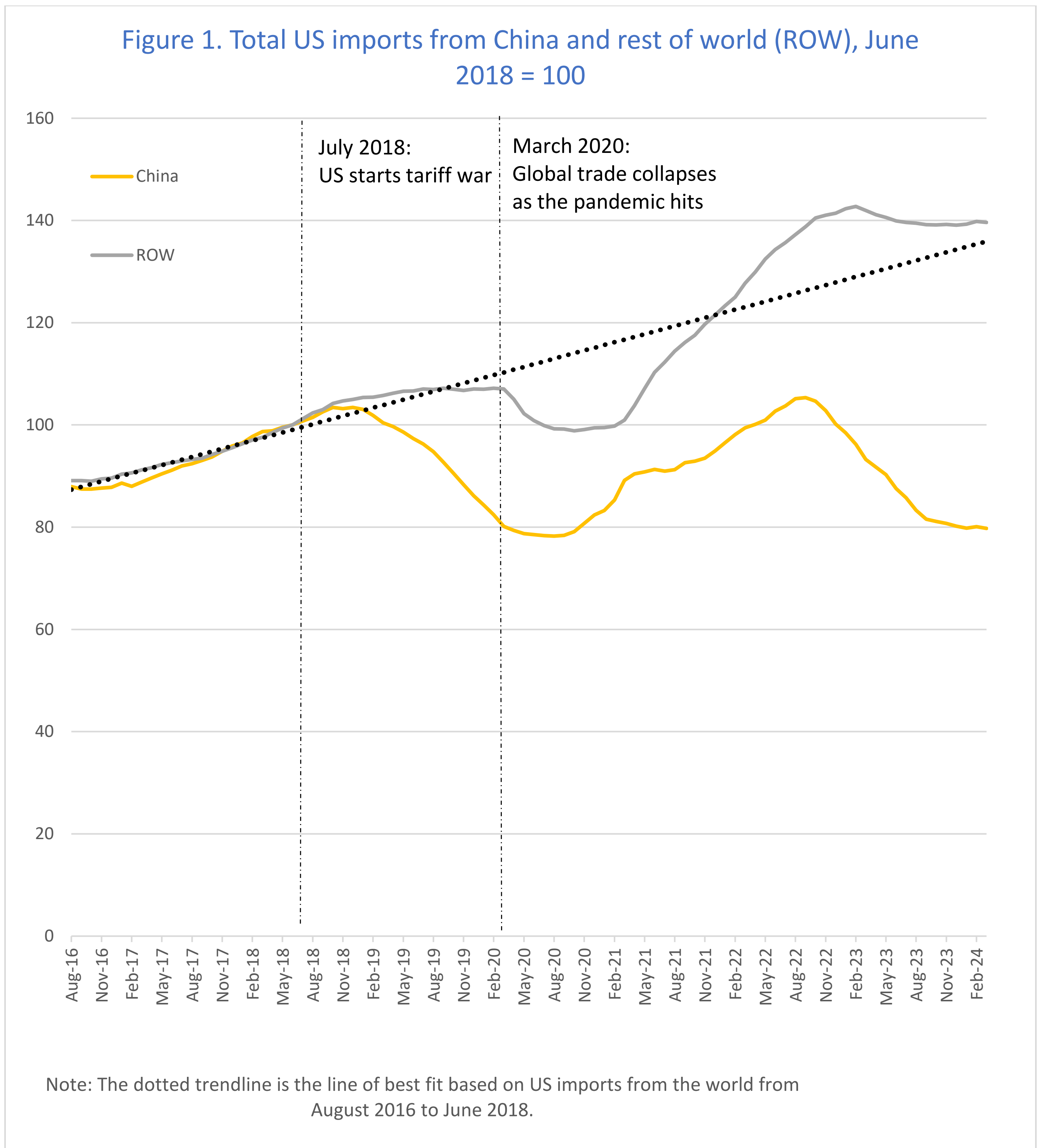
Table 1: US-China Trade War by The Numbers					
Share of Chinese exports covered by US tariffs	Average tariff levied by US on China exports	Average tariff levied by the US on exports from other countries	Share of US exports covered by Chinese tariffs	Average tariff levied by China on US exports	Average tariff levied by China on exports from other countries
66.4%	19.3%	3%	58.3%	21.1%	6.5%

Source: Bown (2023)

Table 2: Manufactured Goods Classification by Degree of Manufacturing	
Degree	**Goods**
Labor-intensive and resource-intensive manufactures	Manufactures of Leather, Fur, Cork, Wood, Paper, and Non-metallic Minerals (Glass, Pottery, etc.); Textiles; Furniture; Travel Goods; Bags; Clothing; and Footwear
Low-skill and technology-intensive manufactures	Iron, Steel, Manufactures of Metal, Motorcycles, Cycles, Trailers, Railway Vehicles, Boats, Office and Stationary Supplies, and Miscellaneous Manufactured Articles n.e.s.
Medium-skill and technology-intensive manufactures	Manufactures of Rubber; Power Generating, Metal Working, Electrical, Specialized, and Other Industrial Machinery and Equipment; Road Vehicles and Parts (excl. Motorcycles and Trailers); Prefabricated Buildings; Sanitary, Heating, and Lighting Fixtures; Plastic Articles n.e.s., and Toys
High-skill and technology-intensive manufactures	Chemicals, Office Machines and Automatic Data Processing Machines, Telecommunication and Sound Recording Apparatus, Cathode Valves and Tubes, Aircraft, Professional and Scientific Instruments, Photo Apparatus, Optical Goods, Watches and Clocks, Arms, Ammunition, Printed Matter, Art, Antiques, Jewelry, Musical Instruments

Source: UNCTAD

Figures



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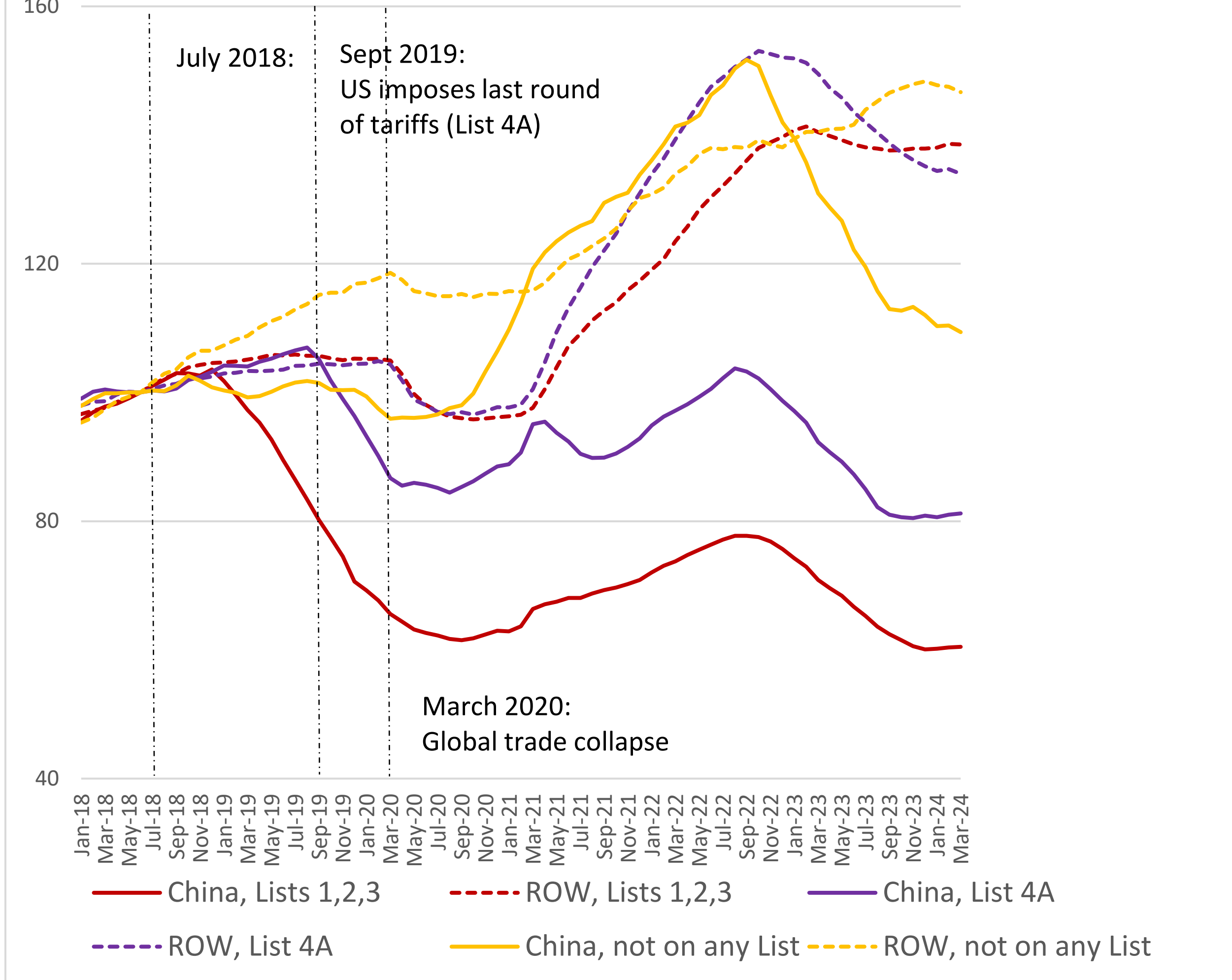

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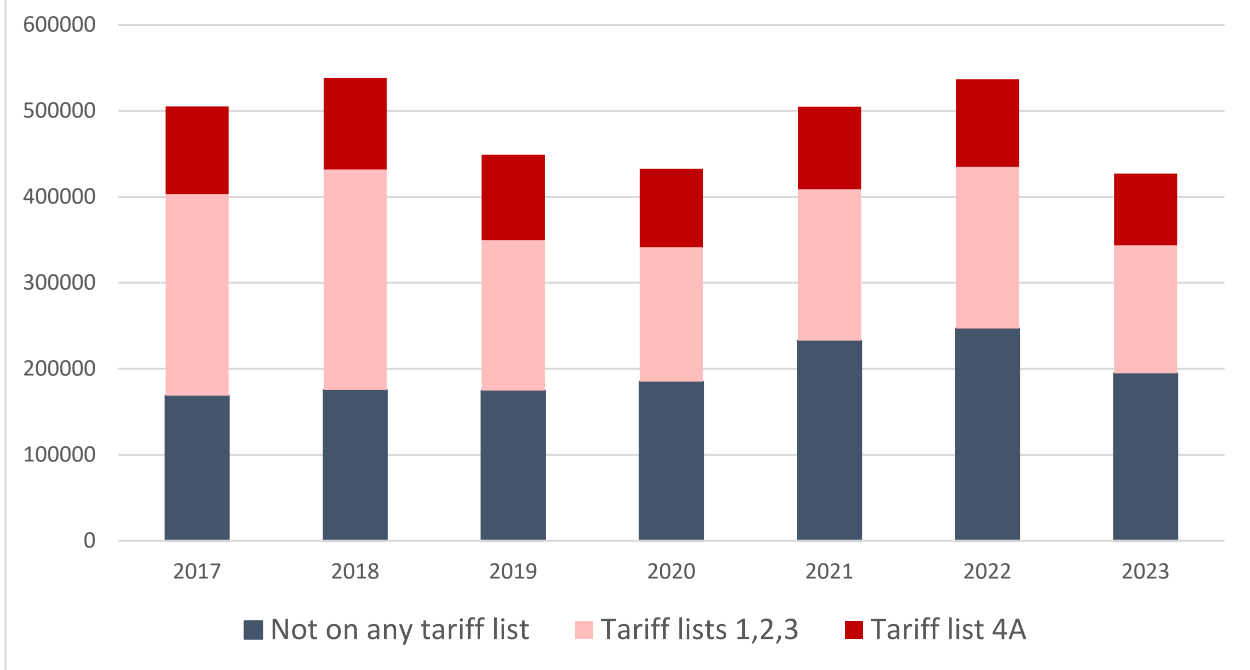

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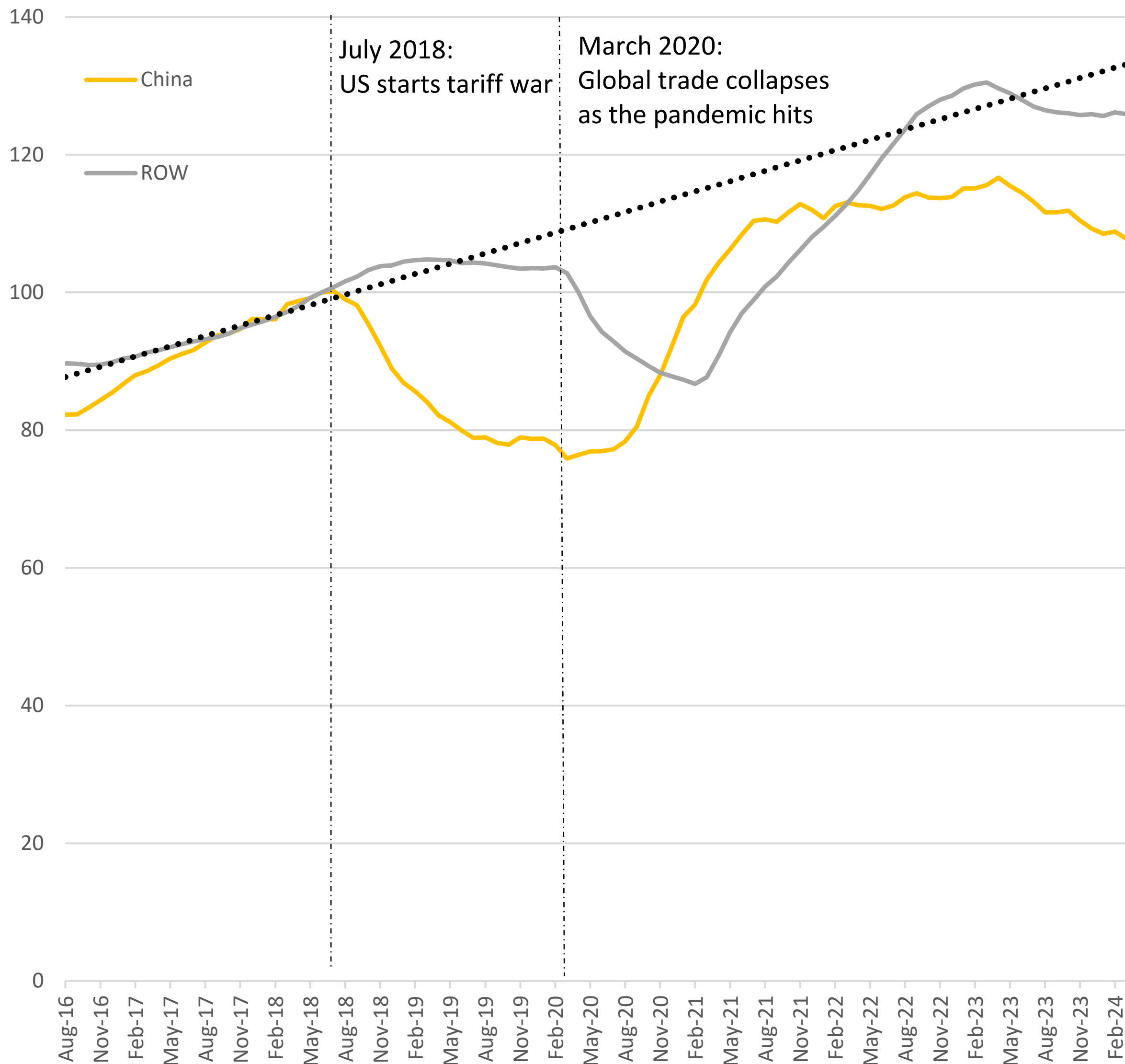

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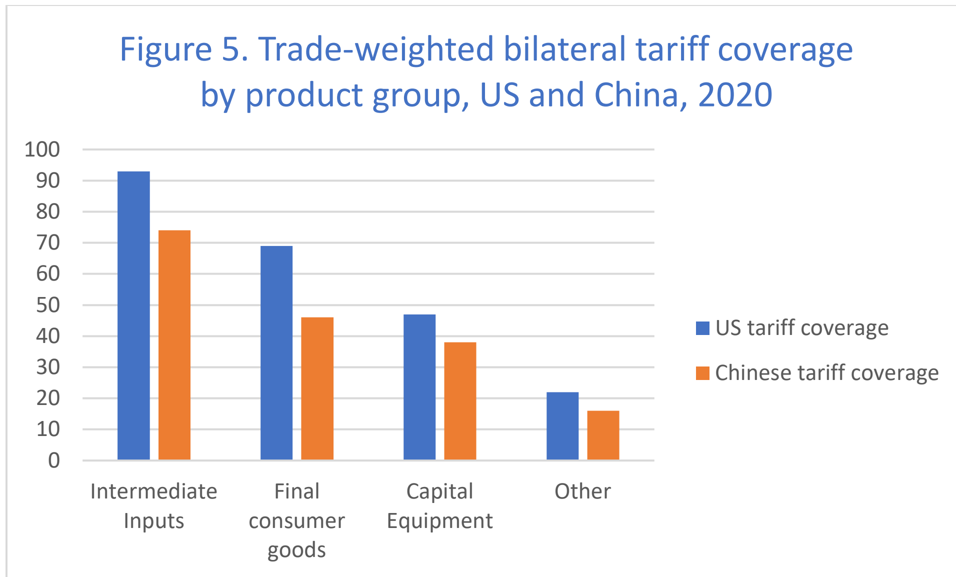

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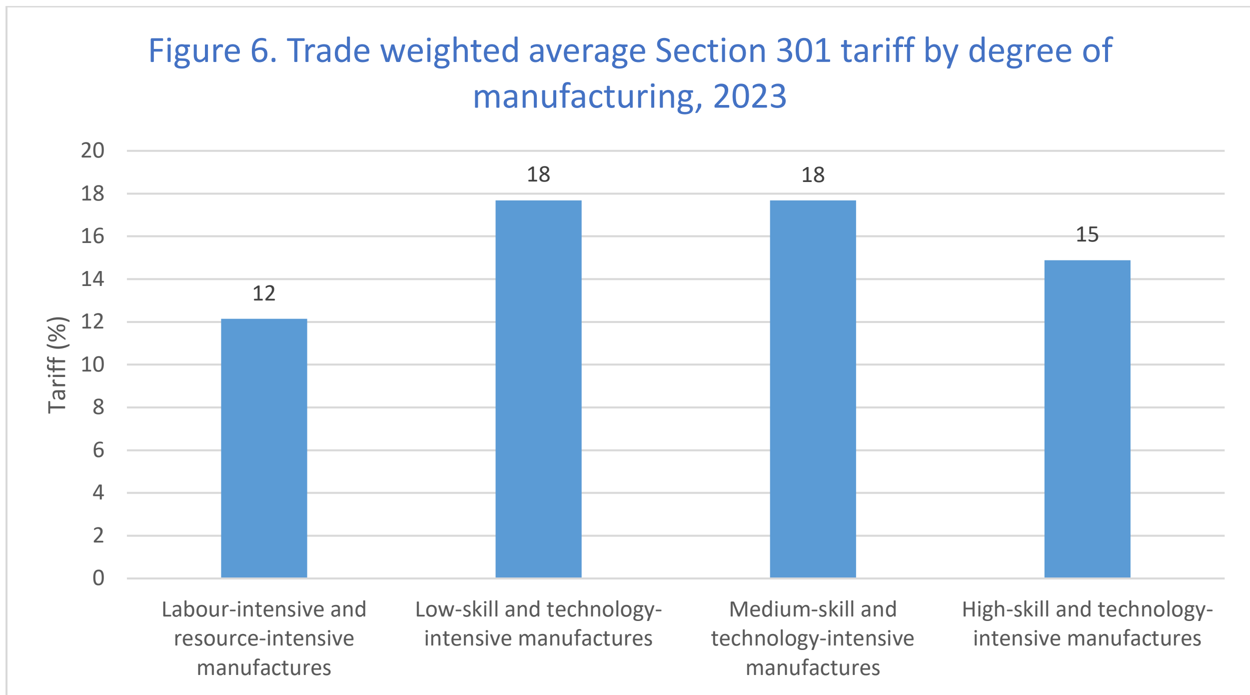

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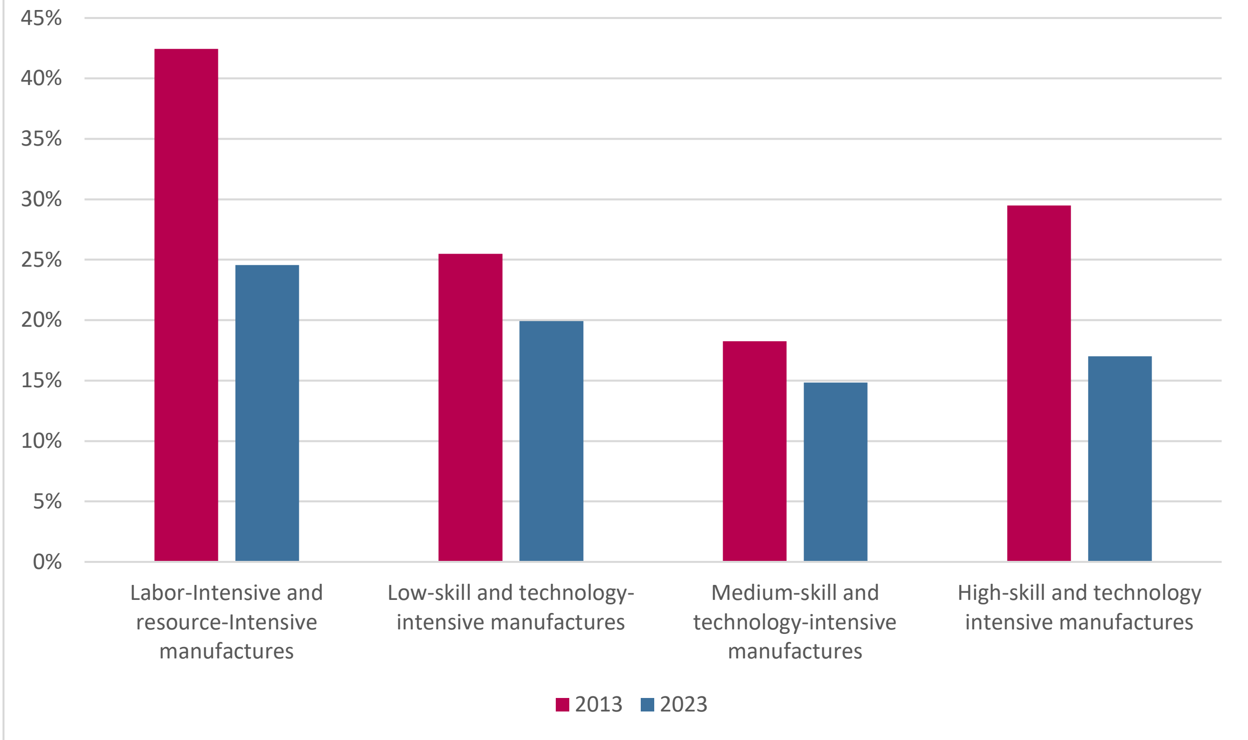

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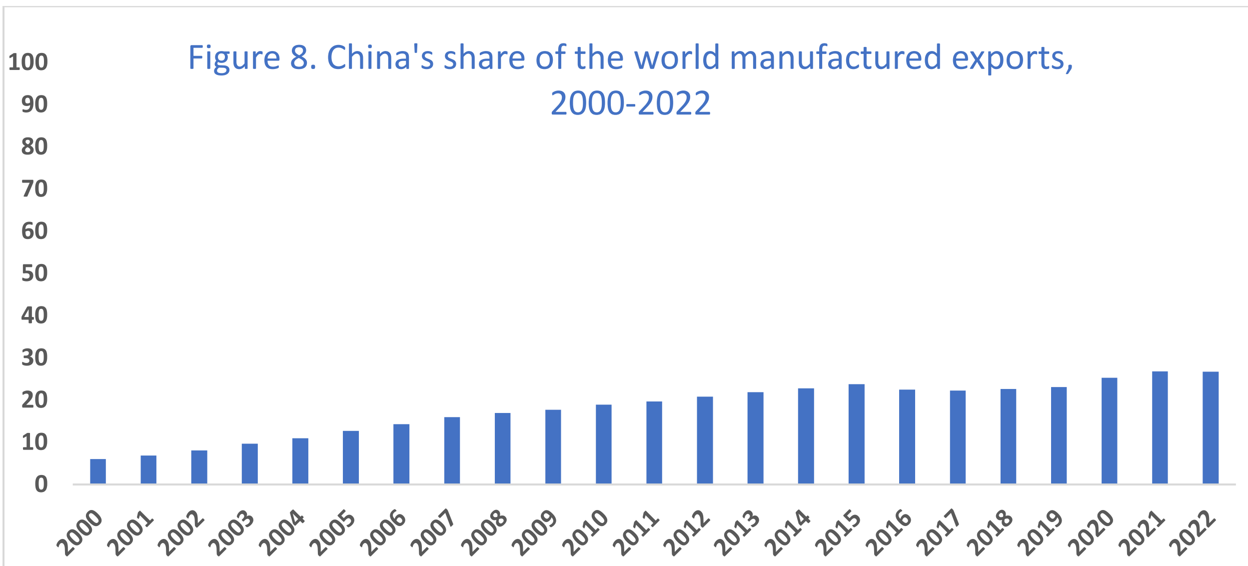

Source: WTO Stats and calculations by author. Note that the EU is treated as one trading region for this calculation.

OPENING STATEMENT OF DAVIN CHOR, ASSOCIATE PROFESSOR OF BUSINESS ADMINISTRATION AND GLOBALIZATION CHAIR, TUCK SCHOOL OF BUSINESS AT DARTMOUTH

DR. CHOR: Thank you, Commissioners Miller and Wessel, our co-chairs, for the opportunity to speak at this hearing. In this testimony I'll speak more from the perspective of a trade economist and economics researcher and present an overview of recent work that has documented shifts in the U.S.'s trade and supply chain links with China since 2017 and discuss their consequences.

The testimony draws on a paper on this topic that I co-authored with Laura Alfaro which was presented in August 2023 at the Jackson Hole Economic Policy Symposium convened by the Federal Reserve Bank of Kansas City.

I've incorporated several updates since that symposium, and these will really underscore how rapid and fluid what we have dubbed as great reallocation in U.S. supply chain activity, how rapidly and fluidly it's unfolding.

Between 2017 and 2023, U.S. imports of goods from the world at large actually grew at an average annual pace of 2.7 percent despite the interruption experienced during the COVID-19 pandemic.

However, this aggregate expansion in U.S. imports masks a very significant shift in the composition of these imports away from China. As Figure 1 in my testimony shows, the share of U.S. imports that originate from China fell from 21.6 percent in 2017 so 16.5 percent in 2022. This dipped further to 13.9 percent in 2023. So, to put things in perspective, China has lost about one-third of its U.S. import market share since 2017.

Who has gained? The countries that have gained the most have been Vietnam and Mexico. So, you could think of this as there being more friendshoring and nearshoring.

Both Vietnam and Mexico have seen their share in U.S. imports each rise around two percentage points. And for Mexico this increase was concentrated especially in 2023, so much so that Mexico replaced China that year as the single largest direct source country of U.S. imports.

So, placing this in context, this is the most significant reconfiguration in the pattern of U.S. imports that we have seen since China's entry into the WTO in 2001.

In our regression analysis, we have confirmed that this reallocation in import market shares was induced in part by the U.S. tariffs as the shift away from China towards Vietnam and Mexico was more pronounced for products in which the U.S. placed higher China tariffs.

Apart from friendshoring and nearshoring, there are also tentative signs that more productions stages are being re-shored to the U.S. Figure 3 in my testimony illustrates how the upstreamness of the U.S.'s exports and imports has evolved over time using a measure which I've helped to develop in my past research with several other co-authors.

Higher values of this measure mean that more stages of production, more processing and assembly are needed before the item becomes a final good. And around 2017, we can see inklings of an uptick in the upstreamness of U.S. imports as circled in the figure.

This suggests that more finishing stages of production are now being performed and completed in the U.S., an early indication that these activities are increasingly being re-shored. But of course, we need to continue to monitor these trends as well as other measures such as industry employment.

The reallocation of U.S. supply chains from China I described has been motivated by a renewed focus on supply chain resilience and national security. And while some of these concerns are understandable, I would sound two cautionary notes.

First of all, this reallocation will come with rising prices. That companies are now switching to Vietnam and Mexico suggest that these locations are a second-best alternative from a cost perspective. Moreover, the recent surge in U.S. demand for goods from Vietnam and Mexico is pulling up wages and industrial rents in these countries.

And Figure 5 in my testimony presents evidence that between 2017 and 2022 decreases in China's share in U.S. imports are already being accompanied by increases in the unit prices of these products that are brought in from Vietnam or Mexico.

Second, the reduction in the share of direct imports from China does not mean that the U.S. is now less reliant on supply chain partners that are headquartered in China. This is because Chinese companies have upped their engagement in Vietnam's and Mexico's economies in terms of both international trade flows and foreign direct investment.

And I provide several data points on these trends in my written testimony. And this has naturally raised concerns about whether this is just re-routing of goods that are ultimately made in China which the Commission is well aware of and has heard from three experts at a prior hearing earlier this year.

This ongoing reconfiguration is being driven in large part by policy measures, the U.S.-China tariffs. And in my written testimony, I have synthesized findings from a companion body of studies on how the U.S.-China tariffs have negatively impacted such outcomes as output, employment, and prices in both countries.

Let me focus a little bit on the impact on China, because I think we know much less about how much these tariffs have affected economic outcomes there. This is no surprise, in large part due to the, shall I say, less transparent data environment in China.

In research that I've published jointly with my co-author, Bingjing Li, we have used satellite readings on night lights so human generated light emitted from the earth's surface to circumvent these data limitations.

And our regressions have detected a more severe dimming in night lights for locations within China that were more directly exposed to U.S. tariffs, suggesting that the tariffs have dampened economic activity in these locations, for example, because of a reduction in night shifts in factories, or reduced occupancy in worker dormitories that are often located right next to these factories.

The size of the effects is not cripplingly large, but they have certainly set back Chinese industrial activity and locations that prior to 2017 were engaged intensively in exporting to the U.S.

Let me finish with two policy recommendations that I draw from this recent research. First, I would argue that there needs to be a clearer recognition that policy actions to reduce the U.S.'s direct dependence on supply chain links to China incurs significant trade-offs.

For the U.S., the tariffs have resulted in rising prices, not just on imports from China, but also from alternative source countries such as Vietnam and Mexico. Yet research indicates that, at least so far, the attendant benefit to U.S. manufacturing jobs has been relatively small.

And although it may be tempting to read the evidence that China's economy has been hurt by the tariff actions as an indication that the U.S. tariffs are, quote-unquote, working, they are doing so also at a cost to the U.S. economy.

While national security and strategic technology concerns deserve consideration, these need to be weighed against the costs from the broad use of tariff instruments on the swath of imports from China, and an approach that is more focused on establishing a, quote-unquote, small hard and high fence, would be preferable, defining a clear set of products with supply chains that would be secured on national security grounds or otherwise being open to international trade in non-sensitive goods.

Second, on the concern that Vietnam and Mexico are being used as a back-door route, this is likely to trigger calls for trade retaliation, trade restrictions to be applied on goods from Vietnam and Mexico to the U.S.

I would urge an avoidance of a knee-jerk reaction, particularly because Vietnam and Mexico are likely to be important allies, right, in helping to -- let me back up a little bit, I would argue that blanket calls for tariff increases from Vietnam and Mexico would risk alienating these countries when there are, instead, more measured approaches such as strengthening and enforcing rules of origin that can help to control the pure transshipment of Chinese goods.

I would argue that these collaborative approaches are preferable, since building U.S. supply chain resilience will require strengthening ties of alternative source countries among whom Vietnam and Mexico will surely feature prominently.

PREPARED STATEMENT OF DAVIN CHOR, ASSOCIATE PROFESSOR OF BUSINESS ADMINISTRATION AND GLOBALIZATION CHAIR, TUCK SCHOOL OF BUSINESS AT DARTMOUTH

Testimony before the U.S.-China Economic and Security Review Commission
Hearing on "Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology" [*]

23 May 2024

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Since 2017, global supply chains have come under severe strain from multiple forces: trade tensions between the U.S. and China, the Covid-19 pandemic, and geopolitical conflicts (such as the Russia-Ukraine war). In this testimony, I present an overview of findings from research that has documented recent shifts in the U.S.' trade and supply chain links with China, while highlighting several key implications of these trends. The testimony draws especially on a paper on this topic that I co-authored with Laura Alfaro (Harvard Business School), which was first presented in August 2023 at the Jackson Hole Economic Policy Symposium convened by the Federal Reserve Bank of Kansas City (Alfaro and Chor 2023). The material in this testimony contains several updates incorporating the latest additional year of data available since that Symposium; this will underscore the rapid and fluid nature of the reallocation of U.S. supply chain activity as this continues to unfold.

This reconfiguration of U.S.-China supply chain relationships is poised to leave a profound mark on domestic economic outcomes. This testimony also synthesizes the findings from a companion body of recent studies, on how the U.S.-China tariffs have already impacted such outcomes as output, employment, and prices in both countries. These insights are important for weighing the tradeoffs – the costs and benefits – of pursuing such policies that seek to reduce the U.S.' dependence on supply chains linked to China.

1. The "Great Reallocation" in Global Supply Chains

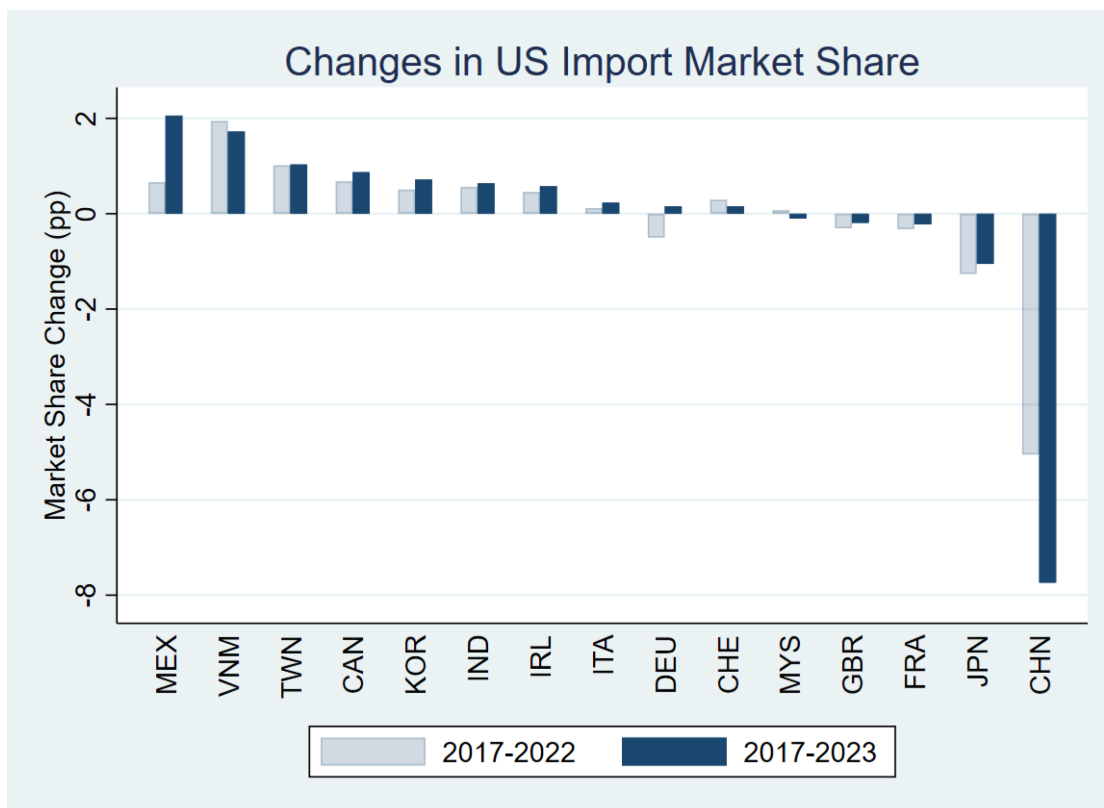
Amid the commentary and debate about whether the world at large is entering a phase of "deglobalization" (e.g., Antràs 2021, Baldwin 2022, Colantone et al. 2022, Aiyar et al. 2023, Goldberg and Reed 2023), it is useful to first register the point that the U.S. remains closely engaged with the rest of the world through international trade. Between 2017-2023, the U.S.' exports of goods expanded in real terms by 10.0% (or at an average annual pace of 1.6%), while

[*] I am grateful to Bashudha Dhamala for research assistance. All errors are my own.

its real imports of goods grew by 17.0% (an average annual growth rate of 2.7%). In fact, U.S. goods imports reached a highwater mark in 2022 ($2.79 trillion, in chained 2017 dollars) on the back of a strong recovery in world trade from the Covid-19 pandemic, before easing off slightly in 2023 (to $2.74 trillion).[1]

More Friendshoring and Nearshoring: However, this aggregate expansion in U.S. imports masks a significant shift in the composition of these imports away from China as a source country. As Figure 1 shows, the share of U.S. imports that originate directly from China fell from 21.6% in 2017 to 16.5% in 2022 (light blue bars). This dipped further to 13.9% in 2023, so that China has overall lost about one-third of its U.S. import market share – or close to 8 percentage points – since 2017 (dark blue bars).

Figure 1: Changes in U.S. Import Market Share



Data Source: U.S. Census Bureau.

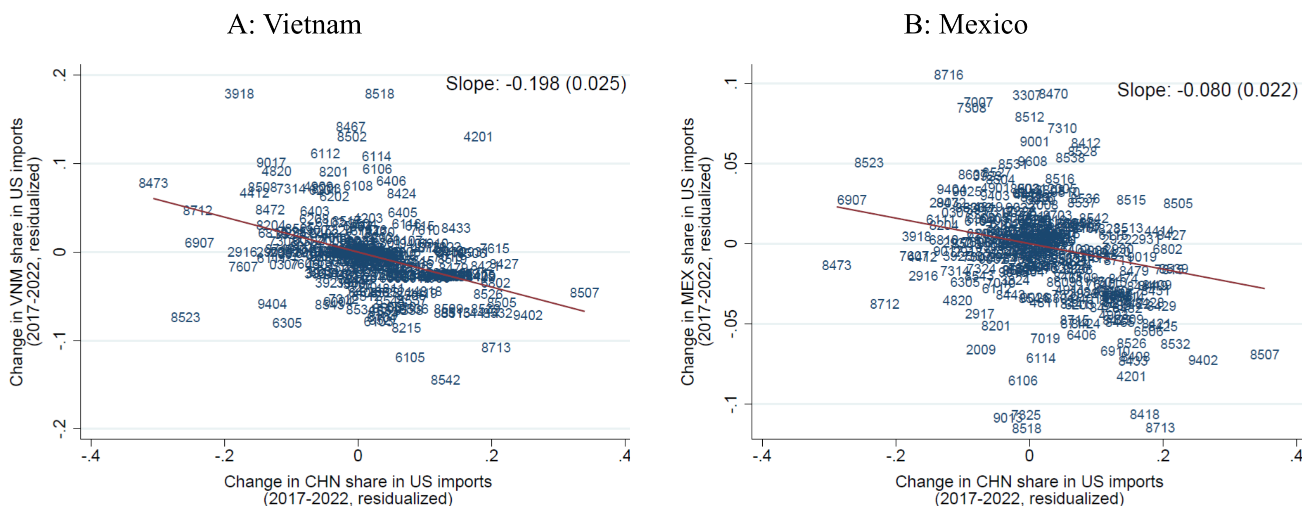
[1] Based on data from the U.S. Census Bureau.

The countries that have gained the most ground amid this reallocation in U.S. import shares have been Vietnam and Mexico, shifts that point to how U.S.-based companies are engaging in more "friendshoring" and "nearshoring" from these locations, in lieu of direct importing from China. Both Vietnam and Mexico have each seen their share in U.S. imports rise around 2 percentage points between 2017-2023. This increase for Mexico has been particularly concentrated in one year – namely, 2023 – so much so that Mexico replaced China last year as the single largest direct source country for U.S. imports (accounting for 15.4% of U.S. imports in 2023). Figure 1 corroborates and reinforces results uncovered by other international trade economists (Bown 2022, Grossman et al. 2023, Freund et al. 2023, Fajgelbaum et al. 2024), who have also documented this sharp and swift decrease in China's share in U.S. imports since the onset of the U.S.-China tariffs. Placing this in context, this is the most significant reconfiguration in the pattern of U.S. imports in recent decades, as it looks set to undo a good portion of the U.S.' direct dependence on China as a supply chain partner since China's entry into the World Trade Organization (WTO) in 2001.

In Alfaro and Chor (2023), we have further shown using more detailed Harmonized System (HS) 4-digit product-level trade data that China's loss in import share was indeed Vietnam's and Mexico's gain. Figure 2 illustrates this negative correlation: Vietnam and Mexico have gained a greater share in U.S. imports (vertical axis, Panels A and B respectively) in HS 4-digit products where China lost more ground (horizontal axis). Figure 2 moreover allows us to identify key products in which Vietnam and Mexico saw particularly large surges in their share of U.S. imports, these being data points that are positioned well above the predicted best-fit lines (in Panels A and B respectively). Both countries experienced significant increases in their import shares in various types of electrical and electronic equipment: in the case of Vietnam, these were microphones (HS 8518), electric generating sets (HS 8502), and telephone sets (HS 8517), while in the case of Mexico, these were discs, tapes and storage devices (HS 8523) and calculating machines (HS 8470). Vietnam also picked up import share in plastic floor coverings (HS 3918) and various forms of apparel (HS 6112, 6114). On the other hand, Mexico's imports in glass, iron, and steel products (HS 7007, 7308, 7310), as well as in automobiles and automobile parts (HS 87), performed particularly well; the latter is noteworthy as they point to Mexico gaining a bigger role in value chains involved in the manufacture of motor vehicles for the neighboring U.S. market. In additional regression analysis, we have confirmed that this reallocation in import

market shares was induced in part by the U.S. tariffs on China: the shift away from China toward Vietnam and Mexico was indeed more pronounced for products on which the U.S. levied higher tariffs on China starting in 2018 (Table 4, Alfaro and Chor 2023).

Figure 2: Correlations between Import Share from China versus Vietnam and Mexico (2017-2022)



Notes: Illustrated for the top 300 HS4-digit products by 2017 import value from China. The 2017-2022 change in the Vietnam (respectively, Mexico) share in U.S. imports is plotted on the vertical axes, while the 2017-2022 change in the China share in U.S. imports is plotted on the horizontal axis. Each of these share variables is residualized of HS2-digit fixed effects and the 2012-2017 change in the Vietnam (respectively, Mexico) share in U.S. imports.

Tentative signs of reshoring: Apart from engaging in more friendshoring or nearshoring, there are also nascent signs that U.S. companies have responded to the changing supply chain landscape by relocating more stages of production to U.S. shores ("reshoring").

We shed light on this through descriptive measures that summarize the "upstreamness" of U.S. imports and exports. This builds on a measure of industries' upstreamness developed by Fally (2011) and Antràs et al. (2012). As the name suggests, the upstreamness of an industry is its positioning relative to final users of finished goods; more specifically, it is the average number of stages that output from that industry will traverse – think of these as additional stages of assembly – before the finished good reaches an end-user (for example, when a consumer buys a smartphone). This can be computed using the information on linkages and transactions across industries contained in the U.S. Input-Output Tables (from the Bureau of Economic Analysis). As

constructed, an upstreamness value of 1 means that the entirety of the output of an industry goes directly to final-users (e.g., goods at the last stage of assembly). On the other hand, higher values of upstreamness mean that multiple stages of production are needed before the item becomes a final good (e.g., raw materials, chemical products, parts and components). By merging these with product-level trade data, one can then compute measures of the upstreamness of a country's exports (respectively, imports) that take into account the composition of these exports (respectively, imports) across traded products.[2] These measures of export and import upstreamness are informative of where the country is positioned within global supply chains, specifically whether the country tends to be engaged in more upstream or downstream stages of production.

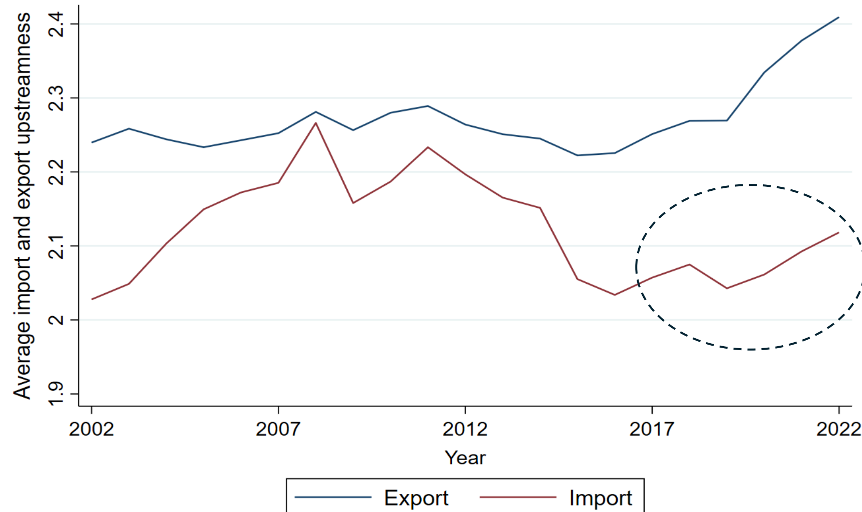
Figure 3 illustrates how the upstreamness of the U.S.' exports and imports have evolved over the past two decades. Throughout this period, the U.S. has been an exporter of relatively upstream products. This is because the U.S.' main exports include: (i) agricultural commodities and natural resources (notably, petroleum); as well as (ii) electronic integrated circuits, machinery, and other goods-in-process that are sent abroad for further processing and assembly. In turn, the U.S. tends to import goods that are relatively finished and ready to be absorbed in final consumption or investment in the U.S. economy (e.g., near-finished motor vehicles, electronic products). That said, in the most recent years of this data, starting around 2017, one can discern an uptick in the upstreamness of U.S. imports (as highlighted in the figure). This suggests that more finishing stages of production are now being performed and completed in the U.S., providing a tentative indication that these stages of supply chain activity are increasingly being reshored.

[2] More specifically, these measures are calculated as the weighted average across the upstreamness values of each product, in which we use the product's share in the country's total exports (respectively, imports) as weights:

$$U_{US,t}^{X} = \sum_{p=1}^{N} \frac{X_{pt}}{X_t} U_p, \quad U_{US,t}^{M} = \sum_{p=1}^{N} \frac{M_{pt}}{M_t} U_p.$$

In the above formulae, X_{pt}/X_t is the value of exports of product *p* expressed as a share of total U.S. exports in year *t*, M_{pt}/M_t is the corresponding share of product *p* in the U.S.' total imports in year *t*, and U_p is the upstreamness value associated with product *p*. The weights therefore reflect the importance of each product within the export (respectively, import) profile of the U.S.

Figure 3: U.S. Export and Import Upstreamness (2002-2022)



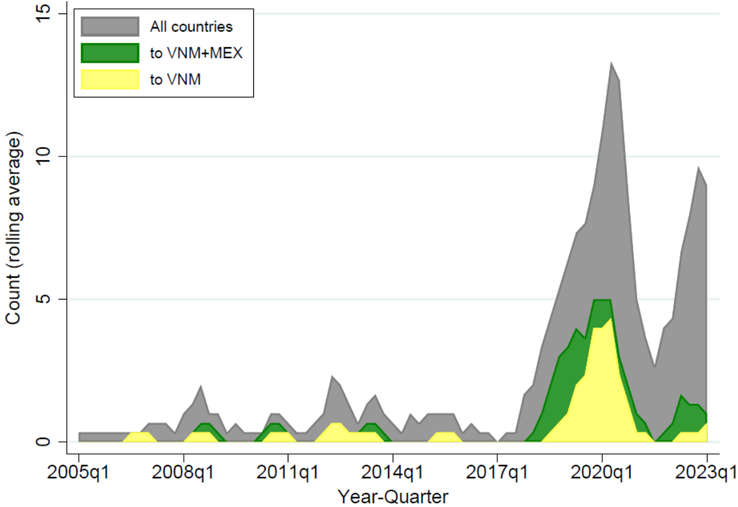
Notes: Based on the methodology in Chor et al. (2021), using UN Comtrade data and the 2012 U.S. Input-Output Tables. Excluding petroleum products delivers a qualitatively similar figure.

An alternative approach to gauge the extent of reshoring would be to examine U.S. employment in various manufacturing industries. The available data from the Bureau of Labor Statistics' Quarterly Census of Employment and Wages does point to a modest upturn in employment in some key industries: For example, between 2017-2022, U.S. domestic employment in automobiles, electronics, and semiconductors grew at an annual rate of 3.1%, 0.8%, and 1.9% respectively. For electronics and semiconductors, this positive turnaround in jobs coincides with the rollout of the tariffs on China and industrial policies in support of these sectors. On the other hand, the increase in automobiles appears to be more a continuation of a trend that pre-dates these policy actions, as employment in this industry was already growing from 2012-2017 at an annual rate of 4.9% (Alfaro and Chor 2023). In sum, while there are several tentative signs of potential reshoring, more work will be needed to continue monitoring these indicators, to determine how substantial and sustained these trends will be moving forward.

Direct evidence from firms: We complement the above with evidence that corroborates that the above trends reflect purposeful firm-level decisions to shift their import sourcing away from China. Figure 4 uses textual information from transcripts of earnings conference calls

conducted by publicly-listed firms, in which key issues of concern to shareholders and management are raised and discussed; this approach of examining earnings calls transcripts follows Hassan et al. (2019). The occurrence of "friendshoring", "nearshoring" and "reshoring" in these earnings calls has seen two key spikes in recent years.[3] The first coincides with the rise in U.S.-China trade tensions in mid-2017 under the Trump administration through to mid-2020. After a brief lull, there has been a second spike in mentions of these key words in earning calls starting in 2022, suggesting that a significant number of firms are engaging in discussions about their China supply chain strategies in light of the continued use of discretionary tariffs and the public turn toward industrial policy under the Biden administration. Mentions of shifts from China to Vietnam and Mexico specifically have cropped up in these earnings calls, with Vietnam featuring frequently during the first spike and Mexico drawing more attention since 2022.

Figure 4: Friendshoring/Nearshoring/Reshoring in Earnings Calls (2005Q1-2023Q3)



Notes: Friendshoring/Nearshoring/Reshoring in call transcripts in Refinitiv Eikon processed by NL Analytics; counts are three-quarter rolling averages.

2. Two points of caution

The reallocation of U.S. supply chain activity away from China described in the previous section has been motivated by two broad concerns. First, a series of high-profile disruptions and

[3] Specifically, to capture text that speaks to a potential shift in sourcing from China to another country (say Vietnam), our measure counts the number of occurrences of: (i) the root form of "reshor*", "nearshor*", or "friendshor*" that appear in tandem with "China" and "Vietnam", and: (ii) the phrase "China to Vietnam".

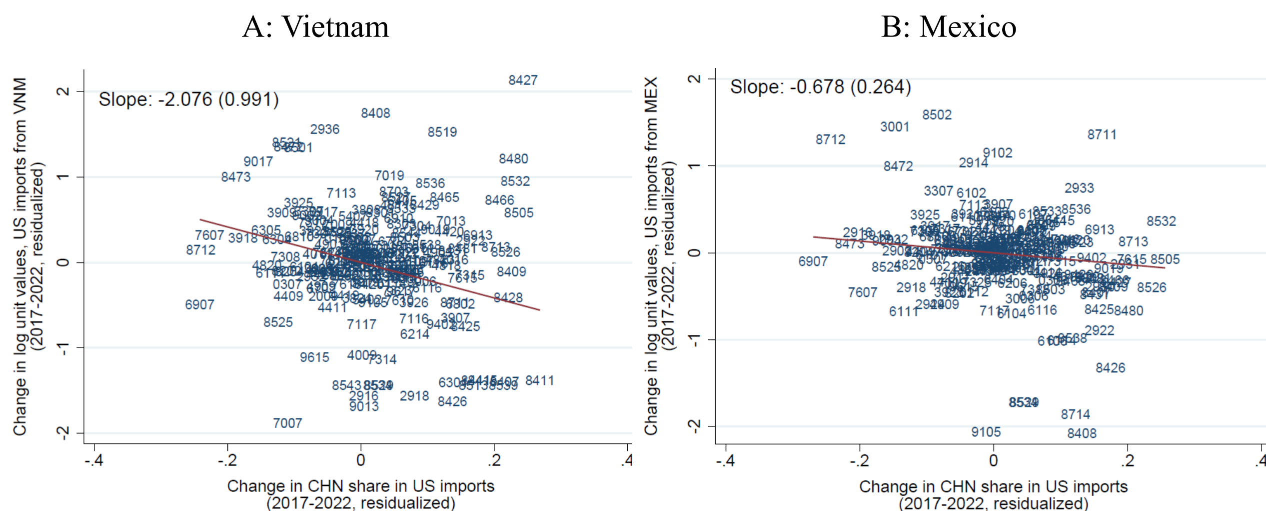
shortages of critical goods – most notably, during the Covid-19 pandemic – has led to more calls for businesses and policymakers to improve supply chain resilience.[4] Second, U.S.-China trade tensions have brought the deep supply chain relationships between the two countries under close scrutiny, particularly for products deemed to be important for national security, or of technological or strategic value.

While this renewed focus on supply chain resilience and national security is understandable, we would sound out two cautionary notes over the ongoing shifts in favor of friendshoring and nearshoring.

Rising Prices: First, there are already indications that this turn toward alternative import source countries will come with rising prices. That U.S.-based companies are now switching to Vietnam and Mexico suggests that these locations are a second-best alternative from a cost perspective when compared against the original first-choice location, China. Moreover, the recent surge in U.S. demand for goods from Vietnam and Mexico can be expected to pull up wages and industrial land rents in these countries, as manufacturers expand capacity to try to meet the rise in demand from the U.S. Along these lines, Figure 5 shows that such upward pressure on the prices of imports from Vietnam and Mexico is already evident in the trade data: Between 2017-2022, decreases in China's share in U.S. imports (horizontal axis) have been accompanied by increases in the unit values of these products that are imported from either Vietnam or Mexico (vertical axis, Panel A and Panel B respectively). Bearing in mind that the overall fall in China's share in U.S. imports between 2017-2022 was 5 percentage points, we estimate in Alfaro and Chor (2023) that this would translate into prices for imports from Vietnam and Mexico that are 9.8% and 3.2% higher respectively.

[4] This view is aptly captured in the following quote from a speech by Treasury Secretary Janet Yellen: "Favoring the friendshoring of supply chains to a large number of trusted countries, so we can continue to securely extend market access, will lower the risks to our economy as well as to our trusted trade partners" (Yellen 2022).

Figure 5: Correlations between Import Share from China versus Unit Values in Vietnam and Mexico (2017-2022)



Notes: Illustrated for the top 300 HS4-digit products by 2017 import value from China. The 2017-2022 change in log unit values of U.S. imports from Vietnam (respectively, Mexico) is plotted on the vertical axes, while the 2017-2022 change in the China share in U.S. imports is plotted on the horizontal axis. Each of these variables is residualized of HS2-digit fixed effects and the 2012-2017 change in the log unit values of U.S. imports from Vietnam (respectively, Mexico).

Second, the reduction in the share of direct imports from China does not necessarily imply that the U.S. is now less reliant on supply chain partners that are ultimately headquartered in China. This is because Chinese companies have very noticeably upped their degree of engagement in Vietnam's and Mexico's economies. In terms of international trade flows, China's exports to Vietnam were already growing at a fast pace of 10.2% per annum between 2013-2017, yet this increased further to 11.5% between 2017-2023. This trend is even more stark for China's exports to Mexico: These grew at an annual pace of 5.5% between 2013-2017, and accelerated to 14.6% between 2017-2023.[5] For many products shipped into Vietnam (respectively, Mexico) from China, there has also been strong growth in these same product categories in Vietnam's (respectively, Mexico's) exports to the U.S., raising the concern that what may be going on is just a re-routing of goods that are ultimately made in China. For Vietnam in particular, ongoing work by Edmund Malesky and his co-authors that was presented at a prior hearing of this committee (Iyoha et al. 2024), as well as parallel work by Liu and Wang (2024), is probing this issue to better understand

[5] Based on UN Comtrade data.

how much of this increase in Vietnam's exports to the U.S. is simply a pure transshipment of goods of Chinese origin that contain minimal Vietnamese value added.

China's recent increased economic engagement with Vietnam and Mexico can be seen too in foreign direct investment (FDI) flows. This is borne out in the FDI statistics reported by national agencies in these respective countries. In Mexico, Chinese firms' FDI in the manufacturing sector grew fivefold from US$31.6 million in 2017 to US$151.5 million in 2022. The bulk of this surge in Chinese FDI into Mexico has been concentrated in two industries that are particularly relevant for U.S. supply chains, namely computer and peripheral equipment (NAICS 3341) and motor vehicle parts (NAICS 3363).[6] While the U.S. still accounts for just over 50% of manufacturing FDI in Mexico, and China's share only stands at slightly over 1% as of 2022, the fast pace at which Chinese FDI has grown means that Chinese firms are poised to be key players in the Mexican manufacturing sector moving forward.

The FDI data available for Vietnam are less detailed, but if anything, the role of China as a source of inward FDI into Vietnam is even more pronounced. Using the Vietnam Annual Enterprise Data, McCaig et al. (2022) report that China's share in the total value of FDI into Vietnam rose from 0.004% in 1999 to 7% in 2017 (see their Figure 4). Data from Vietnam's General Statistics Office confirm that this trend has been sustained in more recent years: China's share by value of all FDI projects granted licenses by Vietnam in 2021 was 7.7%, compared to just 2% for the U.S.[7]

3. Impact on the U.S. economy and on China's economy

Policy measures – most notably, the U.S.-China tariffs – have played a decisive role in triggering this reallocation of U.S. cross-border sourcing away from China. Over the course of 2018-2019, the average U.S. tariff on goods from China rose to about 20.7 percentage points at its peak, affecting 74.7% of China's exports to the US – equivalent to 14.2% of the value of China's total exports to the world – in 2017. In response, China enacted retaliatory tariffs on

[6] Based on data from the Government of Mexico, Secretary of the Economy, Economic Global Intelligence Unit, July 2023 version, available at: https://www.gob.mx/se/acciones-y-programas/competitividad-y-normatividad-inversion-extranjera-directa?state=published.
[7] See: https://www.gso.gov.vn/en/px-web/?pxid=E0416&theme=Investment

goods from the U.S. averaging 16.6 percentage points, covering 66.0% of China's imports from the U.S. (or 5.6% of China's total imports from the world) in 2017.[8]

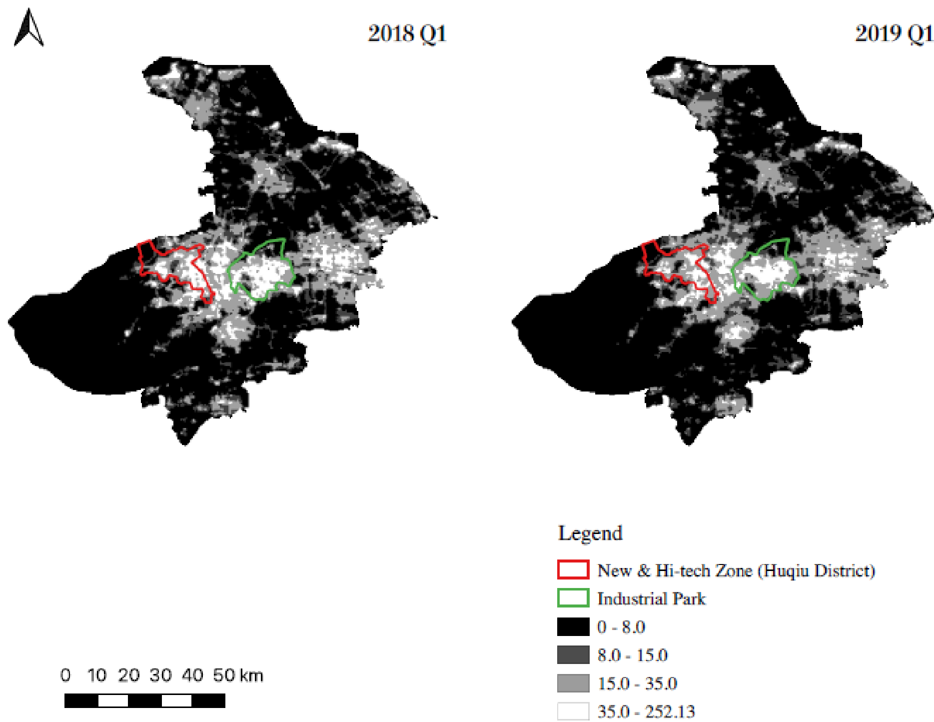
A significant body of research has documented the impact that these policies have had on the U.S. economy. On goods prices, Amiti et al. (2019) and Fajgelbaum et al. (2019) estimate from trade data that the U.S. tariffs on China have been passed through almost one-for-one to U.S. import prices. Examining the specific case of washing machines, Flaaen et al. (2020) find that the 2018 safeguard tariffs raised prices in the U.S. by 12 percent relative to a control group of other household appliances, even as washer manufacturers have relocated some of their production to U.S. shores. While some of these import price increases have been absorbed by retailers (Cavallo et al. 2021), one can expect that U.S. consumers too will ultimately bear a portion of this burden. Separately, several papers have studied the impact of the U.S. tariffs on employment outcomes. These have uniformly found that the tariffs on China had minimal impact on employment in industries that received protection, even though the tariffs have often been cited as a measure to support and bolster U.S. manufacturing jobs. Instead, the tariffs levied by China on goods from the U.S. appear to have had some negative impact on U.S. jobs in those industries that bore the brunt of China's tariff retaliation (Flaaen and Peirce 2019, Autor et al. 2024).

Turning to the impact on China, we know as yet much less about how the tariff war has affected economic outcomes there. This is due in large part to China's less transparent data environment: For example, China's statistical offices do not have a practice of releasing information on employment outcomes on a regular basis for detailed industries; there are also ongoing concerns over the reliability of official data during periods when the performance of China's economy might be viewed as a politically sensitive issue. To circumvent these data limitations, my co-author Bingjing Li (Hong Kong University) and I have used satellite readings on night-lights – the intensity of human-generated light emitted from the earth's surface at night – to study whether the U.S.-China tariffs have impacted China's economy. This builds on a recent literature that has proposed the use of such measures – gathered passively by satellites that orbit the earth – as a proxy for economic activity in settings where direct data are difficult to collect (Henderson et al. 2012). The satellite data moreover have a high spatial resolution, so we are able to observe these night-lights for 11km-by-11km grid cells overlaid over a map of China.

[8] As calculated in Chor and Li (2024), based on tariff data from Bown (2021).

Figure 6 provides an example of what this granular night-lights data can reveal. The figure shows the intensity of night-lights emitted from Suzhou, a large export-oriented prefecture in the coastal province of Jiangsu, comparing the situation in the first quarter of 2018 (prior to the U.S.-China tariffs) against that observed one year later. Relative to the rest of the prefecture, there has been a more pronounced dimming in night lights from two industrial areas – the Huqiu New & Hi-tech Zone and the Suzhou Industrial Park – that have a high concentration of export-oriented factories.[9] As the U.S. tariffs have likely hurt export orders at Chinese manufacturing firms, this dimming in night-lights could reflect reduced night-time operations in these industrial areas, or lower occupancy in worker dormitories located adjacent to these factories.

Figure 6: Night Lights Intensity in Suzhou in Q1/2018 and Q1/2019



Notes: From the VIIRS-DNB dataset. The highlighted zones are: the Huqiu district, which lies to the west of the Suzhou Industrial Park.

The more systematic regression analysis in Chor and Li (2024) shows that what we illustrate in this figure for Suzhou is manifest across China at large. Using customs data that pre-

[9] The year-on-year change in mean log night lights was -0.105, -0.085, and -0.067 for the New & Hi-tech Zone, the Industrial Park, and the rest of Suzhou respectively.

date the U.S.-China tariffs, we constructed a measure of each grid location's potential exposure to the U.S. tariffs on Chinese goods, by geolocating firms to grid cells using web-based mapping services (Google Maps and Amap). We find that there was indeed a more severe dimming in night-lights for locations in China with a larger share of exports to the U.S. that were subject to higher tariffs. We further translate these into implied effects for more conventional economic measures, namely GDP per capita and employment. We find a lot of heterogeneity across the geography of China in how much the U.S. tariffs affected economic activity: Close to 70% of China's population resides in grid cells with close to zero direct exposure to the U.S. tariffs. But for the 2.5% of China's population in the most tariff-exposed grids, we infer a decrease in GDP per capita of 2.52% and a decrease in employment of 1.62% over the eight quarters in 2018-2019, relative to unaffected grid locations.

4. Policy Recommendations

In the previous sections, I described the reallocation of U.S. supply chain activity away from China that is rapidly unfolding, and discussed the growing body of evidence on its impact on economic outcomes in both countries. What guidance for policy can we take away from this?

First, there needs to be a clearer recognition and acknowledgement that policy actions to reduce the U.S.' direct dependence on supply chain links to China will incur significant tradeoffs. For the U.S. economy, the U.S.-China tariffs have resulted in rising prices not just on imports from China, but also from alternative source countries such as Vietnam and Mexico; yet this has so far come with minimal attendant benefit to U.S. manufacturing jobs. And although it may be tempting to read the evidence that China's economy has been hurt by the tariff actions as an indication that the U.S. tariffs are "working", they are doing so also at a cost to the U.S. economy. While national security and strategic technology concerns deserve consideration, these need to be weighed against the costs incurred from the broad use of tariff instruments on a swathe of imports from China. An approach that is more focused on establishing a "small yard and high fence" – to quote National Security Advisor Jake Sullivan – would be preferable: defining a clear set of products whose supply chains are to be secured on national security grounds, while otherwise being open to international trade in all other non-sensitive goods.

Second, the rapid growth in imports from Vietnam and Mexico has already raised concerns that Chinese firms are using this as a backdoor route to circumvent the U.S. tariffs on

China. This is likely to trigger more calls for trade restrictions to be applied on goods exported from Vietnam and Mexico to the U.S. There is a need to avoid any such knee-jerk reaction. Vietnam and Mexico have good reason to view the incoming trade and FDI from China somewhat favorably, as this has the potential to bolster their domestic economies as they gain a larger slice of global supply chain activity.[10] Blanket calls for tariff increases on Vietnam and Mexico would risk alienating these countries, when there are instead more measured approaches such as strengthening and enforcing rules of origin, that are aimed precisely at curtailing the pure transshipment of Chinese goods with minimal Vietnamese or Mexican value added. Such collaborative approaches ought to be preferred, especially since building U.S. supply chain resilience will necessarily require strengthening ties with alternative source countries among whom Vietnam and Mexico will surely feature prominently.

[10] A nascent body of work has started to document the effects of the reallocation of supply chain activity through Vietnam and Mexico on these economies; see in particular Mayr-Dorn et al. (2023), Nguyen and Lim (2023), and Rotunno et al. (2023) for Vietnam, and Utar et al. (2023) and Chiquiar and Tobal (2024) for Mexico.

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PANEL I QUESTION AND ANSWER

COMMISSIONER WESSEL: Thank you to all our witnesses. I will take the prerogative of the Chair to ask the first questions, and then we will go in alphabetical order with Commissioner Cleveland going next.

Thank you all deeply for this. And, you know, I think we're still at a point of transition in our trade policies, and trying to understand what course we should take, and how do we make it durable, how do we make it more understandable and articulated clearly, both to the public and our trading partners?

But let me ask you a couple of questions. And, Dr. Lovely, in your last, I believe it was your last participation here, let me quote from your testimony. You said in 2014 FIEs were the source of 46 percent of total U.S. exports to the world, the share of U.S. -- China's exports to the United States that originate in FIEs was significantly larger at 60 percent.

I found that striking. And again, that goes to, I think, the questions that policy makers are looking at which is not sort of a narrow slice economic analysis of the impact of an individual tariff on end production and prices but rather the injury that may have occurred prior to that, and the cost of that injury, whether it is the loss of a production facility where the tax base has been damaged, where workers are out of work, et cetera, all of the costs.

And I think the economics profession has not yet caught up to the policy challenges and really trying to understand from all the panelists. And Mr. Greer, you were in the belly of the beast, so you had access to a lot of economists, and the ITC, and the others.

How should we look at updating, if that's appropriate, the models to take advantage or to look at a much more, a broader scope of issues?

You primarily talked about efficiency and consumer cost. And I appreciate that has to be, you know, a major focus. But there has to be a larger aperture, in my view, as to how do we gage what the impact of our policies are, what the past impact has been, what the potential future course can be.

And policy makers, I think, across the aisle, certainly here at this Commission, we've had unanimous reports, the vast majority of the last decade, if not longer.

Congress, the Select Committee, and others, I think there's a bipartisan agreement about addressing some China challenges. How does the economics profession though, help us going forward rather than, to be very honest, being left behind?

Dr. Lovely, can you start?

DR. LOVELY: Sure. Thank you for that question. It's a big one.

I think we are starting to have a wider aperture, but I would argue that it's not just the economists who need a wider aperture. We talk a lot about the bilateral relationship as if China and the U.S. were the only two countries in the world, which it simply isn't.

My testimony today focused, I think, on the efficacy of the tariffs in achieving their goals. The cost in terms of, you know, to consumers and producers tells policy makers that these choices have to be made clearly. Because they come out of the tax payers' pocket. So that is why I think getting these policies right is so important.

I would challenge the past narrative that China is responsible for all of our ills. I grew up in Pawtucket, Rhode Island, and I spent almost my entire adult life in Syracuse, New York. So I don't think anyone needs to tell me about deindustrialization. I've witnessed it since I was a little kid.

And I can say that we are not putting that genie back in the bottle. We have to look forward, and that China alone was not responsible for those, that there were also a lot of other -- I think a lot of that would have gone anyway, and that multi-nationals play a big role. And that was what my earlier testimony tried to bring into the picture, part of that widening the aperture.

I think our narrative has to include that. And as we look forward, we have to look at how we can bring our friends and allies into a new structure. And that's why I think that the objective, you know, playing whack-a-mole with supply chains, which I talked about and Davin talked about, is so important. We need to get our friends and allies onside.

So that's what I see when I think about a wider aperture. Focus on efficacy. You know, action looks good, but if it doesn't pay off in the long run, the voting public will figure it out. So, we need to take effective action. And just whacking everything around is just not going to do it. The cost will be too high.

So again, I go back to what is the goal. If the goal is decoupling at any cost, then broad unfettered tariffs make sense. Just blow the relationship up.

If you wish to protect U.S. tech and reduce the cost for U.S. taxpayers, and have effective policy which requires working with our allies, then you need to target your trade policy.

COMMISSIONER WESSEL: Mr. Greer, do you have a fairly quick response?

MR. GREER: Sure. Certainly, efficacy of the measures is an important consideration, I think part of what we're talking about today. I think it's important to understand, however, there are costs of not acting, right. And maybe this gets a little bit to your question, Commissioner Wessel, of what are other factors we need to consider. There are costs of not acting.

The point that Dr. Lovely made about multinational corporations being complicit in this, I 100 percent agree, right. This is not just an issue of China's out there eating everybody up. It's you have a bunch of folks who are getting on that bandwagon, or did get on that bandwagon, to participate in that, and U.S. policy makers too, right. This was like a group thing.

But we certainly have to consider, you know, job losses. You have some folks who are trying to consider, you know, we talk about deaths of despair in America. And some of the deaths of despair of men, right, men with high school educations, are in some of these depressed areas that were deindustrialized.

And clearly there are a lot of factors there. But you do have to consider is there a factor that there's a stickiness in labor mobility in the United States. And people want to stay where they grew up, right. They're not like all these Washington people.

And when you lose those opportunities there are costs there. And so I think there are a lot of complex things. And I don't know the full answer. But we certainly have to consider a broader set of what the costs are of not acting in addition to considering efficiency.

COMMISSIONER WESSEL: My time is -- I'm over my time. So, Dr. Chor, we'll ask you, for the record, if you can provide your thoughts, if you have some.

Chairman Cleveland?

(Simultaneous speaking.)

COMMISSIONER WESSEL: Okay, please, Dr. Chor, if you'd like to respond, please go do so.

DR. CHOR: The one thing I might add is that, you know, I'm much more in favor of a collaborative approach together with third countries.

For example, you know, one way to go about things with Vietnam and Mexico, in principle, is it's really not in their interests to just be doing pure transshipment for China, right. That's not how they add value ultimately to their economies.

And that, I think, is a reasonable pitch, to try to bring in these third countries onboard, to try to enforce some potential tariff jumping. Thank you.

COMMISSIONER WESSEL: Chairman Cleveland?

CHAIRMAN CLEVELAND: Thank you. Two years ago, the Commission recommended that Congress consider revocation of PNTR. And I'm curious. I think, Mr. Greer, you mentioned it in your testimony. I'm curious what you see as the viability and necessary steps to unwind it in a way that doesn't have a negative impact on our economy.

MR. GREER: Sure, thank you. I think consistent with this Commission's recommendation, the recommendation of the House Select Committee on China, I think there is a growing consensus that China should not benefit from permanent normal trade relations with the United States. And there are a lot of reasons for that.

And I think folks, you know, understand unfair trade practices, their development into an adversary rather than a collaborator. And it seems just completely malpractice from a policy perspective, if you're a U.S. policy maker, to be giving preferential, permanent, normal trade access to, you know, a competitor.

I think when it comes to the mechanism, I think that there have been ideas out there about phasing in a revocation of PNTR, which I think makes sense.

When you look at the Section 301 action under the Trump administration, when those tariffs were imposed, even those were imposed on a phased-in basis. And there was an exclusion process which, you know, some people liked, some people complained about, the courts ultimately upheld.

So, I think there are ways to do this, to send signals, clear signals to the business community, to our allies and partners about what we're doing and where we're going to go. And while we certainly would like to have third countries onboard, I think the chance of someone like Japan or the EU moving before us on this and leading, isn't going to happen. People are constantly calling for U.S. leadership. This is the leadership, right, this is the part where you go out, and you make it happen.

I mean, to some degree we no longer have normal trade relations with China in many ways. And so, let's do what Dr. Lovely suggested, well, she didn't suggest this action, I'm sure, but be clear about what we want to do and articulate it, and not have it be, you know, waving in the wind, but have Congress itself, who controls trade regulation, come down and say here's what we're going to do. We're going to revoke PNTR. It's no longer appropriate, and here's how we're going to do it. We're not going to do a cliff, we're going to have phase-in. We're going to try to do this in a studied way, but we're going to do it.

CHAIRMAN CLEVELAND: Okay, anybody else?

DR. LOVELY: We have essentially moved away from, obviously, MFN tariffs with China. I was disappointed when I saw that Commission recommendation. I do try to read what the Commission puts out, and I respect this Commission. However, I was disappointed, because removing PNTR would be deeply disruptive to the global economy.

I also believe it would be deeply counterproductive to U.S. goals. First of all, it's a signal not just of economic war on China which, make no mistake, it clearly is. It's also a sign of economic war on the WTO. Allies -- we will not be leading, allies will not catch up with us. They will not follow us.

The WTO is deeply important to the European Union. It's deeply important to Japan, to South Korea, to other major allies. They will not follow us, they will turn elsewhere. So, it's a recipe for further isolating and eroding U.S. leadership. Thank you.

CHAIRMAN CLEVELAND: If I could pursue that with you for a moment, yes, I have a moment. When we made the recommendation, and I appreciate your frankness, when we made the recommendation it was based on the 35 commitments that China made in order to enter the WTO. And we basically did an analysis of those commitments.

And China's failed to live up to virtually every one of them in some part or wholly. So, with no intent of launching a war on the WTO, although it deserves significant reform, I'm just curious what's the -- how do you look at the fact that they failed to comply with the fundamentals of the agreement and yet continue to benefit from it?

DR. LOVELY: Thank you, Commissioner. The U.S. hasn't brought a WTO case in, I think, seven years.

CHAIRMAN CLEVELAND: Right.

DR. LOVELY: We should, we were preparing a mega case against China. We should make them live up to their obligations. On that I clearly agree.

Pulling out of the one institution which creates the rules for global trade, on which not only our allies but small developing countries, would erode U.S. leadership and affect all aspects of our leadership including military and security cooperation.

So, the other thing about removing PNTR is that we can't then choose what tariffs we put on China like we do now. We'd have to go to Column 2. Those are the statutory rates. They're low on some goods, they're high on manufactured goods.

Again, we have no idea what the cost would be to U.S. businesses and consumers. I think it's just an easy handle, it's a lever. It's almost a slogan. But it's not smart.

CHAIRMAN CLEVELAND: Okay. We may turn to you to see what Column 2 looks like if this actually is pursued, so thank you.

COMMISSIONER WESSEL: Commissioner Friedberg?

COMMISSIONER FRIEDBERG: Thank you very much. Dr. Chor, Dr. Lovely, I'd like to pursue with you this issue of diversion, of trade. You mentioned United States imposed tariffs, imports of certain goods from China went down, imports from other countries, of third countries, particularly Vietnam and Mexico, go up.

So, the first question is how much of that is simple transshipment, just taking a product and putting a different label on it, first.

Secondly, do we have any idea, that portion that is not simply being re-labeled, how much value is actually being added in those third countries?

And then the third question would be if we want to encourage the diffusion, the genuine diffusion of productive capacity, wouldn't it make sense to impose some kind of tariff that would be calibrated according to the amount of value that was actually added in the third country? So, if it's most of the value is added, in fact, in Mexico, that's one thing. If most of its value is added in China, that's another. And it would be appropriate perhaps to impose a higher tariff in that case. Dr. Chor?

DR. CHOR: On your first question, I think the answer is that, frankly, from the data we do not know how much, how large that phenomenon is.

Do I think that there's no transshipment, pure transshipment going through? No, I don't. I do think that there probably is some re-labeling of stuff with minimal value added from Vietnam and Mexico.

Do I think it's all of the phenomenon, I don't think so either. Because, you know, the anecdotes are that Vietnamese labor is in demand. Mexico is relatively welcoming of the --

(Audio interference.)

DR. CHOR: -- and gain a slice of the supply chains. So, I don't these countries are purely naive on those fronts. So, I think this is a question for which, you know, the policy needs are running ahead of what the data will let us see at this point. And I know that's a frustrating answer to hear, but that is how I think about it as an empirical researcher.

I fully agree that there is the capacity, right. It will take some buildup in capacity, but we have existing frameworks already in place with rules of origin to try to make sure that there isn't this kind of a back door.

The automobile industry in Mexico has had decades in which they have had to comply with rules of origin that have been put in place. And I think that is a useful framework to build upon in order to make sure that this back door route doesn't become a flood.

COMMISSIONER FRIEDBERG: Thank you. Dr. Lovely?

DR. LOVELY: I think there is clearly transshipment. As Dr. Chor said, we don't know from the data. I mean, probably see, you know, Customs and Border Control would know best. But what we do know is that, when we talk about trade diversion as a result of the high tariffs on China, we pick up this diversion by looking at which products were already being produced in which countries.

So, if you think of the point of view of a American company that needs, say, an electric motor, they don't want to go a country that's never produced an electric motor. So, they look for the next low cost location. And that's where we pick up the diversion.

If we look over a longer term, say since the global financial crisis, countries that are now popping up, Vietnam, Mexico, were already gaining market share, slow, they're small, but they were already gaining market share. So, there is some real capacity there.

On the rules of origin, I would say then we need to negotiate trade agreements or look back into perhaps a revised TPP, because that has to be done in some kind of formal framework.

COMMISSIONER FRIEDBERG: I only have a minute, and I realize this is a large question. But suppose the objective of U.S. policy was to encourage the further diffusion, the genuine diffusion of productive capacity, indigenous productive capacity to third countries like Mexico or Vietnam. What would be the array of tools, policy tools, that would be appropriate to achieve that objective?

Dr. Lovely?

DR. LOVELY: Trade Agreements. We are working on the IPEF, Indo Pacific Economic Framework. I think we have been disappointed in the results so far. We may be asking too much too soon of countries that are still in a -- many of them are low, middle income.

They're anxious to develop, they're very anxious to access the American market. So, we have -- you know, and they're anxious to have closer ties, security ties and other ties with the U.S., because they also see China. But we need to help them. We need to do more than ask them to raise costs.

And I think here we have to be careful, because usually we do this because we say we don't want unfair competition for our workers. But we have to be honest. There's a lot of industries that are not coming back to the U.S. And we need to look at which partners can be our friends and allies, and how we could do it most cheaply.

Again, I come from Rhode Island. We used to be the foam rubber capital of the world. I know what those factories are like inside. I don't think that this is going to be the future of American manufacturing that will be able to pay American wages. So, we need to be realistic and create pathways for these countries to develop into being our suppliers.

COMMISSIONER FRIEDBERG: Can we give Dr. Chor just a few seconds? Could you give us a very brief answer?

DR. CHOR: I agree with Dr. Lovely that I think what needs to be done is assurances on market access to third countries that are willing to play by the U.S.'s, you know, broadly speaking, rules, right.

And a broad swath of tariffs or trade restrictions on Vietnam or Mexico as a stop-gap measure to sort of plug this hole, because there's a surge in trade flows, would send exactly the wrong message.

COMMISSIONER FRIEDBERG: Thank you.

COMMISSIONER WESSEL: Thank you, Commissioner Glas?

COMMISSIONER GLAS: Many thanks to you all. I want to dive into enforcement. I think we are living in a very dynamic environment in the global economy, especially with Chinese overcapacity impacting a variety of sectors with high youth unemployment. And they're flooding the world stage with their products in a way that is putting our workers and our industries out of business.

In this particular environment, the Chinese Customs is saying that they are sending to the United States $100 billion more products than our Customs claims receiving. Some of that could be illegal transshipment, some of that could be de minimis, whatever it is, so I'm not sure we actually have an accurate picture of how much China is actually continuing to dominate the world stage with a lot of the national narrative being there are so many shifts.

In addition, with UFLPA under enforcement the Chinese have a great incentive to hide polysilicon and other kinds of products on the list in other markets to gain access to the U.S. economy.

We're also finding rule of origin violations, even within our free trade agreements, to take advantage of the tariff-free system and claim it is a made in Mexico product, but it may be made of Chinese inputs.

Digging a little deeper into this, Mr. Greer, in your testimony you talk about new trade tools, anti-dumping, countervailing duty, but I actually think the issue goes even much further than that. CBP is down 4,000 officers who actually handle trade enforcement at our ports.

I mean, there's little to no civil and no criminal penalties when there is fraud. So how can we bolster our efforts? It's one thing to set trade policy over at USTR and Congress to pass new laws, but how do we ensure the effective enforcement of the rules we already have in place that are damaging the U.S. economy?

MR. GREER: Thank you. Yes, I think that, one, I agree with you. We have a lot of very effective tools in place already. So, we have these conversations about new tools. And they're certainly ones that we need and should have. But we need to enforce the ones we have as well.

And, you know, this is not really an easy answer, and it may sound a little bit like a glib answer, but political will is incredibly important. You could have all the tools in the world, you could have all the enforcement officers in the world but, if you're not receiving strong political direction from elected political leadership, it will be very difficult for those folks at Customs who want to enforce, and who are interested in making sure that the laws are honored, it will be hard for them to do that.

I will say, I am encouraged to some degree that we have seen movement, particularly on forced labor. I'm aware just, you know, through my practice of folks who are doing a lot to come into compliance. I'm aware of Customs detaining things, seizing things, holding people's feet to the fire. But it does need to be expanded like you say.

And so if that means we need to make sure that CBP has the necessary budget to do enforcement, that we need to make sure that, you know, enforcement leadership at CBP is empowered politically, and is able to go to political leadership and say here's what we're doing, if you need a political person to be running enforcement at CBP, I mean, I think there are a variety of things you can do.

You know, it's not super glamorous though, more structural, and organizational, and financial. But I think there's a lot you can do to increase enforcement.

COMMISSIONER GLAS: Thank you, Dr. Lovely, Dr. Chor, any comments?

DR. LOVELY: Thank you. I was heartened to see that there was some extra funding for customs in the latest announcement from the White House on the extension of new tariffs to some of the industries that I think you're probably concerned about for over-capacity in export surges -- import surges in the United States.

I think it's important that we invest in technology. My son's first job coming out of college was doing Customs brokerage. And I was shocked at the number of paper documents that appear on his screen, hand-written paper documents in the most technologically advanced country in the world. We need to invest in technology to help the human capital that's at the Customs in CBP.

I think we also need to think about carrots not sticks, that is the countries that are sending these goods can assist us as we've seen in issues having to do with immigration.

So again, as Dr. Chor said, there are methods we can use to empower these countries, reward them for participating in playing by so-called U.S. rules.

DR. CHOR: Dr. Lovely read my mind in the sense that I believe there's tremendous scope in technology to help this process. With artificial intelligence, that's what AI is supposed to be able to do, right, sort of recognize and pickup potentially suspicious packages, you know, with regards to folks that might be side-stepping the de minimis rules, et cetera. So, I think that really, to me, is the answer for, especially when labor is a constraint.

COMMISSIONER WESSEL: Thank you. Commissioner Helberg, appearing virtually?

COMMISSIONER HELBERG: Thank you all for the testimony. I want to start with relatively low hanging fruit questions. Our Commission has assessed every single year that China has failed to live up to its WTO commitments.

Dr. Lovely, do you think China will ever live up to its WTO commitments? It's been over two decades. I'm curious to know if there's any U.S. policy that you think could change China's behavior at this point?

DR. LOVELY: Study after study has found that China has changed practices when it's been found to be in violation at the WTO. There are unfortunately many aspects of WTO rules that are vague, to say the least. And many of them have to do with intellectual property.

And I think that clearly getting China to agree to meet the obligations to which it has already agreed, we need to also work to reform the WTO at the same time. That is a difficult row to hoe, I understand. It doesn't provide a big bang for the buck right away.

But over the longer term, that is the best way to exert U.S. leadership and to keep friends and allies on our side. It's a difficult --

(Simultaneous speaking.)

COMMISSIONER HELBERG: Dr. Lovely, I want to be mindful of time, so I just want to ask yes or no questions. Will China ever live up to the WTO commitments, and do you think these studies that you cited include the fact that the U.S. trade deficit with China has nothing but sky-rocked over the last 23-plus years? Do your studies --

DR. LOVELY: Yes, I think it will live up to its agreements if it's held to its agreements, A. And, B, I don't think the U.S. deficit is China's fault. China went into almost trade balance, and we still had a big deficit. That's a whole nother question we can talk about, about why the U.S. is spending more than it makes. But it's a different conversation.

COMMISSIONER HELBERG: Okay. So, your testimony is that the U.S. policy can change China's behavior and that China could eventually live up to its WTO commitments despite the fact that it has an unbroken record of failing to do so over the last 23 years?

DR. LOVELY: Your words, not mine.

COMMISSIONER HELBERG: I think I heard you say that China could live up to its WTO commitments.

DR. LOVELY: Yes, it's the second half of your statement that I disagree with. Thank you.

COMMISSIONER HELBERG: I'm happy to hear that you disagree with the fact that China will live up to its WTO commitments.

Dr. Greer, do you support repealing PNTR?

MR. GREER: I do support repealing PNTR. And I certainly believe that Congress should look into the best way to do that.

COMMISSIONER HELBERG: Thank you so much. And does China have a civil military fusion doctrine that amounts to a vast web of various laws and authorities that allow it to instrumentalize and subordinate its private companies, especially its technology companies, to advance its political and strategic interests? Yes or no?

MR. GREER: Yes.

COMMISSIONER HELBERG: Has China implemented an aggressive pursuit of dominating strategic technological sectors including for focus on companies like DJI focused on drone manufacturing or Hesai LiDAR which are now becoming pervasive in the U.S. market?

MR. GREER: Yes.

COMMISSIONER HELBERG: In addition to repealing PNTR to create a macroeconomic incentive to new supply chains outside of China, would it make sense for the U.S. government to double down on existing efforts to impose restrictions on the sale of heavily subsidized Chinese technology companies like DJI drones and Hesai LiDAR in the United States?

MR. GREER: Yes.

COMMISSIONER HELBERG: And we're currently in an AI arms race as everyone in private industry, as well as in Congress, has recently acknowledged.

Humanoid robots are emerging as a new front in that arms race. And Tesla, OpenAI, Amazon, Microsoft, and Nvidia are all making major bets to give AI a physical body through human-like robots.

And while this sounds like science fiction, humanoids are already being deployed in warehouses. And China has identified this as a strategic technology and it's about to mass produce them by 2025. A company named China Unitree announced the release of a Chinese humanoid that can outrun humans at 11 miles per hour. It can swing a bat. And it's heavily subsidized, and it has been announced that it will be available for sale for $16,000.

Would it make sense for the U.S. government to restrict the sale of Chinese controlled humanoid robots on U.S. soil?

DR. GREER: Yes.

COMMISSIONER HELBERG: Does anyone on this panel see a problem with Chinese controlled humanoid robots roaming around our warehouses and the streets of our cities?

DR. CHOR: I am unaware of this company that you are mentioning of. So, I should defer from making any comment on it.

COMMISSIONER HELBERG: Dr. Lovely, do you think China will promise that Chinese controlled humanoid robots will be well behaved and in accordance with WTO, and rules, and human rights treaties?

DR. LOVELY: I think we're already taking steps under our export controls to slow Chinese development in AI. I think the U.S. is far, far ahead in AI and that we should continue to pursue these policies of restricting access to the U.S. market for Chinese technologies, yes. And I think there's appropriate statutes for doing that.

COMMISSIONER WESSEL: I apologize, Commissioner Helberg, the time has expired. If there are additional questions you want to submit to the witnesses, we can certainly have that done.

Commissioner Kuiken?

COMMISSIONER KUIKEN: I'm the new guy, so I'll be on my best behavior here and observe the time limits, something I've never done in a staff briefing in my life.

You guys have all sort of said little bits and pieces that are interesting. And I want to try to see if we can have a conversation with all three of you to bring some of them together so there's actually sort of some actionable things here.

First of all, it sounds like all three of you generally agree that Customs and Border, BIS, and CFIUS are not adequately funded. Is that a fair conclusion?

MR. GREER: I think those agencies could benefit from additional funding, yes.

COMMISSIONER KUIKEN: Mary?

DR. LOVELY: I'm not an expert in BIS and CFIUS.

DR. CHOR: I would say there's scope for Customs and Borders to be tightened up.

COMMISSIONER KUIKEN: Okay. All of you have talked about sort of the WTO. And Dr. Cleveland mentioned one of the previous years' recommendations. Can we think about this in sort of an actionable way, in an incremental way here for a second?

If you were to do something, what does Phase 1 look like, or Step 1 look like?

Mary, you said something about Congressional involvement in trade, how do you increase that. To me, when I heard you say that, and then I heard some of the other comments, I was sort of thinking about, like, what is the thing that Congress, in an election year, could actually accomplish in this space that doesn't get the Executive Branch all spun up and in sort of a compromise space?

So, could all three of you just sort of talk about how, if we were to implement a previous year's recommendation, or sort of recommend the implementation of a previous year's recommendation by the Commission, what Step 1 would look like? And I'll let all three of you respond.

MR. GREER: Thanks. I certainly think that Step 1 should include an articulation of where we stand on normal trade relations with China. Congress had said this on a bipartisan basis, this is where we are. You know, your question about what's politically sustainable is a little harder, right, to answer.

One other thing that potentially could be done that would be politically sustainable is you could say we are going to take, you know, when it comes to dealing with retaliation from China, or helping manage supply chains, you could do something and say, well, we have a lot of tariffs

on China in place. We've just increased them. Why don't we take some of that revenue and provide it to companies and workers that are harmed by any retaliation by China? That seems like the kind of thing that maybe Congress could get behind in an election year.

COMMISSIONER KUIKEN: Mary?

DR. LOVELY: Well, I'm probably getting the first one wrong, but the Biden administration has been confront, compete, invest. I might have the first one wrong?

But in terms of competing, strengthen the United States, we've been doing that through our industrial policy, invest, investment in new areas. For example, just recently there was an announcement of the Micron money that's going into Syracuse. And I've never seen the community as activated, and to reach into the city and to help those who have been left behind.

So, I think these are important things that have flown through this Congress. I also think it's important for Congress to think about restricting the use of Section 301, whether that could fly in an election year, I'm highly doubtful.

COMMISSIONER KUIKEN: You were the one that said something about Congressional involvement in trade cases. When you sort of say that, what is the thing that you're looking for Congress to do? Is it just get more information about the ongoing case? Is it creating some sort of reporting mechanism, is it forcing the USTR to come up and give a briefing, is it creating a classified report? What is the thing?

DR. LOVELY: I think one of the beauties of the U.S. system is the administered protection system where Congress allows a certain authority and sets processes for how complainants will receive relief.

And this allows everyone in the United States to say there's a set of rules, and these rules are applied fairly. I don't think that has applied to the administration of Section 301. And I think that undermines the rule of law in the United States and the faith that the government isn't making special deals.

Exemptions, and I am perfectly happy to say exemptions have been above the board, but they're ripe for corruption. And the fact that we don't see that is worrying to me.

Again, I'm not casting dispersions on anyone. But I'm saying don't put the instrument out there. Place some restraints on the use of these tools.

DR. CHOR: I think first and foremost that it's not as well-known as it is to myself as a researcher out in the public that China's share of U.S. imports has actually gone down by one-third, right? I think recognizing that de facto there has been a contraction in that direct relationship should sort of strike us as, hey, there is significant action going on here and Congress can play a role in sort of making that known in that we are moving our way, moving on our way towards that goal of reexamining the supply chain links. I know it's a messaging issue and I think that the word needs to get out there that if you're not careful, this horse can bolt the cart and complete decoupling is going to be incredibly painful for the American economy.

COMMISSIONER WESSEL: Thank you. Co-chair Miller.

COMMISSIONER MILLER: Thank you. We're in a very different inflationary environment now than we were back in 2018 when we first started the China tariffs, and to implement tariffs as a real bipartisan tool for trade policy. We're also seeing a very strong dollar right now. We had a strong dollar before; now we're looking at a very strong dollar. How should we approach the use and scope of tariffs or adding newer, higher tariffs in an economic environment where these issues are prevalent now or in the future.

And I want to be very specific here. I'd like to hear each of your viewpoints on this issue. Should we look at tariffs as something that should be off the board in a very high inflationary

environment? Should we be tactical about this? And if there's high inflation then we need to figure out what tariffs might not cause inflation and utilize them, but not use the other ones.

Or are tariffs such a priority in certain cases that we should push them forward as a priority, but at the same time, look to accompany them with accompanying measures that would potentially devalue the dollar or take care of the inflationary problem. I'd be interested in thoughts of each of you.

MR. GREER: Yeah, just to echo your point, Commissioner, when tariffs were imposed on China in 2018, and then again in 2019, inflation actually went down between that time. And so, the connection between those tariffs and inflation, there doesn't appear to be much of one. My understanding, I'm not an economist, but I've read these studies, and the inflation we saw in the past few years were on things like healthcare, food, housing, education, things that we don't import from China as a general matter. I think it's clear and I think obvious to me that if we're in a higher inflation environment you certainly should consider what the effects might be on particular goods, right?

I mean, even when the 301 tariffs were originally imposed on a $40 billion-dollar tranche, the focus was on items that were targeted by the Made in China 2025 Policy, not retail consumer goods, and many of the tariffs were focused on goods we did not import from China, like electric vehicles which we don't import now really. So, I think there are certainly very sophisticated ways you can look at that, on how you should impose tariffs, to what degree, what the scope is, what the rate should be.

DR. LOVELY: Thank you, Commissioner Miller. I think that when we think about tariffs we think about a one-time increase in the CPI, a big bump up and Peterson has estimated it at about 1 percentage point to the U.S. inflation rate. When we think about tariff reform as I have advocated, I think it's clear that we do need tariffs in some places. I think they should be higher in some places and lower in others in keeping with the carefully articulated strategic vision of the United States.

I do think that there is a longer-term danger of tariff creep, of the small yard getting too big when it's applied to tariffs, and that that will erode competition in the U.S. economy. We can't afford our companies to get lazy. I think competition is important. We have a very large economy so a lot of it is domestic competition, but on sectors that are heavily concentrated, we do need to be open to foreign competitors to keep American consumers having the lowest prices, the best products, and a lot of variety.

I think international trade serves this purpose. I also think the U.S. should beware of retaliation against U.S. exports. We are the second largest manufactured good exporter in the world, and while it's a relatively small share of U.S. employment, it's an enormous bundle of goods that the rest of the world depends upon. So, I think we need to think about that as well, and our status as maintaining an open system globally for us, for our allies, for our friends.

COMMISSIONER MILLER: Thank you. Dr. Chor.

DR. CHOR: So, when tariffs are implemented, someone has to pay for them, and what I typically will teach my MBA students is that it is some combination of the consumer bearing some of it, the buyer bearing some of it, or the supplier taking a hit on their margins, right? Some combination of that has to be happening.

And to say that China is paying entirely for the tariffs, I think that's an extreme scenario in which for some reason, China has so much market power or that it can pass on, or sorry, that the U.S. has so much market power that it forces China to cut its prices in its entirety of the tariff. So, I think the reality is somewhere in between, and in fact, the empirical evidence has

suggested that the past truth has been much more on U.S. buyers than on the Chinese side. So that's what the body of research suggested.

I prefer a much more tactical approach. So, a broad swath of tariffs on a range of products runs the risk that we are going overboard here.

COMMISSIONER MILLER: Thank you, it looks like I'm out of time.

COMMISSIONER WESSEL: Vice Chair Price.

VICE CHAIR PRICE: Thank you all for coming today and for your testimonies. This has been very interesting. I want to, at the risk of being a little redundant and maybe even simplistic, I want to drill down even more on the tariffs and to add on to the last question.

Dr. Lovely, you said just now tariff reform in some places, some higher, some smaller. Can you drill down a little bit more on that in our current environment exactly what you would see, doing more of, less of, etc.?

DR. LOVELY: Thank you Vice Chair Price. I certainly would look at the knowledge-intensive sectors, sectors where we think China may have benefitted, Chinese companies may have benefitted from forced technology transfer. And I would take a look at what the tariff rates are on those. The first round, actually, I did a policy brief on this, the first round did contain tariffs on a lot of so-called knowledge-intensive sectors. We quickly run into a problem there though, which is a lot of that trade, as Commissioner Wessel said earlier, is happening through multinational companies. And we have to then deal with how much we want to tax flows, where the profits accrue to our own companies. Apple is a good case.

I'm not saying that that's a case where they have benefitted, but I think that is the sort of thing. We're going to have to look at pharma and other sectors. So, this is going to be difficult, but I think it's what we have to do. In other areas, and Mr. Greer pointed out that it was only later in these tariff waves that tariffs were placed on consumer goods. And the last, List 4B, was actually withheld because it included a lot of things like toys and children's boots.

I think we need to ask why do we have a tariff on a tablecloth, but you don't have a tariff on a Fitbit or an Apple Watch? So why are we taxing the people who shop at Walmart, but we don't tax the people at the specialty store? I think there's obviously a lot of answers to that having to do with political economy. But I think that if we're really going to say we're going to pursue our strategic interests, we have to look at the whole package with eyes wide open and address these difficult issues of what do we do about all these flows in tech that are mediated by multinational corporations either headquartered here or headquartered in our allied nations.

VICE CHAIR PRICE: Very helpful. And Mr. Greer, would you like to talk about when you would use tariffs and not?

MR. GREER: So, I think that there is a strong strategic value in tariffs, regardless of what the specific tariff might be, rate. If you look back to pre-PNTR period, China had MFN access to the United States, but we didn't see the huge off-shoring to China. Why? Because there wasn't certainty of access to the U.S. market. There wasn't certainty that they would benefit from permanent normal trade relations.

Then we see that, that's when we see a lot of the shift in manufacturing to China. And I would say that there's a value in uncertainty. Some people might call this we're renting the U.S. market to others instead of selling it to them. And whether the tariff on an electric vehicle is 75 percent or 100 percent, I'm happy to have economists talk about what makes the most sense, but there is an enormous value in just having a tariff and China knowing that they don't have - not just China knowing, but multinationals understanding that they're not going to be able to use China as an export hub in an unfettered way.

So beyond strategizing where we should increase tariffs or decrease them as the case may be, as the Biden administration has done, it's important to embrace the strategic value of tariffs and where there's area to tweak them, then do that.

VICE CHAIR PRICE: Dr. Chor, would you like to add anything?

DR. CHOR: I think the time is right to sort of review what's on Section 301 and what's not, and sort of refine that list. I agree with Dr. Lovely on this front. In 2018 and 2019, there was a sense in which the need for action went ahead, and perhaps now that it's been four or five years on, it's time to relook. What products exactly we care the most about because they're precisely the most strategic, they are technology-intensive, they're knowledge-intensive.

This is where we want American workers to be. Those are industries that add a lot of value where we can be world leaders and that pay high wages. That's where we want to be focused on in terms of - and lower the tariffs on the other stuff that are nonsensitive.

VICE CHAIR PRICE: Thank you.

COMMISSIONER WESSEL: Commissioner Schriver.

COMMISSIONER SCHRIVER: Thank you. Good morning. Thank you to our witnesses. I really enjoyed your statements and learned a lot. I have one question that's a little bit more narrow in scope and then one that I think is broader in scope. Let me start with the narrow.

And Mr. Greer, nice to see you again and thanks for your service, and thanks for being here today. You were certainly on the front lines of a lot of action that was taken in the previous administration related to trying to shore up supply chain integrity in critical sectors, work on semiconductors, batteries. I'm wondering how we get ahead of the next problem area and is there a critical sector that we haven't focused on yet, and what you think might fall in that category.

MR. GREER: Yes, and we've heard about a couple of them today. I think we're in the thick of it with semiconductors and there's more work to do there. Dr. Lovely talked about pharmaceuticals. Huge issue, right? And obviously the pandemic brought this into focus.

But so many of our APIs are coming from China and other places too. What tools do we use to get at that? Politically it's probably hard to do a CHIPS Act for pharma, even if it might make sense theoretically, but are there other things you can do? Like Puerto Rico used to have a tax regime that benefitted the pharmaceutical industry there in Puerto Rico. That lapsed and the pharmaceutical industry went to a different island. They're all in Ireland now, a lot of them. So that's an area.

We heard earlier from the Commissioner about robotics. I think that's a very serious area we need to be looking at. I think aviation, right? If you look at Comac and what they're doing, I mean, the fact that the United States gave an FAA authorization to Comac airplane a few years ago is kind of interesting to me. So, I think that there are these sectors where we need to start working now so we don't end up where we are with EV, solar panel, steel, aluminum, and maybe semiconductors.

COMMISSIONER SCHRIVER: Great, thank you. The broader question I want to ask, and it's sort of informed by the work we do on open source Chinese language exploitation. Informed by that, my view is the trade war didn't start in 2018-19, it started long before that. We just weren't engaging, we were under assault.

We haven't talked a lot about China's strategy or China's thinking behind how it approaches trade. I wonder if there's compelling evidence that China's not just trying to seek economic advantage, advantage their own industrial champions, take actions that improve the labor statistics, etc., but actually their ambitions are to actively seek deindustrialization of the

United States, actively seek to gain dominance in supply chain areas that are critical to us for the purposes of having leverage and potentially employing that leverage.

If there's evidence to that approach, would that change anybody's opinion on things like PNTR? In other words, do Chinese intentions and ambitions, and does their strategy matter or is that irrelevant? Maybe I'll start with you, Dr. Lovely. Thank you.

DR. LOVELY: I don't believe that is their intention. I think they're focused domestically. They certainly have enough domestic problems. I think we're seeing their trade and investment flow shift to a new set of countries that the U.S. should also be looking at to make sure that we are establishing relationships. I believe we are doing that in the Pacific as we need to do.

Whether their motivation matters, I think their actions matter. And I have argued here for a strategic response by the United States. One that, as I said, is effective and takes account of the cost to the American tax payer. So, their motivation, actions is what I would look at.

DR. CHOR: If I could put things in a little bit of perspective. I think China is keenly aware that its economy needs to adapt moving forward. The trade war is not the first hit that they've experienced to their external trade in the past decade. In the mid-2010s, Chinese exports to the rest of the world actually failed to recover to sort of pre-global financial crisis trends. And we heard anecdotes about factories and low-end factories related to furniture and apparel sort of shuttering in the traditional manufacturing hubs. It was a challenge that they were keenly concerned about in terms of how to manage the way forward.

So I think from China's perspective, we here in the U.S. might be thinking that they're on this trajectory that seems really linear and they're on their way, but I actually think that they are keenly concerned about the kinds of challenges that they are facing, and that's their perspective of how to navigate these waters vis-à-vis the U.S. in terms of trade relations.

COMMISSIONER WESSEL: Commissioner Sims.

COMMISSIONER SIMS: Thank you all for your testimony. I've learned a lot and I will say, Dr. Lovely, I particularly appreciated your testimony because sometimes I think it's helpful, like the testimony that makes my heart beat a little faster, it makes my blood kind of get going is what I prefer. So, I want to engage with you on one question in particular about the potential revocation of PNTR.

Because to me, as I'm looking at this, I'm certainly no economist, but revoking PNTR seems to me to be basically an acknowledgment of what already exists, which is we do not have normal trade relations with China, because they don't want to have normal trade relations with us. They want to lie, cheat, and steal, and they want to do it with impunity.

And so, I guess, I don't want to put words in your mouth, but my impression from your testimony was essentially if China understands the rules and they're not too vague, they want to follow the rules. And I'm curious as to how you would come to that conclusion because as I look at the evidence, and certainly when I was in the Office of the Director of National Intelligence, and trying to assess their intentions, it's always difficult no matter who you are trying to assess outside looking in, but my impression was that their intention was not to abide by the rules.

And so, I'm curious as to how you might come to the conclusion that that would be their intention.

DR. LOVELY: Thank you for the question. I think it's very difficult to separate the economic security from the national security, especially when you're looking at national security every day. I think China does want to play by the rules. It also wants to have its own system, which is a state-driven system. And as many people have pointed out, this is a basic source of conflict within the global trading system. And it's why we need to make sure that we have the

adequate trade remedies that we have here and that they are pursued effectively and quickly. And that's another place where Congress could act.

So, I do think they want to play by the rules. They have almost always abided by WTO cases that went against them. I think that we also miss, because we focus on the areas where we should be strategically reacting, we miss a lot of trade that happens from the millions of private companies in China that occur every day at market prices. So, I think there's a tendency to say this is a bad country. They are doing X, Y, and Z to us, without dis-aggregating it and looking at it.

So again, I think if you just want to whack China, if you say there's no hope for this, go ahead. We've done it, we can expand that bundle 100 percent, right? But if we say no, that we want to encourage relations, we live in the same world, we've talked a lot about how China is deeply integrated into the global economy, then we look at friendshoring and nearshoring, we can't avoid talking about China as well, then we need to take a more sophisticated view.

And I have argued I think consistently here today that that requires the U.S. government to take a very sober look at how we are interacting with China, not only individually, but through multinational firms as well.

COMMISSIONER SIMS: I don't think China is a bad country. I certainly don't think the Chinese people are bad people, but I do think the Chinese Communist Party has nefarious intent. I'm thinking about some specific examples, and I can't remember the name of the company, but there is an American wind turbine company, I believe it was, that was the leading manufacturer in the world.

You mentioned intellectual property and there's some vagueness around intellectual property, theft rules, and things like that. What the Chinese did with them was they basically stole their technology, stood up their own company and then drove up their own market share in the industry to the point that they became the dominant player. I don't see any universe where there was any vagueness to what they did to that company. And that's an example that I think is replicated across numerous industries to the point that they kind of have a playbook. I don't think it's a one-off; I think they actually have a playbook by which they do this. And the end result is they gain the market share at the expense of a company from America or other free market economies.

I don't know if I have a question so much as I'm really wrestling with the conclusions that you have come to that if we only engaged with them a little bit more soberly and responsibly and we all just kind of got along in the world, how that would change that outcome that seems to have been replicated across so many industries.

DR. LOVELY: I think you're mischaracterizing my testimony.

COMMISSIONER SIMS: Okay, I certainly don't want to do that.

DR. LOVELY: I didn't say we should all sit around and sing Kumbaya. I think what I'm saying is that the U.S. needs to be more strategic. It needs to clarify its intent, and it needs to make clear that our allies and friends know what that intent is. Otherwise, we really risk repelling them, and I think revoking PNTR would be a very quick way to do that.

COMMISSIONER SIMS: Thank you.

COMMISSIONER WESSEL: Commissioner Stivers.

COMMISSIONER STIVERS: Thank you. Thank you all for being here today. I've learned a lot from all of your testimonies. Let's talk about phase one for a moment, Mr. Greer.

You mentioned that, and we know from Phase One, that China committed to all sorts of structural reforms on agriculture, IP enforcement, financial services and other matters. We have had a few years to analyze the data at this point. What is your conclusion on China's compliance with the structural parts of the phase one deal?

MR. GREER: With respect to the structural parts, I would say generally noncompliant. When the Phase One agreement first went into place the Chinese made actually substantial efforts to move on those structural issues. For example, on agricultural regulations we saw, actually very quick movement to approve certain U.S. facilities and agricultural exports. We did in fact see a huge upswing in agricultural imports into China from the United States.

I would say though now my understanding just from in the industry is that China has already reneged on some of those, and there have been situations where they have started to revoke licenses that otherwise were granted; on things like currency, right? They made promises about currency, I mean, look where they are now, they're back where they've always been. They pick where they want to float their currency.

With respect to forced technology transfer, they would only make general commitments. That's why it's a phase one, they wouldn't go very far when we offered them an opportunity to have a grand bargain they did not want to do it. They did not want to have those kinds of rules. So those general commitments on forced technology transfer - I'm concerned that they're still engaged in that, although the U.S. has taken strong measures to prevent it. So, I would give them probably a failing grade on Phase One compliance.

COMMISSIONER STIVERS: Considering that and considering their lack of progress on the WTO and PNTR commitments, is there any value in bilateral agreements with the Chinese government that is not something that can easily be verifiable in the short-term?

MR. GREER: Listen, we'll probably always have some degree of trade with China, right? The question is we just have to manage it. The Chinese have agency in all of this, right? It's not just a unilateral thing where U.S. policy is going to carry the day. They have had decades of opportunities to develop a politically sustainable trading relationship with the United States, and they have chosen otherwise.

I think the United States is always going to be open to talk to folks. If the Chinese come and say, well let's talk, everyone will always talk. But the American policy makers should not defer or delay enforcement action in the interest of talking to the Chinese.

COMMISSIONER STIVERS: They're going to follow their interests and they're not going to be persuaded by our kind of overall economic view.

MR. GREER: I generally agree with that.

COMMISSIONER STIVERS: Dr. Lovely, do you have any thoughts on that?

DR. LOVELY: I certainly agree that the U.S. should not defer or delay enforcement action. It's what it means to rule while we enforce the laws as well. I would take issue with a couple of things.

I think that China, and this is found in the recent USTR review, that they did make progress towards some of the promises, including on agriculture regulation, also on market access for financial services firms, and in removing JV requirements. There are very few that remain, but they have removed more.

So, I also think there's absolutely no sign of currency manipulation at the current time. Obviously, the dollar is strong against the Chinese RMB, but it's strong basically everywhere. And it's due to a whole bunch of things, including as we know, the tightening of monetary policy

in the United States. It's something that China is actually actively trying to prevent further fall of their currency.

So again, I think things kind of get put into a big bundle. Right now, we should not defer a delay for the sake just of conversation, but we need to be having conversations with the Chinese. We do now, as you know, there are working groups both through Commerce and Treasury. Those have I think in some sense provided an important avenue, particularly as the U.S. keeps rolling out more export controls, tightening export controls, putting more companies on the sanctions list. We're able to, at least at a minimum, explain to the Chinese why we're doing it and what we want from them. That's what I think is the most important thing for us to do.

COMMISSIONER STIVERS: Yeah, I'm a little less optimistic about the working groups, but I hear you.

Dr. Chor, you stated that tariffs on China, that minimal impact on employment and industries, even though the tariffs were justified to support and bolster U.S. manufacturing jobs. Right now, the U.S. is at historically low unemployment rates.

What I didn't see in your testimony and anyone else should comment here, is the impact on wages. Have you analyzed that? Have you read studies about how the tariffs on China have impacted wages in the United States?

DR. CHOR: That's a good question. Off the top of my head I don't recall particular studies that touch on those fronts yet. And I think it's very much an open question that we should be looking into.

COMMISSIONER STIVERS: Okay, anyone?

DR. LOVELY: I would say it's an incredibly hard problem. We have to realize that trade is a very small share of the U.S. economy, and that that China share, which has been diminishing, is also a small part. So, we're talking about influence on the U.S. economy that's relatively small compared to other things that are happening, such as fed policy, fiscal policy.

I think we do have an understanding that for a variety of reasons, including technological change and the emergence of China, we did see pockets of deindustrialization that caused enormous social distress and that the U.S. needs to be ready for that. Because even if China disappeared tomorrow, we know, we've heard, we're going to undergo enormous technological change. What are we going to do?

What about when everybody who works in a call center no longer has a job because it's going to be done by AI?

So, I think the lessons that we have are that we act ahead. We are, as we talked earlier about acting preemptively in industries where we feel that China is going for over-capacity, as we already know. EV imports from China are minuscule, yet we've taken action ahead of time. What are we doing in terms of labor market supports? This is something that I think has been struggled with, but we need to struggle with that more.

COMMISSIONER STIVERS: Thank you.

COMMISSIONER WESSEL: Thank you to all three witnesses. I think we are very benefitted from all your work over the years that you've been working, as well as the engagement with this Commission and with Congress.

I think we may have some questions for follow-up. We would also welcome any thoughts primarily from the two economists on whether what kind of lag are we seeing, if you will, because we had the pandemic, etc., at what point do you have confidence in the economic models in terms of the data and the disruptions, and at what point do you think-- if we should

have full confidence, fine, if there's a period of time which you think we still need to go through until there is constancy in the numbers so that the models provide more information. So would welcome that.

With that, we will adjourn for ten minutes and appreciate your participation.

(Whereupon, the above-entitled matter went off the record at 10:39 a.m. and resumed at 10:52 a.m.)

PANEL II INTRODUCTION BY COMMISSIONER LELAND R. MILLER

COMMISSIONER MILLER: Our next panel will evaluate the effectiveness of the Small Yard High Fence export control approach to maintaining the United States' technological lead and preventing China from acquiring sensitive technologies.

We will start with Mr. Kevin Wolf, partner in the international trade practice at the law firm Akin. Mr. Wolf will analyze the impact of unilateral versus plurilateral export control measures in the context of a broader scope of national security concerns.

Next, we will hear from Ms. Giovanna Cinelli, National Security Fellow at George Mason University's National Security Institute. Ms. Cinelli will consider practical applications of export controls including coordinating export control and sanctioned parties lists, and sharing of information.

Finally, we'll hear from Mr. Peter Harrell, non-resident scholar at the Carnegie Endowment for International Peace. Mr. Harrell will discuss how export controls fit within the broader foreign policy goals of the United States, and address how to formulate an integrated approach to protecting data flows.

Thank you all very much for your testimony. The Commission is looking forward to your remarks. I ask of all of our witnesses to please keep their remarks to seven minutes.

Mr. Wolf, we'll begin with you.

OPENING STATEMENT OF KEVIN WOLF, PARTNER, AKIN

MR. WOLF: Sure. Thank you, by the way, for asking me back to testify and thanks for all your good work. As always, these are my own comments. I'm not here on behalf of anyone else or a particular client.

In looking back at some of the testimony that I incorporate by reference for your review in response to the questions asked, there were some common themes that evolved. One, the force multiplying technologies that exist today, and the national security threats from China that were the case when the current export control system was created in the 1990s, are very different. And thus, the export control system needs to adapt accordingly.

A second theme is that to make those controls both effective, meaning that they actually stop the technology of concern going to China and other countries of concern, they need to be plurilateral. The other producer nations need to have similar controls so that they're also then not counterproductive, which means that the work that would otherwise have been done in the U.S. just simply moves to another country.

And given the nature of the need for controls to be plurilateral, there's sort of a core principle that if ever the justification is for a new regulation on the movement of hardware/software technology is solely for economic protectionist reasons, solely to advantage a U.S. company, it will always eventually do exactly the opposite because no ally is going to agree to impose a control on the same technology from its system in order to help a U.S. company.

Historically, the way in which that was addressed and the classical export control structure after the Cold War, which was focused on fairly specific and, in retrospect relatively narrow non-proliferation objectives, was for allies to come together in a series of one of four multilateral regimes, allies and partners. And the decisions about what should be controlled or not to accomplish that much more straightforward national security objective of the things that are necessary to produce or develop or operate weapons of mass destruction or conventional weapons, the list of items would adjust based upon consensus when all the members agreed.

For thirty or so years that system essentially worked, but Russia has largely started, for the last at least three years, blocking any progress given the consensus nature of that system. So, we need to start thinking differently about how we work with allies in order to make the controls more effective and less counterproductive. In addition, one of the comments I'd like to get into this Commission and otherwise, is that none of these regimes and no other regime has any sort of common-sense approach, or common approach about controlling items to achieve human rights objectives. That just simply doesn't exist. It's all generally voluntary and that needs to be a core factor of this.

I have a long set of recommendations, I'll go straight to them for the Commission's benefit. The first one is really to support any administration efforts to work with the allies to create a new vision or new way of thinking about export controls that goes beyond the sort of classical non-proliferation objectives to address contemporary national security issues, that goes outside the scopes of the existing constraints of the four regimes. That works outside the scopes of the existing regimes in addition to the regimes, which still have their value.

And there's another issue that the committee needs to take into account with respect to the impact of export controls, as referred to in other sessions about the impact of the various China data and security laws on the ability to get the information necessary in order to ensure compliance. With respect to the question about what -- is there a coherent strategy, an export control strategy in the Biden Administration, my view is that the coherence -- although there

were lots of ideas that have been tossed out in the last several years and lots of different directions, it wasn't really until about September-October of 2022 when a vision laid out by National Security Advisor Jake Sullivan and then implemented in October of 2022 by the Commerce Department, basically said the export control objective with respect to China, although the rules are insanely complicated and long, it really all boils down to four objectives.

To cut off from whatever source, either from the U.S. or from abroad, from U.S. person services whether listed or unlisted, whatever the inputs are for the development or production of one, advance note semiconductors in China, logic, NAND and DRAM, the compute side of what's needed for artificial intelligence applications, super computers, and then the inputs necessary to produce semiconductor manufacturing equipment, front-end semiconductor manufacturing equipment.

So, if you're looking at what the sort of per se national security objective is with respect to contemporary as opposed to traditional or classical export controls on China, it's really to accomplish those four objectives. And every change that's happened in the export control system on this topic since October has all been in furtherance of that objective and tweaking it to make it more effective and less counterproductive.

The reason for this is the decision made that these are the enabling technologies, the technologies to make the things to make the things to give China its military advantage. One of the things I have a whole section in here describing sort of the reaction I get when talking with the allies about these controls. And I travel a lot, I speak at a lot of conferences, and there isn't a lot of confidence in or belief in that these are truly national security objectives of the United States because they're so different and so strategic and so indirect from the actual development or production of an actual weapon.

So, my core theme is in order to make the U.S. controls and these very real, legitimate contemporary national security issues addressed by the controls is when you do a better job of working with our allies and convincing the allies that these are national security objectives and not economic protectionist objectives behind the controls. And that means not just using leverage or pressure, but really more importantly to convince the allies and work with the allies that these types of controls imposed on their systems are in their security interests as well. That's where a lot of work remains to be done, and I have a whole long list of recommendations to accomplish that.

So, I will stop there. I realize many of my objectives are naively optimistic, but my sort of core theme is all the other alternatives are worse: doing nothing, purely unilateral controls, leaving it up to the legacy regime system, will neither advance our national security interest or achieve effective and not counterproductive controls. Thank you.

COMMISSIONER MILLER: Thank you. Ms. Cinelli.

PREPARED STATEMENT OF KEVIN WOLF, PARTNER, AKIN

Testimony before the US-China Economic and Security Review Commission

Hearing on "Key Economic Strategies for Leveling the US-China Playing Field: Trade, Investment, and Technology"

Panel II: "Measures to Limit the Flow of Key Technologies to China"

Kevin Wolf

May 23, 2024

Thank you for asking me to testify again. I am happy to help the Commission with its work and mission however I can. Although I am now a partner in the international trade group at the Akin law firm and a non-resident Senior Fellow at Georgetown University's Center for Security and Emerging Technology, the views I express today are my own. I am not advocating for or against any potential changes to legislation or regulations on behalf of another. My views are influenced by my 31 years of work in the area, which includes my work as a compliance attorney, a Special Compliance Officer, and my service as the Assistant Secretary of Commerce for Export Administration during both terms of the Obama Administration.

I. Incorporation of Previous Testimony and Recommendations

My testimony today builds upon and updates the following other testimony and commentary relevant to your hearing, which I offer to the Commission for its consideration:

- A May 1, 2022 article describing why a new plurilateral export control regime is needed.

- 2023 commentary directed to audiences in Japan and South Korea about the need for the allies to give themselves the legal authorities and resources to enable plurilateral controls to address contemporary common security threats and human rights issues.

- May 11, 2023 testimony before a House Committee on Foreign Affairs subcommittee, which (i) describes the policy objectives for recent export controls; (ii) contains recommendations for how to make export controls more effective and less counterproductive; and (iii) calls for more resources for BIS.

- February 28, 2023 testimony before the Senate Banking Committee, which describes (i) lessons learned from FIRRMA regarding the need for allied outreach; (ii) the policy history of ECRA and the public debate about export control policy; (iii) how export controls are being used for strategic objectives; and (iv) recommendations for how to make export controls more effective and less counterproductive.

- September 8, 2021 testimony before the US-China Economic and Security Review Commission, which describes why a coherent statement of the contemporary national security objectives is needed to make effective export control policy (which has largely occurred since this testimony).

- A January 14, 2022 comment on US-EU control issues, which describes (i) the history of allied, US, and multilateral dual-use export controls; (ii) the scope of EU authorities to create unilateral controls; and (iii) recommendations for better EU-US export control coordination.

In re-reading what I have written before, the summary of my primary public advocacy for the greater good in the area is the following:

- The force multiplying technologies and the national security threats are materially different than they were when the current regime-based export control system was largely created in the 1990s to address primarily non-proliferation objectives. Thus, the national security objectives of export controls should expand accordingly.

- To make such new controls both more effective and not counterproductive, they need to be plurilateral, i.e., imposed by the producer nations in addition to the US. Although short-term and long-term unilateral (i.e., US only) controls are, of course, warranted in some cases, history and basic economics confirm that they eventually become ineffective and counterproductive (at different rates, depending on the technology) because they create a structural regulatory and economic incentive for US companies and their foreign competitors to develop the technologies outside the United States with non-US technology and content.

    - **This means that if ever the justification for a new control is solely to help US industry succeed economically, it will always eventually result in precisely the opposite outcome because no ally is going to agree to a plurilateral control just to help US industry.**

- For the new, non-classical China-specific strategic controls to have a chance at becoming plurilateral, the US needs to devote considerably more time, resources, and political capital to (i) convincing the allies that the new controls are critical to addressing *common security threats* (as opposed to US economic protectionist objectives); and (ii) listening and responding to legitimate allied concerns about the impact on their economies of their imposition of comparable controls.

    - **This means that if the allies are going to impose new types of controls in their systems, they must believe it is in their security interest to do so.**

- For any agreed-upon plurilateral controls to be effective and nimble, the US is going to need to work with the allies to substantially increase (i) their legal authorities to impose list-based, end-use, end-user, and service controls for items and activities outside the scopes of the mandates of the four primary export control regimes; (ii) their resources for their export control licensing, policy, technical, and enforcement agencies; and (iii) inter- and intra-governmental coordination on licensing, emerging technology policy analysis, and enforcement.

- The allies should together use export controls to address traditional and contemporary threats to common human rights objectives.

    - **Because most items used to commit human rights abuses, particularly with respect to mass surveillance, are widely available commercial items, the allies are going to need to agree to create end-use, end-user, and service controls in addition to traditional list-based controls on specific items to have an impact.**

II. Terminology

- The word "effective" in my comments refers to the topic of this panel, which is how to limit the flow to China of key technologies warranting control, from whatever source.

- The word "counterproductive" in my comments refers to the title of this hearing, which is how to make the regulatory playing field level for US industry.

- "Plurilateral" controls are those like-minded countries impose with some degree of coordination together outside or adjacent to the structure of the multilateral export control regimes.

- "Multilateral" controls, in this context, are those that are imposed because of consensus agreements within one of the four primary multilateral export control regimes.

- "Classical controls" is my term for controls imposed to address the non-proliferation-focused definition of national security objectives for export controls created in the 1990s. (These are still important controls, but not adequate to address additional contemporary national security issues created by Russian and Chinese state policies and the force-multiplying nature of emerging technologies.)

- "Unilateral" controls, in this context, are those only the United States imposes.

- "Extraterritorial" controls are those the US imposes over foreign-made items outside the United States because they contain US content or were produced from US technology or software, or with equipment that was produced with such

technology or software. The "de minimis" and the "foreign direct product" rules are the two ways the Export Administration Regulations (EAR) impose extraterritorial jurisdiction over such items.

- "US person" controls are those that are over activities of US companies or citizens when the underlying commodities, software, and technologies involved in the service are not subject to US controls. A "services" control is the same concept, except imposed by other countries over their companies and citizens.

- "List-based" controls are those against identified commodities, software, and technologies on a control list.

- "End-use" controls are those against exports, reexports, and transfers of unlisted items if for specific end uses.

- "End-user" controls are those against specific entities and generally apply to exports of otherwise unlisted or uncontrolled items.

III. General Comment About the Status of the Export Control Policy Discussion

Thirty-one years ago, I started working in export control compliance, enforcement, and policy issues, which was at the end of the Cold War-era's COCOM system. At the time, I worked for subject matter experts who had been working in the area since the middle of the Cold War. I have seen the long arc of the policy's evolution and past failures and successes. For most of that time, few serious policy thinkers focused on or even knew about export controls. I can, therefore, say with authority that the area is going through a policy transformation far more significant than was the case during the collapse of the COCOM system.

The public discussion is largely about what the national security and foreign policy objectives for export controls should and could be regarding exports to China and Chinese companies of commercial items that are enabling and emerging technologies given China's military-civil fusion policies and China's status as the pacing challenge for American and allied militaries. A related discussion is about which commercial items, end uses, and end users warrant controls to address contemporary human rights issues. There are many different views on the solutions to these issues by many people new and old to the area. This is terrific. With all the new attention to the topic by people with a wide range of backgrounds and expertise, the ultimate policy outcomes will likely result in outcomes for the greater good. So, I thank the Commission and others in the policy analysis community for spending so much time on what was once a highly esoteric topic.

After a summary of my recommendations for the Commission to make to Congress, I have structured my written remarks to respond to questions I understand the Commission members and staff have.

IV. Summary of My Recommendations for the Commission to Make to Congress.

My primary recommendations to the Commission for making to others to help make export controls more effective and less counterproductive, particularly with respect to issues involving China and Russia, are the following:

1. Support Administration efforts to work with the allies to develop and articulate together a significantly expanded vision for export controls to address contemporary common strategic security and human rights issues that are outside the scopes of the existing post-Cold-War-era multilateral export control regimes.

2. To ensure that such a vision can be implemented and updated in allied country domestic regulations and policies over the long term, support Administration efforts to create a new, additional multilateral export control regime to identify:

    a. items of classical non-proliferation and conventional military concerns that cannot be addressed by the existing regimes given Russia's membership (which gives it a veto);

    b. items outside the scopes of the existing regimes' mandates that warrant strategic trade controls, particularly with respect to China and Russia;

    c. items used to commit human rights[1] abuses anywhere in the world; and

[1] The Australia Group is the only regime that does not include either Russia or China. It has, as a result, been the only regime to be able to put forward in recent years material changes to controls, including the addition of controls over emerging technologies such as DNA software synthesizers and foundational technologies that impose emerging chemical-biological weapons threats, such as marine toxins, novichoks, and peptide synthesizers. Thus, it is an example of what can happen when only like-minded countries work together on contemporary export control issues. That said, the Australia Group does not have the mandate or authority to identify for participating state control biotechnology items that do not have a WMD-related nexus. Thus, for example, the Australia Group does not identify for participating state control biotech items used in human rights violations, such as DNA sequencers and related accessories and reagents. One of the mandates of the new regime I advocate would be to address such issues that cannot be addressed because of the organizational and subject matter limitations of the WMD- and conventional-weapons focused regimes.

d. unlisted items to, and activities in support of, end uses and end users of concern to enhance the effectiveness of such controls.

3. Support Administration efforts to work with the allies to create and announce in 2024 standards describing the legal authorities and resources necessary for an allied country's export control agencies to (i) control such items and activities; and (ii) effectively enforce such controls.

4. Once such standards are developed, even in draft, support Administration efforts to work with allied legislatures and executive branches to create for their export control agencies such authorities and resources to enable the quick and effective creation of plurilateral controls over items and activities to address contemporary common security and human rights issues.

5. Echo in a regular and bipartisan way that a new regime (even an ad hoc plurilateral regime of Wassenaar member states), the proposed new way of thinking about strategic export controls, and the creation of new legal authorities in allied countries are in the *common security* interests of the allies. To help overcome the current allied skepticism of these ideas, make it clear that the ideas are not part of a mercantilistic plan to advantage US companies to the economic detriment of allied country companies. To enhance this message, create incentives and benefits, such as significant reductions in unnecessary trade barriers and increased market access opportunities, for allied participants in a new regime and plurilateral strategic trade control arrangements.

6. Support Administration efforts to work with the allies and partners to create formal export control-focused and dramatically better-resourced data mining, investigation, and enforcement coordination efforts, with particular attention to global distributor and reseller networks. New rules without robust data analysis and enforcement are wildly less effective.

7. In addition to providing the Administration with all the resources necessary to implement these recommendations, fund and require the Administration to create within the departments of Commerce or State, or in the NSC, a senior position (e.g., a "Special Envoy"), with all the necessary expertise, staff, and resources, to devote their full time and attention to doing the hard, time-consuming work with the allies necessary to help the US export control agencies convert these recommendations into actual allied country regulations and policies.

8. Similar to what the Treasury Department is doing with respect to sanctions, and to better implement section 4811(3) of the Export Control Reform Act of 2018 (ECRA), Congress should fund the creation of a Commerce Department office focused on studying and regularly reporting to Congress on the effectiveness of old and new export controls, and

identifying those that are counterproductive for US industry and national security and foreign policy objectives. (It may surprise the Commission to learn that BIS does not have resources to evaluate properly the effectiveness of most of its controls.)

9. Require the creation and submission of a public report from the export control agencies on the impact of the following laws of China and their impact on (i) the US Government's ability to review diversion risks in export license applications, (ii) the reliability of audit and disclosure findings, and (iii) the ability of companies to comply generally with the export controls and sanctions: the National Intelligence Law, the rules on Counteracting Unjustified Extraterritorial Application of Foreign Legislation and other Measures, the Countering Foreign Sanctions Law, the Cyber Security Law, the Internet Security Supervision and Inspection by Public Security Bodies Law, the Data Security Law, the Counter-Espionage Law, and others described on pages 23 and 24 of the Defense Department's 2023 report on military and security developments involving China. The study should also address whether the State Department's travel warnings have an impact on the ability of companies to ensure compliance with export control regulations.

V. Highly Condensed and Simplified Chronology of the Evolution of the National Security Objectives of Export Controls

To set the stage for my commentary and recommendations, it is important to know the essence of how the national security policy objectives of dual-use export controls have evolved over the decades.[2]

Cold War -- Under COCOM, export controls had broad non-proliferation objectives as well as broad strategic objectives to contain the Soviet Union and its allies. Allies coordinated on individual licensing decisions.

Post-Cold War to Today -- Under the four multilateral regime system, the primary -- "classical" -- national security objective of export controls has been to, in essence, regulate:

(i) weapons of mass destruction (WMD) (nuclear, chemical/biological and missile-related items);

(ii) conventional military items (and items of importance to terrorists); and

[2] Apologies to all the subject matter experts and government officials who can easily identify dozens of other rules and developments along this timeline. This highly generalized chronology is solely for the purpose of setting up my points later, not to give a complete history of all rule changes and their nuances.

(iii) the bespoke and dual-use commodities, software, and technology that have some identifiable relationship to their development, production, or use.

"Catch-all" controls on services involving uncontrolled technologies were limited to those in support of the development, production, or use of WMD.

- Understanding the scope of these "classical" controls is important because the allied country export control laws and systems are largely based on, and limited to, them.

- This system was created in an era when it was easier to tell the difference between which items were of clear benefit to "civil" and, separately, "military" applications and end users.

- Within the "national discretion" concept, each regime member determines whether a license should be granted based on its own assessment of the diversion risk and its own national security considerations.

2017 to 2018 -- Bipartisan and public discussion of what became ECRA. ECRA codifies the authorities for classical export controls. It also requires an "ongoing" assessment and control of the "emerging and foundational technologies" that are "essential to national security" that are not within the scope of classical, regime-based export controls. Neither Congress nor the Administration defines what these terms mean, although many have opinions.

- This ECRA provision and the policy discussion were largely in response to China's (i) military-civil fusion policies to modernize its military capabilities; (ii) technology acquisition policies to strategically subsidize capabilities in critical economic sectors; and (iii) massive human rights abuses using such technologies.

2018 to Today -- Lively discussion within think tanks, the Administration, Congress, the Commission, the media, and industry about which additional technologies should be controlled for which reasons, and whether such controls would be effective and not counterproductive.

August 2020 -- The Bureau of Industry and Security (BIS) expands the extraterritorial application of the Export Administration Regulations (EAR) Foreign Direct Product rules to apply to otherwise uncontrolled foreign-made items produced with US technology or software, or equipment produced with US technology or software, if destined to or involving a Huawei-related company. The concept behind this jurisdictional change becomes the defining characteristic of all the significant follow-on China- and Russia-specific extraterritorial controls.

2021 to Today -- Consensus-based Wassenaar Arrangement starts to break down because Russia and others block progress in identifying new technologies for identification as dual-use items to be controlled.

February 2022 -- US, allies, and partners begin imposing export controls on commercial and industrial items outside the classical dual-use controls to achieve strategic objectives against Russia, namely, to cut off the flow from the US and its allies and partners of the items necessary for Russia's industrial base to continue to function given its relevance to supporting the continued invasion of Ukraine.

September 2022 -- National Security Advisor Jake Sullivan sets out the beginning of what becomes the coherent US national security strategy pertaining to export controls and China -- "Computing-related technologies, biotech, and clean tech are truly 'force multipliers' through the tech ecosystem. And leadership in each of these is a national security imperative." "[W]e have to revisit the longstanding premise of maintaining 'relative' advantages over competitors in certain key technologies. We previously maintained a 'sliding scale' approach that said we need to stay only a couple of generations ahead. That is not the strategic environment we are in today. Given the foundational nature of certain technologies, such as advanced logic and memory chips, we must maintain as large of a lead as possible."

October 2022 -- BIS publishes novel, unilateral, extraterritorial list-based, end-use, end-user, and US person services controls that are the essence of current export control policy against China, which is, to the extent possible, to stop the development and production in China of:

(i) advanced node semiconductors (logic, NAND, and DRAM at specific technology nodes);

(ii) semiconductor manufacturing equipment;

(iii) advanced computing items important to AI applications (e.g., GPUs); and

(iv) supercomputers.

Point: The Biden-Harris Administration determined that the existence of indigenous capabilities to develop and produce these items in China or by Chinese companies is a per se national security threat.

April 27, 2023 -- NSA Sullivan states that "Our export controls will remain narrowly focused on technology that could tilt the military balance. We are simply ensuring that U.S. and allied technology is not used against us. We are not cutting off trade [with China]."

Summary of 2023 -- The governments of Japan and the Netherlands separately impose plurilateral controls over specific semiconductor production equipment important to producing advanced node logic.

- Neither country, however, imposes any controls to track US controls over (i) support by their citizens or companies for advanced node production in China; (ii) end-use controls; or (iii) end-user controls. Thus, the regulatory playing for US industry is significantly unlevel as a result notwithstanding the policy and diplomatic significance of these first plurilateral controls that were not specific to Russia.

October 2023 -- After reviewing the impact of the October 2022 controls for a year, BIS updates them, with the biggest changes being to (i) substantially increase the types of GPUs and other integrated circuits subject to controls; (ii) imposing licensing obligations on shipments to Middle East and other countries of concern for diverting items to China; (iii) imposing controls on exports to any country worldwide if to a company headquartered in China or owned by a company that is; (iv) adding to the Entity List the Chinese companies involved in GPU development; and (v) imposing controls over the use of Chinese-origin GPU designs.

Spring 2024 -- Individual Wassenaar member states begin separately and unilaterally imposing controls on items related to semiconductor production, quantum computing, and additive manufacturing that would have likely been agreed to in earlier years by the Wassenaar Arrangement had it not been for vetoes by Russia and other member states. This is, therefore, the beginning of a new “Wassenaar Minus One [or More]” ad hoc plurilateral coalition, but still within the mandates of the Wassenaar Arrangement charter.

I would encourage you to read the March 2024 keynote speech of Under Secretary Estevez to see a clear summary of the evolution and status of the national security objectives of US export controls.

VI. Is there a coherent US export control policy against China?

Regardless of whether one likes the policy or thinks it is effective, US China-specific export control policy objectives have been relatively coherent and stable since the fall of 2022. To repeat the summary from above, the policy since then has been to use novel, unilateral, extraterritorial list-based, end-use, end-user, and US person service controls to stop or delay the development and production in China (or by Chinese companies) of:

- advanced node semiconductors (logic, NAND, and DRAM at specific technology nodes);

- front-end semiconductor manufacturing equipment;

- advanced computing items important to AI applications (e.g., GPUs); and

- supercomputers.

All the plurilateral efforts, tweaks, proposed legislation, and corrections to the regulations have been in furtherance of these four objectives.

These are the primary "force-multiplying" technologies referred in the Jake Sullivan speeches. Similar controls related to quantum computers are likely to be imposed soon based on the review of the UK and other controls recently imposed. Controls on biotechnology-related items are more uncertain.

Not only are the national security objectives for China-specific export controls relatively coherent, they are echoed in statements of the national security objectives for other adjacent regulations and proposals. For example, one of the more direct statements of the national security objectives and the reasons for the BIS's China-specific export controls is in the Treasury Department's preamble to its August 14, 2023 advanced notice of proposed rulemaking on outbound investment, where Treasury stated the following:

- "Certain advanced semiconductors and microelectronics, quantum information technologies, and artificial intelligence (AI) systems will underpin military innovations that improve the speed and accuracy of military decision-making, planning, and logistics; enable the compromise of encryption and other cybersecurity controls; and advance mass surveillance capabilities."

- "The potential military, intelligence, surveillance, and cyber-enabled applications of these technologies and products pose risks to U.S. national security particularly when developed by a country of concern such as the PRC in which the government seeks to (1) direct entities to obtain technologies to achieve national security objectives; and (2) compel entities to share or transfer these technologies to the government's military, intelligence, surveillance, and security apparatuses."

- "The PRC government explicitly seeks to advance these technologies and to ensure that new innovations simultaneously benefit its military and commercial aims. The PRC government is aggressively pursuing these objectives to confer a decisive advantage to its military, intelligence, surveillance, and cyber- enabled services. The PRC government is also encouraging a growing number of PRC entities to undertake military research and development, including weapons production, which exploit private investments in pursuit of this goal."

The Department of the Treasury, however, has not created regulations to impose sanctions (other than investment controls) against companies in China engaged in military-civil fusion or other activities contrary to US national security interests, such as providing support for the Russian military. This is important to keep in mind because of the inherent limits in trying to address the issues listed above only with the use of export

controls and the eventual new outbound investment screening tools.

VII. What is the reaction of the allies?

I am regularly asked to travel to allied countries to speak at conferences about export control compliance and policy. I participate or listen in to most of the other international export control conferences that are virtual. With the usual caveat about the hazards of sweeping generalizations, most attendees do not really understand why the US Government is imposing its new China-specific controls. Of course, my perspective is defined by the foreign government officials, think tanks, industry representatives, media, and academics who attend the conferences. I am confident US Government officials have much more direct conversations that they cannot report. Nonetheless, the inputs for my blunt observation are quite broad, deep, and consistent. Without understatement, knowing, respecting, and changing these attitudes will be critical to the success of US export control policy. Basically, most attendees do not see the national or common security justification of the controls. "What is the relationship between 128 layer NAND and a nuclear weapon?" "Semiconductor production equipment just make chips and have nothing to do with weapons." "GPUs are for games and datacenters." "North Korea is a threat. China is a market."

Implicit in the questions and comments I hear is the view that an item should only be subject to export controls if it has some identifiable, *direct* and immediately identifiable relationship to the development, production, or use of a weapon. There must be something inherent in the item that makes it usable for a weapon. This is what I refer to as a "classical" export control. Therefore, because all the new China-specific controls are over items and activities that are for civil applications, there is often an assumption that there must be some other motive behind the US Government's actions. There is some "plot," think tank commentators say. The US is imposing the controls as part of its industrial policy to give an economic advantage to specific US companies, most say. (As counsel to many US companies, I can confirm that this is decidedly not true.) The controls are being imposed as "leverage" as part of broader US-China geopolitical objectives, they comment. The controls are "purely political," others mumble.

I politely disagree. National security is the motive of the new controls. To be sure, it is a broader-than-classical view of national security, but national security is still the motive. Given the complex nature of the supply chains and technologies, whether the parameters in the controls are properly calibrated is a separate question. Industry and the US Government need to regularly work together to address inadvertent over- and under-controls. Indeed, I add, the controls are all in the *common security* interest of the US and the allied country I am visiting. It is in the national security interest of *that country's* military that the Chinese military does not have the skills and technical inputs necessary to give, for example, their fighter jets and electronic warfare systems the advantage over the allied country's fighter jets and electronic warfare systems. The difference, I say, is that the new controls are in direct response to two things – (i) China's overt policy of using the civil items at issue to modernize its military to give its

weapons and advantage over allied weapons; and (ii) the enabling or, in NSA Sullivan's words, "force-multiplying" nature of the emerging technologies at issue.

That is, instead of attempting to regulate everything, which would be impossible and counterproductive, the new regulations focus on the types of technologies that are critical to making the things of importance to a military advantage work. Instead, for example, of just regulating the radiation-hardened chip that is necessary for a missile to function (a "classical" control, in my parlance), the US is controlling the inputs for the indigenous development and production of the otherwise uncontrolled supercomputers needed to do the advanced designs to modernize the missile. Then, moving my arm to the left, I say, the regulations control the types of semiconductors that are critical to the computers needed for designing the missile. Then, moving my arm further left, the regulations are controlling the semiconductors that are needed to develop the AI-functionality the weapon will need to have quicker reaction times. Then, still moving my arm to the left, the regulations also control the equipment and the items needed to produce the equipment that are needed to produce the semiconductors that are needed for the AI and computer applications that are needed to improve the weapon. Then, in another arm movement to the left, I say they are then controlling the US person services that are needed to keep the tools running that are needed to produce the chip that is needed for the AI and computer applications that are needed to the do computer modeling to modernize the weapon. Furthermore, BIS is sanctioning the Chinese companies that support the development and production of chips that create the AI-related and computer applications that are needed to modernize the missile.

The difference, I say, is that the common security objectives look to the whole of the Chinese technology ecosystem that is needed for it to support the modernization of its weapons. The US is controlling the thing to make the thing to make the thing to make the thing that will give its military the advantage over ours. These are "strategic" country-specific controls targeted at the country that is the pacing adversary for the US and the allies. These strategic controls are in addition to the long-standing China-specific embargoes against anything, regardless of significance, that is in any way designed or modified for a military- or satellite-related item. These classical controls and embargoes, although critical, are no longer sufficient to achieve the broader national security concerns given China's policies.

Most usually say that they understand better the US motives after I go through my strategically-control-the-thing-to-make-the-thing-to-make-the thing routine. Others clearly understand, but quietly do not object because they see the US unilateral controls as giving advantages to their country's companies over their US company competitors. Others understand but say the policy will never work because no ally is going to buy into the same scope of China-specific controls given the size of the market.[3] Others say that the very public nature of the US policy objectives has just accelerated the rate of

[3] A fair point made during the conferences is that the US discussion of new controls is too focused on addressing China-specific issues. There are many additional issues that warrant more controls and policy discussion where the issue is not unique or specific to China, particularly with respect to human rights issues.

indigenous Chinese development of the same technologies US policy is designed to stop. My broader point is that, except for a small number of officials in close allies, most people overseas I meet do not buy into the policy need for the new US China-specific strategic controls.

VIII. Are the new US controls effective?

With the caveat that I am reporting anecdotes and impressions, my sense is that the plurilateral controls on specific types of items are going to be quite effective at delaying and disrupting the indigenous development and production of advanced node semiconductors in China. They, however, only really kicked in last year given the grace periods allowed to the allies. It will take some time for their full impacts to work their way through the systems. The controls over items directly affected by the various extraterritorial foreign direct product rules are also quite effective at delaying and disrupting the production of items dependent upon semiconductors given that all semiconductors on the planet are made, in part, with the use of equipment that is the direct product of covered US technology or software.[4]

The US controls outside the plurilateral controls that are end-use, end-user, or US person service controls have indeed been disruptive and will be effective for a while, but are quickly becoming ineffective. This is so for a very simple reason that does not require any economic data or evidence to consider. No other country has agreed to impose any of these types of controls. To be more specific:

- No other country has imposed controls over the export from their country of unlisted items if in support of the development or production of advanced node semiconductors, supercomputers, or semiconductor production equipment in China. (The US controls are in EAR section 744.23.)

- No other country has imposed controls on the export from their country over items when an entity on the Entity List would be a party to the transaction. (The entities on the Entity List are in Supp. No. 4 to Part 744.)

- No other country is prohibiting its companies and citizens from providing services in support of the development or production in China of advanced node semiconductors, supercomputers, or semiconductor manufacturing equipment. (The US controls are in EAR section 744.6(c)(2)). Moreover, no other country is willing to do what the US has done, which is to connect such services to activities that ultimately benefit the development of China's WMD development programs.

[4] Indeed, for the sake of radically simplifying compliance, leveling the playing field for US and allied industries, and making enforcement easier, particularly with respect to diversions to Russia, an idea to discuss is whether BIS should simply declare all items containing a semiconductor that are destined to one of the prohibited end uses, end users, or destinations in the now 10 (!) foreign direct product rules are presumptively subject to the EAR rather than the current approach requiring evidence of knowledge.

These differences in the scopes of control between the allies and the US are serious and threaten over time to undermine all the good work the US Government has done at developing a coherent common security and export control policy.

Also, when thinking about effectiveness, one must think about effectiveness over different periods. Given the dominance of US industry in the sectors at issue, unilateral controls are almost always effective in the short term. Even for foreign-made items against which an extraterritorial zero de minimis rule or a foreign direct product rule applies, effectiveness over the medium and long term, however, is fleeting because foreign manufacturers can eventually design out US-origin content and stop using US software and tools so as not to jurisdictionally taint their foreign-produced products. Again, this is why plurilateral controls imposed by the producer nations are ultimately critical to the success of the US policy objectives.

Finally, the complexity of the new regulations runs the risk of reducing their effectiveness. The latest rules are among the most complex and novel export control regulations ever published. I realize the rules need to be more complex so that they are tailored and address more complicated technology and supply chain issues. Nonetheless, the funds for BIS's exporter services outreach and training functions have not been increased to match the need. For the rules to be understood, complied with, and enforced, their details need to be easily known and understood by muggles.

IX. What do we need to do to convince the allies that a new way of thinking about the scope of export controls is in our common interests?

I am not in the government, so I do not know what is being said how often to whom. I do not know what evidence or advocacy is being provided. There is, however, clearly considerable progress in developing some ad hoc plurilateral controls in addition to those against Russia. In 2023, the Dutch and Japanese governments each separately imposed plurilateral controls on equipment specific to the production of advanced node semiconductors. As a result of the October 2023 EAR amendments, the US tool-specific list-based controls mostly aligned with the Dutch and Japanese controls. In March 2024, the UK, France, and Spain separately imposed unilateral controls on various types of items pertaining to quantum computing, semiconductor production, and additive manufacturing. As explained in its White Paper on export controls, the European Commission has emphasized the need for greater coordination at the EU level of national control lists, as well as introducing uniform controls on items not adopted by the Wassenaar Arrangement as a result of Russia and other countries blocking progress on votes. Last month, Japan imposed similar unilateral, now plurilateral, controls. I assume the United States and other allies will publish similar implementing controls soon.

These separate, unilateral actions are informally referred to as being part of the "Wassenaar Minus One" approach. That is, if like-minded Wassenaar member states informally agree during the Experts Group meetings that such controls are warranted and would have been agreed to in previous years but for Russia (and perhaps other

countries), then the like-minded countries are agreeing to create plurilateral controls one by one. That like-minded allies have agreed to begin finding or creating the unilateral authorities to impose controls outside the scope of the traditional regime controls should be considered a victory for BIS and the greater good. It is not a tidy new export control regime with a catchy title and a round table, but it is an ad hoc plurilateral arrangement that flows from an existing regime, which also probably is easier from a legal, policy, and optics perspective for most allies to implement.

Although the ad hoc plurilateral controls do not exactly line up across each country (which creates significant compliance complexity), they basically impose new controls against some or all the following items:

- Additive manufacturing equipment that can produce metal components, and related software and technology;
- technology for coating systems;
- integrated circuits that can be used for machine learning of AI systems;
- quantum processors based on superconducting arrays;
- cryogenic cooling systems and related items;
- a variety of additional types of equipment used to produce advanced node semiconductors, and related software and technology;
- scanning electron microscopes for use with semiconductor imaging;
- cryogenic wafer probing equipment used in quantum computer development;
- materials that are used in the production of semiconductors important to quantum computers;
- software designed to extract semiconductor design data;
- technology to develop or produce advanced node semiconductors generally; and
- quantum computers, components, and related software and technology.

Although excellent progress, an even more extraordinary amount of work is going to be needed to continue the harmonization with other allies and addressing additional items that warrant control in this ad hoc way. The export-control-focused staff at BIS and the other export control agencies is not much larger than it was when I was there, but their missions are dramatically larger. The technology and supply chain issues are also significantly more complicated. You will have to speak to a government witness about what additional resources are needed to even have a chance at future success. Based

on a review of BIS's Fiscal Year 2025 budget request, however, it is clear that a massive increase in resources is needed to do the work necessary to make the new controls more effective and less counterproductive.

In addition to what BIS and the other export control agencies have asked for, my view is that the administration also needs an export control-focused ambassador-at-large or a special envoy who reports to the White House, but who coordinates closely with the departments of Commerce, State, Defense, other relevant agencies, and the Intelligence Community. The sole job of this person would be to work with the allies on all the issues pertaining to making plurilateral controls real, effective, and not counterproductive. Of course, BIS and ISN are ultimately responsible and I am not suggesting a change in their positions of authority. My sense, however, is that the job of going country to country to country to country and back again to hear the concerns of each of the allies, to regularly explain in detail the common security justifications for each of the new controls, and to work through ideas for harmonized controls and enforcement is a full-time job. Because the success of all the new export controls (and a level regulatory playing field for US industry) depends upon the allies agreeing that the controls are in their national security interests, too, plurilateral engagement should be the highest export control priority for the Administration at levels and at a pace beyond the already high current levels and pace.

Ideas for what the mission of this new position could include are:

- Working with all the relevant agencies in the governments of countries that are allies or partners to encourage and facilitate their creation of the additional authorities and resources they need to implement and enforce controls on the export, reexport, or in-country transfer of items, and the provision of specific services, that could pose risks to the national security and foreign policy interests of the United States *and those countries*. Such work should include encouraging such countries to implement legal authorities that would allow for their regulation of exports, reexports, and transfers in-country of:

    - specific items that are outside the scopes of the existing multilateral regimes;

    - listed and unlisted items for specific end uses, such as conventional military end uses, that are in addition current "catch-all" controls that are specific to weapons of mass destruction; and

    - listed and unlisted items involving specific end users of concern to common security and human rights interests.

- Working with such governments to encourage and facilitate their creation of authorities beyond those specific to classical non-proliferation objectives that would allow for the regulation of specific activities of their citizens and companies outside their countries if such regulations would be in furtherance of additional

common security and human rights objectives.

- Providing technical assistance to create such authorities and resources. Such efforts should include a public and regularly updated description of the scopes, and differences in scopes, of United States, allied, and partner countries export control authorities and policies to help with compliance efforts by multinational exporters.

- Communicating the risks and vulnerabilities associated with the export, reexport, and in-country transfer of items, and the provision of specific services, that are contrary to national security and foreign policy interests shared among the allies and partners.

- Working with these countries to establish complementary export licensing policies on specific types of items for specific end uses, end users, and destinations.

- Sharing information with the governments of the countries regarding the administration and enforcement of export control policies and procedures.

- Identifying and explaining critical items that are priorities for addressing the national security, economic security, and foreign policy threats to the United States of China's military modernization and human rights abuses, including mass surveillance.

- Regularly providing descriptions and assessments to Congress and the Administration of:

    - the legal, regulatory, and policy areas of potential alignment and gaps or impediments of the relevant allies and partners in any efforts to coordinate, jointly implement, and unify export controls and licensing policies for critical items;

    - the actions necessary to achieve a unified approach to export controls into broader foreign policies and common security objectives with the relevant allies and partners, including through incentives and disincentives; and

    - the increase in resources, authorities, and political commitments needed for the allies to develop comparable export control licensing, policy, and enforcement systems to those of the United States.

- With the support of the relevant US Government agencies, continue to inform the allies and partners about, and develop a common understanding of, the reasons why the new controls are in the common national security interest of all the countries, particularly with respect to the impact of China's:

    - military-civil fusion policies and entities contributing to that effort;
    - human rights abuses using commercial technologies; and
    - national security laws and regulations.

- Assist in the development of new sanctions authorities to use against Chinese companies engaging in activities contrary to common security interests when export controls would not be an effective tool or using them would be counterproductive.

US embassies in the countries at issue, of course, would be critical to providing support to the new special envoy, but could not replace the work of the position in mind. The position needs to have unique subject matter expertise and the ability to distil and provide cross-cutting recommendations to the Administration regarding the issues and options of all the allies and partners.

X. What can the US do to support allies that agree to new, non-classical plurilateral controls?

My core theme is that allies should want to agree to impose new controls for more than just classical non-proliferation reasons because they believe the controls, if plurilateral, are in their national security and foreign policy interests. The plurilateral controls that are needed cannot be developed solely as a result diplomatic leverage and arm-twisting. As mentioned above, getting this done will require massive amounts of time, resources, listening, advocacy, and evidence. It will also require more engagement with the national security establishments and militaries of the allies in addition to their commercial and foreign ministries to break through the usual government policy silos. The US is somewhat rare among allies in having its department of defense directly involved in export control policymaking. Getting allied militaries more involved in the process is necessary to ensure that the discussion of the issues is not left only those responsible for trade policy given that these are common *security* issues.

Nonetheless, for allied country domestic political reasons and to otherwise help take the economic sting out of such new controls, the US government could consider creating a suite of "economic security" options that could be offered in support of the countries that adopt plurilateral controls over items for more than classical non-proliferation reasons. We should all be sympathetic to the point that the allies are much more exposed to the impact of formal and informal retaliation by China than the US is. Think of this topic as the sweetener to the vinegar that is export controls. Please also appreciate that this section is the least developed idea in my testimony. Indeed, most of these ideas are probably bad ideas for other reasons. By raising this topic, however, I am trying to start a larger discussion of this "economic security sweetener" idea with people more expert in these areas than I am. None of the ideas is mutually exclusive.

Idea 1: Create AUKUS-like export control arrangements with other very close allies.

Congress and the Administration deserve great credit for moving the AUKUS changes through legislation and the export control rules. These changes are the logical and policy extension of the Obama Administration's Export Control Reform efforts, which were themselves the logical extension of the Bush Administration's defense trade treaty efforts. AUKUS though is part of a wider US Government effort to coordinate and strengthen the defense relationship between and among Australia and the UK to support defense and technological ties in the Indo-Pacific through reductions in regulatory burdens for the transfer of defense articles and other sensitive technologies. Pillar II of the effort focuses on partner collaboration efforts on advanced capabilities related, among things, to underseas capabilities, quantum technologies, artificial intelligence, advanced cyber, hypersonic, and counter-hypersonic capabilities, electronic warfare, innovation, and information sharing. The US, Australia, and the UK created AUKUS to respond to China's broader military aspirations in the Indo-Pacific region and to respond to President Xi's stated desire to re-unify Taiwan with the mainland. As described in more detail elsewhere, the US has removed most dual-use controls involving Australia and the UK and is working on substantial defense trade reform. In exchange, Australia and the UK are changing their export control systems to make them comparable to those of the United States.

If other close allies were to agree to the whole suite of new plurilateral controls, an option could be that they could become candidates for AUKUS-like Pillar II treatment if they could meet the same conditions as Australia and the UK are expected to meet. In particular, the candidate country would need to demonstrate that it has created comparable export control licensing, policy, and enforcement resources and systems to those of the United States. Thus, an export from that country would be essentially treated and enforced the same way as if it were exported from the United States.

Idea 2: Create dual-use and defense trade license exceptions short of AUKUS-like treatment.

BIS has already asked for comments on how to liberalize controls for allies and partners with respect to License Exception STA. BIS should continue such work. The State Department's DDTC should consider whether there are comparable options for the ITAR, statutory authority permitting.

Idea 3: Require licenses even for allies until and unless they adopt in their own systems the same plurilateral controls.

As noted above, the governments of the UK, France, Spain, Japan, and the Netherlands have each individually announced different types of controls that result in ad hoc plurilateral controls. I assume the US and other allies will be doing so soon. To create incentives for more allies to adopt these and other plurilateral controls, the US and the countries that have acted could continue to require licenses for such items even

to other close allies until and unless the other ally agrees to adopt the same controls in its export control system.

Idea 4: Create novel Validated End User (VEU) authorizations for companies in participating countries.

The Bush Administration created the Validated End User program that allows for exports without individual licenses to specific end users that satisfy various conditions. BIS could create more validated end users for companies in countries that agree to impose plurilateral controls and otherwise enhance the licensing and enforcement systems. Such VEU authorizations allow for the reduction in burden on exports to the authorized companies. That is, they could receive controlled items without having to wait for their vendors and suppliers to apply for and receive individual licenses.

Idea 5: Expand the G-7 membership.

For like-minded countries that agree to impose new plurilateral controls and otherwise ensure that their export control licensing and enforcement systems are robust, another idea would be to move them to the front of the line for G-7 membership consideration. I would expect that South Korea, Australia, and the Netherlands would be interested in this idea.

Idea 6: Create expanded and bilateral critical minerals agreements with allies to adopt plurilateral controls.

Similar to what was agreed to with Japan last year, the US could enter into bilateral agreements to commit to guarantees on access to unprocessed critical minerals and access to expanded processing capacity. This could also include agreements on stockpiling of key minerals that might be the subject of retaliatory controls imposed by China.

Idea 7: Regardless of MFN obligations, reduce tariff and non-tariff barriers in the same or similar sectors at issue in the agreed-upon plurilateral controls.

I am not advocating for general free trade agreements. Nonetheless, to the extent possible (and to the extent they exist), tariffs on items at issue in any new plurilateral controls could be removed for imports into the US from countries that impose them. The Countering Economic Coercion Act could be a model for providing preferential tariffs. One could use the same economic incentives in the act, but tied to whether a country has agreed to impose complementary export controls in addition to being subject to economic coercion.

Idea 8: Improve access to US Government federal grant opportunities.

2 CFR § 200 creates uniform administrative requirements and principles for

discretionary federal grant awards totaling more than a trillion dollars each year. These regulations require grant recipients to use these federal funds "to the greatest extent practicable . . . for the purchase, acquisition, or use of goods, products, or materials produced in the United States (including but not limited to iron, aluminum, steel, cement, and other manufactured products)." Another idea to discuss would be for Congress to require federal agencies to modify this requirement to allow federal grant recipients to use federal funds to purchase products manufactured in countries that impose new plurilateral controls in addition to products manufactured in the United States. This expansion of potential companies from the participating countries that could provide products and services to federal grant recipients would enhance competition resulting in lower prices to the US Government award recipients, making each federal grant dollar go further.

Idea 9: Create opportunities for participating countries to receive the benefit of federal subsidies, such as the Inflation Reduction Act.

The Inflation Reduction Act (IRA) has gained the attention of companies around the world that are planning billions of dollars of investments into the US EV supply chain. The recent final rules issued by the Department of Energy and the Internal Revenue Service provide clarity on certain key provisions. There, however, remain concerns about the fate of the IRA, especially considering recent bills seeking to further restrict eligibility for the tax credits. One idea could be that Congress would not restrict access to these tax benefits by companies from countries that participate in new plurilateral export controls. Congress could, for example, direct the USTR to negotiate with participating countries to provide waivers or other preferential terms for the companies from these countries to participate in the IRA-compliant EV supply chain, and ensure that any efforts to exclude China from the supply chain do not inadvertently harm companies in countries that would participate in new plurilateral export controls.

Idea 10: Amend the Buy America Act to permit more participation in federal procurement by countries that agree to plurilateral controls.

The Buy America Act requires federal agencies to procure domestic materials and products if the purchases would be for use in the US and the items are available from the US. Another idea would be to lower the current price preference of 50% at the Department of Defense and 20% at civilian agencies for products from participating countries. A lower price preference would result in more direct contract awards for products manufactured in participating countries. Congress could also expand the use of current reciprocal defense agreements to civilian agencies, allowing products manufactured in participating countries to count as domestic end products for the purpose of calculating the cost of components.

Idea 11: Amend the Jones Act to permit limited activities of participating countries in, for example, domestic river activities.

I am not advocating any significant changes to the Jones Act, but rather just for opening a discussion of a limited carve-out in limited situations for close allies that would agree to new plurilateral controls.

Idea 12: Ease US visa requirements and accessibility of US job market for foreign talent from countries that agree to plurilateral controls.

The Immigration and National Act (INA) limits the number of H-1B visas to 85,000 and the number of employment-based green cards to 140,000 per year for nationals all countries combined. The act could be amended to increase these numbers and create set-asides for nationals from the countries that agree to new plurilateral controls. A related topic could be that deemed export controls for nationals of participating countries would be removed.

Idea 13: Ease the standards for becoming a CFIUS-excepted foreign state.

Designation as an excepted foreign state has two steps. The first is that CFIUS must determine that a country is eligible. Beyond being a Five Eyes member, the criteria for being deemed "eligible" by CFIUS for such designation are opaque, if not simply unknown. Second, the state must meet criteria related to the robustness of its foreign investment review process as set out in CFIUS's regulations. The eligibility criteria for the first step could be relaxed and imposition of new plurilateral controls could be an explicit and significant consideration, which would not preclude CFIUS's ability to determine whether an eligible state's foreign investment review process is sufficiently robust to justify it becoming an "excepted foreign state" under the regulations. In other words, a country could get the benefit of being publicly designated as "eligible" without putting pressure on CFIUS to immediately determine that country has met the criteria under the second step.

Idea 14: Enter into scientific and technology cooperation agreements with participating countries similar to the one with the EU.

A related idea to discuss would be for participating countries to receive priority treatment in education or workforce development agreements. The US-Japan Memorandum of Cooperation in Education signed in May 2023 provides a useful template for how such agreements could be structured. The Memorandum both initiated a new high-level dialogue on education between the two countries. It also, critically, mobilized private investment from firms in both countries to finance quantum computing research and a new workforce development program, known as the "UPWARDS Network." UPWARDS brings together leading US and Japanese semiconductor firms as well as universities from both countries to expand the pipeline for semiconductor talent -- responding to forecasted workforce shortages as countries around the world invest in new semiconductor fabrication capacity. Countries that adopt

new plurilateral export controls could be given priority for future agreements of this type.

Idea 15: Allow participating countries to receive Defense Production Act funding.

The Defense Production Act treats Canadian entities as domestic sources for the purpose of receiving industrial base grants and loans under Title III. An idea to discuss would be whether to amend the statute to give "domestic source" status to countries that impose new plurilateral controls. Doing so would streamline technological and industrial base collaboration as well. Another idea could be to open to participating countries DPA and Industrial Base Analysis and Sustainment funding for those that provide ideas for research or prototype project solutions to benefit the industrial base.

Idea 16: Expand access to the National Technology and Industrial Base program.

The NTIB includes those in engaged in national security and dual-use research in the Five Eyes countries. An idea could be to expand the scope to those countries that adopt comprehensive plurilateral controls and meet the other requirements of the NTIB.

XI. Are the controls counterproductive? In particular, are American jobs being lost as a result of the unilateral controls without any gain to the national security objectives?

Although there is some public reporting on job losses as a result of unilateral US controls, I have limited data on the issue that I can share. My impression, however, of the unilateral controls where the US de minimis and foreign direct product rules cannot have a practical impact is that they already are being counterproductive. By counterproductive, I mean that the unilateral controls are creating economic opportunities for foreign competitors of US companies not subject to same controls (or complying with existing extraterritorial controls) that result in direct job losses for the US companies. As the unilateral controls continue and grow, then this economic advantage to the foreign competitors will continue to grow as well. Because such internal data are generally proprietary, however, I would ask that the Commission think of ways of getting this information directly from US industry in a FOIA-exempt or other setting that could protect business confidential information.

The real issue in this question is that the US Government does not know the answer. In the past, I have advocated that Congress fund the creation of a Commerce Department office focused on studying and regularly reporting to Congress on the effectiveness of old and new export controls, and identifying those that are counterproductive for US industry and national security and foreign policy objectives. It may surprise the Commission to learn that BIS does not have sufficient resources to evaluate properly the effectiveness of most of its controls. Such an office would be similar to what the Treasury Department is doing with respect to sanctions, and to better implement ECRA

section 4811(3). The mandate for such an office could include:

- Developing economic analyses that inform the design and implementation of export control policy and provides for the assessment of potential collateral effects of proposed controls.

- Conducting research and analysis on critical items and industrial sectors and assessing the availability of comparable or substitutable such items and capabilities of such sectors in foreign countries.

- Analyzing the long-term economic implications of existing export controls and evaluating their effectiveness in carrying out the policy of ECRA section 4811(3).

- Assessing whether existing controls and potential new controls are effective in stopping or controlling the item at issue from being provided, whether from the United States or other countries, to the destination, end use, or end user of concern.

- Regularly reporting the results to Congress.

XII. When should unilateral controls be used?

For many years, I have been advocating for more work to be done to implement plurilateral controls when the multilateral regime system fails or is too slow. I disagree with the view that advocacy for plurilateral controls is just an excuse not to act. It is opposite. As Congress noted in ECRA in its opening statement of US policy, as history has shown, and as basic economic incentives prove, unilateral controls are eventually generally ineffective and plurilateral/multilateral controls are generally more effective and less counterproductive. There are, however, times when unilateral controls are warranted. For example, the US should not wait for the creation of a human rights-focused export control regime to impose controls and licensing policies on instruments of torture, mass surveillance items, weapons, and other items used in human rights abuses. Of course, we should work with the allies to adopt similar controls, but there is a moral imperative to act out of principle, even if less effective.

Another reason to impose unilateral controls is if there is a particular technology where the US has a unique advantage and controlling it is necessary for national security reasons. There are many such technologies that have been identified by the departments of Commerce, Defense, and State over the years. Unilateral controls are, of course, warranted in situations where the control is needed to prevent harm to the warfighter or others. In addition, ECRA authorizes the imposition of unilateral controls on emerging and foundational technologies. ECRA, however, also requires that they become multilateral within three years unless there is a good reason to maintain the unilateral control. Thus, if there is an urgent need to publish such controls unilaterally, Administration officials should expect that the odds are good that the relevant allies are

going to adopt comparable controls soon thereafter. Finally, an entirely separate hearing is warranted just on the history, use, and effectiveness of the BIS's primary unilateral end-user tool, which is the Entity List. Given the wide variety of companies on the list and reasons for their being listed, I cannot give a short answer on the topic. The answer depends upon an almost company-by-company analysis and discussion.

XIII. What is BIS's licensing policy and process?

BIS does not have the authority to issue licenses without cooperation of the other export control agencies at the departments of Defense, State, and Energy. That is, BIS administers an interagency licensing process consistent with the requirements and standards in the Export Administration Regulations. It is indeed the case that in a small percentage of the total cases the first layer of staff at each of the agencies disagree, sometimes strongly, on whether types of licenses should be granted. When there is disagreement among the agencies, the regulations authorize an agency to escalate the decision to more senior career staff for review at the Operating Committee. Its purpose is to resolve the interagency disagreements based on a better understanding of the facts at issue, and regulatory standards in the EAR and precedent for when a license should be denied, granted, or conditioned. The escalation process is also important to have in those situations when agency staff do not, for whatever reason, abide by the regulatory standards or the agreed-upon administration policy.

If an agency does not agree with the determination of the Operating Committee Chair, then it has the authority to escalate the case to the Advisory Committee on Export Policy (ACEP), which consists of Assistant Secretary-level (or designees) from the departments of Commerce, State, Energy, and Defense. Each agency has one vote. Even still, an agency has the authority to escalate any licensing decision of the ACEP to a cabinet-level Export Administration Review Board (EARB). Appeals to the EARB are rare. Thus, it is correct to say that all licenses BIS has issued were agreed to, or not escalated, by the departments of Defense, Energy, and State. (EARB decisions can be appealed to the President, but that has not happened for decades, I suspect.)

To put this process and the numbers in context, according to the 2021 annual report, in FY 2021, BIS processed 41,446 licenses. 568 of those applications were escalated to the Operating Committee for review. 80 of those cases were escalated to the ACEP for resolution. Although the data are not public on the process thereafter, I would suspect that only a very small fraction were resolved at the ACEP with interagency difficulty. When I chaired the ACEP from 2010 to 2017, almost all decisions on licenses (to approve or to deny) were unanimous.

In any event, it is healthy for there to be disagreements among the agencies, each of which is staffed with people with diverse backgrounds, expertise, and equities. The interagency review ultimately results in a better understanding of the facts, regulations, and concerns so that final decisions can be consistent with Administration policy, the law, and, of course, national security and foreign policy objectives. Under the current

system set up in the 1990s, if any one agency ever were to be inappropriately influenced by outside pressure, the checks and balances of the other agencies' involvement would prevent any applicable license from being issued. This is yet another reason why the process would be harmed if any one agency had a veto or the authority to issue a license over the objections of the other agencies. It is also vital to ensuring consistency with the law and each administration's policy that there be a process to ensure that senior and political officials within each agency have an opportunity to ultimately decide any and every application.

Also, the EAR contain many different licensing policies for different types of exports. Some policies require denial. Some require case-by-case consideration. Some state that applications are presumptively approved. Some state that applications will be presumptively denied. The EAR's licensing policies contain many other variations depending upon the item, the destination, the end use, and the end user. There are no regulatory definitions of the different standards. In my view, however, a policy of presumptive approval should mean that the license should be approved unless there is negative information to suggest a possible diversion to prohibited end use, end user, or destination. A policy of presumptive denial means that the license will be denied unless the applicant and supporting agencies can demonstrate with confidence that the end use and end user of the item will be acceptable. In a presumptive approval policy, it is up to the government to explain why a license should be denied. In a presumptive denial situation, the burden is on the applicant and the supporting agencies to convince all the agencies of the reasons it should be approved.

These comments show that decisions about whether to approve or deny a license are based on regulatory standards that govern BIS's and the other agency's decisions. If someone does not like that BIS issues, after the interagency review, any particular license, then the attack should not generally be on the bureau's (and its interagency colleagues') individual decision (assuming there was a correct and complete understanding of the facts). Rather, attention should be paid to the licensing policy in the regulations describing which exports to which destinations, end uses, and end users should or should not be approved. If the policy does not properly address a current national security or foreign policy issue, then the applicable licensing policy in the regulations should be changed in a transparent way. Attention should also be daily be given to whether each of the agencies are properly applying the agreed-upon licensing policies.

In addition, license approval percentages will always be high because companies generally do not apply for licenses they suspect will be denied. That is, exporters do not usually apply for licenses they know or suspect will be denied based on a review of the licensing policies in the regulations or statements from BIS. (For business and contractual reasons, exporters will occasionally apply for a license knowing it will be denied so that they are able to demonstrate to the counterparty why it could not perform under a contract.) They generally make such decisions to avoid the cost and burden of preparing applications that are not likely to be granted. This means that the numerator in any approval statistic will be based on applications where the exporter generally

believed that the license would likely be approved based on the licensing policies in the regulations. For example, applicants rarely, if ever, apply for licenses to export to China items that are military-related, satellite-related, would involve a known human-rights abuse, or are for a military end use. Such applications will be denied under long-standing licensing policies and are thus not included in any numerator. This result is not unique to BIS. DDTC has a high approval rate for licenses it issues authorizing the export of defense articles for the same reason. My sense is that when the approval percentages get below 90% (and return without action (RWA) rates increase), then this means that the US government is taking a more restrictive licensing policy than the one described in the regulations.

Another comment I often hear is that the issuance of a license is a "waiver" of controls. This is not correct. The issuance of a license is, to the contrary, evidence that the export is *consistent* with US policy, not an exception to it. The regulations requiring the submission of a license are always, by definition, *broader* than the actual denial policy for the items, end users, and end uses at issue. Otherwise, there would be no need for a licensing regime at all. The government wants to see the proposed export before it happens to assess whether there is a risk of diversion based on judgments and information that would not be available to the exporter. For those situations when there is a complete prohibition on exporting something to a particular end use, end user, or destination, then that is what an embargo or comprehensive economic sanction is for. But for unusual situations involving health, safety, or government interests, there is no need for a licensing regime in such cases.

My main point is that if one does not like a particular license policy, then the focus should be on the standard in the regulations for when such licenses should be issued or denied. That is, of course, fair game for a policy discussion. But the issuance of an individual license is not evidence of a "waiver" from or an exception to a prohibition against exports. To get a license, a company must apply to the government for a license explaining why approval would be consistent with the regulations and Administration policy. The application must describe the items, end uses, end users, destinations, and other facts involved. A license application, and a lawyer's providing advice about how to prepare one, is thus evidence of compliance, not evasion. Indeed, BIS trains people how to submit such applications as part of its formal compliance outreach and education efforts. In addition, BIS trains exporters on (and has online decision trees to explain) which activities are and are not subject to the regulations. Indeed, the regulations themselves contain decisions trees describing when an item is and is not subject to controls. Thus, providing advice on which items and activities are and are not subject to the regulations is also not evidence of evasion. It is literally evidence of compliance with the law (described on the BIS website!) and, thus, US government policy. If a policymaker does not like the answer about whether an item is subject to the EAR, then the policymaker should work to change the law and the regulations. The policymaker should also not criticize the exporter for complying with regulations the government has written.

XIV. How should the US go about regulating and controlling emerging technologies and their related exports, particularly when the potential military applications are not yet evident?

A fair criticism of legacy export control identification and control efforts is that they were mostly focused on identifying and regulating the inputs into established technologies of national security concern, primarily weapons that exist or that were in development. There was not as much of a focus as there should have been at studying the potential evolution of emerging technologies and what threats to national security they could present in the future. This is why I and many others advocated for ECRA and its emerging and technologies provision. The standard in this ECRA provision, Section 1758, for controlling emerging and foundational technologies not otherwise controlled in the regime process is when they are "essential to the national security of the United States." 50 USC § 4817(a)(1)(A). That's the entire standard. Congress did not define the terms. Before imposing any such new controls, ECRA requires the decisionmakers to "take into account (i) the development of emerging and foreign technologies in foreign countries; (ii) the effect export controls . . . may have on the development of such technologies in the United States; and (iii) the effectiveness of export controls . . . on limiting the proliferation of emerging and foundational technologies to foreign countries." 50 USC § 4817(a)(2)(B).

With respect to the China and issues such as those related to emerging technologies such as AI applications and quantum computers, I am an advocate for the standard that has governed this part of export control decision-making since Roman times. Start with each weapon or intelligence system that exists *or that could reasonably be created*, and the critical components for each such system, and work backward from that. What are commercially available commodities, software, and technologies critical to developing, producing, and using that item? In China's case, what are the items and services needed to produce those items? What are the items necessary for China to have indigenous capabilities to produce or develop such items? What are the technologies, from whatever source, that would be material to creating or ending a military or intelligence advantage? Few or none of us in this room know the answers to the questions on a technology-by-technology basis.

Another reason I cannot give a complete answer to this question in a few paragraphs is that the analyses and issues for each the different types of technologies are very different. The semiconductor sector is far more mature than the quantum computing sector. China and the US have a high degree of inter-dependency in the semiconductor sector but no interdependency in the quantum computing sector, regardless of modality. The AI sector is diffuse. There are few US or allied chokepoints in the battery or the biotechnology sectors. Also, one must separate out deemed export analyses in the sectors where US success is, in part, dependent upon non-US person visa holders working in the United States from actual exports of hardware, software, technology, and services to other countries that could enhance indigenous capabilities overseas. The foreign availabilities in each of the sectors are also very different, which affects assessments of how effective any particular control could be.

A key public resource for thinking through the policy justifications for the controls is the Defense Department's annual report on "Military and Security Developments Involving the People's Republic of China." There are certainly detailed classified technical analyses of the same points. This is where the Defense Technology Security Administration (DTSA) takes a leading role for the Defense Department. It is the point agency for the export control system to go each of the services, labs, and other parts of the Defense Department to get the inputs from those directly involved in the development and production of the weapons and intelligence systems to answer these questions. Across the Defense Department are daily efforts to identify how emerging technologies, such as AI- and quantum computer-related applications, will advance military modernization efforts. In addition, with respect to most emerging technologies, the Department of Energy and its labs play a leading role at defining and explaining the technical problems and the issues. The Department of State takes the lead at defining human rights policies and the broader foreign policy implications of any such new controls. Commerce's BIS then, of course, uses its expertise on all such issues to distil the interagency consensus into regulations that are understandable, enforceable, and consistent with the structure of the EAR.

My answer to the question then is focused on ensuring that there is a regular order interagency process involving well-funded agencies staffed with subject matter experts in each of the technologies who also understand the threats, the supply chains, the existing legal authorities, and the limits of export controls (as opposed, e.g., to sanctions or other trade tools). In the end, it is all about the staff, who can only be hired with sufficient Congressional funding for each of the export control agencies.

XV. Where is the list of emerging and foundational technologies?

During my previous USCC testimony I was asked when BIS will publish the list of emerging and foundational technologies. First, ECRA does not require the creation of a one-time list. Rather, ECRA Section 1758 requires Commerce to "lead a regular, **ongoing** interagency process to identify emerging and foundational technologies that are essential to the national security of the United States" and that are not already controlled. 50 USC § 4817(a)(1). Second, BIS has published the first unilateral controls on such items with its October 2022 rule described above, which clearly meets the spirit and purpose of Section 1758, although not the letter of the section. That is, ironically, in its first major effort to publish unilateral controls on emerging and foundational technologies, BIS overtly chose not to do so under ECRA's emerging and foundational technologies authorities. BIS wrote that "due to the urgent need for this rule to counter China's actions, it will not be published as a Section 1758 technology rule, which would include a notice and comment period (50 USC § 4817(a)(2)(C))." 87 Fed. Reg. 62186, 62188 (Oct. 13, 2022). In other words, BIS wanted to publish the new unilateral emerging and foundational technology controls but did not want to wait for the completion of the public comment period that Section 1758(a)(2)(C) requires before doing so. Finally, BIS did not stop its efforts to identify emerging and foundational

technologies. Rather, BIS stated that because ECRA does not define either “emerging” or “foundational” technologies, or what the difference is between them, it made more sense to accomplish the objectives of ECRA Section 1758 by simply referring to such technologies as “Section 1758 Technologies.” 87 Fed. Reg. 31195 (May 23, 2022).

XVI. Conclusion

Thank you again for asking me to testify. **I realize that my recommendations about working with the allies to convince them to adopt broader-than-classical export controls are naïvely optimistic. However, all the other alternatives are worse.** I am happy to answer now or later any questions you have on export control issues. I am serious when I say that I have a 3-minute, 30-minute, 3-hour, and 3-day version of each such answer.

OPENING STATEMENT OF GIOVANNA M. CINELLI, NATIONAL SECURITY FELLOW, NATIONAL SECURITY INSTITUTE/GEORGE MASON UNIVERSITY

MS. CINELLI: Thank you, Hearing Commissioner Wessel and Miller and distinguished members of the Commission. Thank you for having me back to talk about a topic of incredible interest and importance to the United States, export controls.

First, I would like to commend the summary that Kevin provided on some of the critical issues. And one of his comments concerning thinking about things in a new way is something that I think is also incredibly important.

Before I begin my comments, I do want to say I'm here in my capacity as a national security fellow. Any views expressed are solely my own. They do not represent any opinion or view of any client or organization with which I'm affiliated. And my written testimony provides some additional details about the commerce regime, which is the focus where most of the dual use activity occurs with China, and where the most regulatory activity has occurred, certainly within the last two years.

So, for purposes of my verbal testimony, I would like to focus on four common themes where each of which alone is impactful, but together they create an incredible drain on industry in the United States, and they also create a regime that is so complicated that it is difficult even for the government to implement. And that is reflected in a number of different ways given the variety of changes that we have seen to the semiconductor rule that Kevin was referencing.

So, the challenges that we see are problems with export classifications. And I will talk briefly a little later in the testimony about why export classification is so key. Problems with identification of sanctioned parties or parties of concern, and diligence limitations, and then the reactive nature of regulations. Understanding that it is important for the U.S. to be flexible and to be able to respond and react, to changing geopolitical and geo-strategic circumstances, any regulatory regime that is premised solely on a reactive model is destined to be behind.

That is what we've seen consistently pretty much since the 1990s when we had a complete shift in the way the approach to export controls occurred. We moved from a Deny and Delay model into a Run Faster model, but in that Run Faster model we did not accompany it with the concomitant investments that were needed to allow industry to remain not only current, but ahead and to meet some of the challenges that we are seeing from the way China competes with the United States.

The United States manages these global relationships through a combination of hard and soft power projection tools. That is generally a very effective combination. On the hard power side we most often see power projections through our military forces in the various transits through the South China Sea, as well as alliance based global gaming exercises, and through overseas military bases.

We also see, for example, alliance regimes, most recently the AUKUS consortium that is going to provide a new framework for how to manage specific issues. And I personally, without being a Pollyanna, would like to say that I have great hope for the success of the AUKUS regime, assuming it's managed properly and the elements of the regime are met before any technology transfers.

Soft power, however, is more often reflected in public statements by U.S. public officials and public statements by allies that express an intent of what should happen, or behavior that could or should change. Export controls in my view have a unique position in that they are a combination of hard and soft power. They reflect or embody the policies, national security

informed policy interests of the United States, and at the same time use the tools of denying access or managing access to what is controlled by implementing what is viewed as national security or foreign policy limitations.

However, this reactive nature, and this was demonstrated in the questions asked in the earlier panel about what should we be looking at, where should we be going, is one of the foundational flaws of the existing export control system. If we are constantly attempting to divine the direction that some place or someone is going, it is going to be easy to miss factors that bring what should be important to the forefront and leave to the side what can be better managed.

Now U.S. export laws and regulations are very complex, they're granular, and at times they're even inconsistent. Part of the reason for that is because within the United States we have multiple agencies, multiple constructs, multiple lists, and multiple standards that are set. Overall, the government, and by that I mean the Executive branch and Congress, and the Judiciary to the extent it has been involved in the discussions, has not been able to come up with common definitions. I simply want to raise the example of artificial intelligence.

There's at least 15 different definitions from the Office of Science and Technology Policy, Congressional definitions in myriad NDAAs, as well as through the Department of Commerce on the export control list where they manage certain elements of what goes into artificial intelligence. And then of course you have all the open source. So, if we cannot find common definitions to assess what export controls should apply to, we begin on a foundation of sand.

So, inconsistencies in these inadequate identifications of the technology make export classification, which is the very foundation for why export controls can be effective. If you do not understand the export classification you're unable to make the licensing decisions that flow from that, and like the evidence concept of the fruit of the poisonous tree, that foundational decision creates the consequences that make everything you've done after that erroneous decision wrong.

The same applies to sanctioned parties. It is very difficult to identify sanctioned parties. There are multiple lists, multiple standards, and there are even times when you look at the Office of Foreign Assets Control's Fifty Percent Rule where you may have no sanctioned party on any publicly available list, and yet by the nature of the relationship between the sanctioned party and the non-sanctioned party, you may actually have a concern with a party you're dealing with that is not on the list.

I have additional details in my testimony, but let me raise just four foundational considerations from Congress's perspective. One, there should be serious consideration given to authorizing one single control list. Multiple government agencies can use it, but there should be one list where the standards are common, the thresholds for technology and functional characteristics are readily ascertainable, and you don't need an engineer, a lawyer, and an economist to figure out what type of controls you have.

Number two, there should be one sanctioned partyies list. Someone may say we have the Sam.gov which correlates and brings together all these different lists, and you can go there and we have software companies that will give you access to comprehensive lists for review. That is not the type of list I'm talking about. Because each of those lists has parties on them for different purposes and without access, which leads me to my third recommendation for Congress, which is information sharing with industry.

Without access to information where data flows, especially in China, have become incredibly challenging, in some instances shut off, it is almost impossible to make a decision on whether the party you're dealing with is legitimate or not. And with that, I'm over time, so please let me stop. Thank you.

COMMISSIONER MILLER: Thank you, Ms. Cinelli. Mr. Harrell next.

PREPARED STATEMENT OF GIOVANNA M. CINELLI, NATIONAL SECURITY FELLOW, NATIONAL SECURITY INSTITUTE/GEORGE MASON UNIVERSITY

Hearing
on
Key Economic Strategies for Leveling the U.S.-China Playing Field:
Trade, Investment and Technology

Panel II: Measures to Limit the Flow of Key Technologies to China

US-China Economic and Security Review Commission

May 23, 2024

Giovanna M. Cinelli

National Security Fellow, George Mason University
National Security Institute

Hearing Chairmen Wessel and Miller and distinguished members of the Commission, thank you for inviting me to testify before you today on a topic of critical importance to US-China relations and to the effective recognition of global interests in this relationship: the use of export controls to manage ongoing engagement with China. I appreciate the opportunity to provide you relevant background regarding how US export controls, in particular the Export Administration Regulations ("EAR") and the Export Control Reform Act of 2018 ("ECRA"), currently address these engagements, and how the Department of Commerce's governing policies on licensing and enforcement have impacted industry.

I am here today in my capacity as a National Security Fellow at the George Mason University National Security Institute and bring my 37 years of experience as a practicing attorney in the national security field as well as my US Naval Reserve intelligence service. The views presented are solely my own and do not represent the views of any individual, client, organization or company with whom I am affiliated. In addition to the practice of law and intelligence reserve duty, my perspectives are also informed by my continuing participation (since 1992) on various US Federal Advisory Committees at the Departments of State, Commerce and Defense. These experiences have allowed me to immerse myself in the operational and compliance requirements of US export controls and the challenges (or positives) of how the regulatory process functions. I look forward to answering any questions you may have.

US Export Controls: Export Control Reform Act of 2018 and The Export Administration Regulations

The United States manages global relationships through a combination of hard and soft power projection tools. Hard power is most often reflected through the power projection of our military forces as well as the global alliances the US and its partners have through gaming exercises, overseas military bases, and aligned international arrangements such as the Nuclear Suppliers Group, the Missile Technology Control Regime, the Australia Group and now, the AUKUS Coalition. Soft power is more often reflected in public statements by senior US Government officials regarding US interests, coordinated public releases by the US and its allies of common positions and the establishment of avenues for enhancing these common positions through laws and regulations of sovereign governments.

US export controls represent a hybrid hard power-soft power approach premised on laws and regulations that articulate US and multilaterally agreed to policies regarding the manner by which sensitive items (products, materials, equipment, software and technology – collectively, "items") may be shared and under what limitations, if any. The impact of these laws has made them one of several tools for managing a global environment while protecting the interests of the US and its allies and partners. While these laws and regulations have responded to changing global conditions, they have been reactive and focused on managing engagements after a critical issue

has been identified. The need for nimble, targeted, and anticipatory regulations in the integrated global environment is enhanced by the speed and diffusion of technology.

Understanding the history of how specific US export control laws and regulations reached their current stage is instructive for assessing the success or failure of national security objectives. Export controls have been in place in the United States formally since 1905 with the passage of the Trading with the Enemy Act ("TWEA"). Since that time, Congress and presidents have passed the Export Administration Act of 1979 ("EAA"), ECRA, the International Emergency Economic Powers Act ("IEEPA"), the National Emergency Act ("NEA"), the Arms Export Control Act of 1976 ("AECA"), and a myriad of sanctions tailored laws related to countries such as Iran, Syria, Cuba, Russia, Venezuela and Belarus.

Each of these laws and regulations include reasons for restrictions, lists of controlled items, licensing policies, and enforcement mechanisms. Although all are based on national security and/or foreign policy interests, this common focus has not produced consistent or reliable outcomes for industry and has contributed to high compliance costs for both industry and the Government. As noted below, ECRA and the EAR provide a case study for this conclusion.

To inform our discussion, my written testimony provides:

- An overview of the EAR
    - Licensing
    - Policy
    - Enforcement

- A case study of the semiconductor and supercomputing rules of October 2022, October 2023 and April 2024; and

- Next steps for Congress to consider

A. EAR: Licensing, Policy and Enforcement

US export laws and regulations are complex, granular and, at times, inconsistent internally and among the various agencies that manage the different regimes. The complexity arises, in part, from:

- The approach used to identify what items are subject to US export laws
- The need to classify any product or technology that will be transferred to a foreign party or foreign country

- Identification of the foreign parties involved in any transaction
- The need to review multiple lists of controlled items
- The different licensing policies and types of licenses
- The presumptions that apply for issuing licenses for specific activities; and
- The diligence required to "know your customer" in a world where key data points may not be readily available.

Understanding and operationalizing the requirements is resource intensive, time consuming, and inherently risky due, in part, to the disagreements that can occur between industry and the US Government regarding the export classification and licensing decisions made by those who export, reexport, retransfer or release controlled items. ECRA and the EAR are not immune to these risks.

Some detailed background on the EAR framework, classification and licensing processes as well as enforcement approach places these challenges in context.

The EAR is based primarily on five main principles:

- Multilateral controls with the authority to impose unilateral controls when deemed appropriate
- Export classification
- Licensing (*i.e.,* authorizations, license exceptions, and decision-making presumptions whether for approval or denial)
- Recordkeeping; and
- Enforcement

The regulations are administered by the Department of Commerce, Bureau of Industry and Security ("BIS") and control the export, reexport, retransfer (in-country) and release of dual-use items between or among US persons and foreign persons, wherever located. Dual-use items include those with commercial, civil, or civil-military applications and post-Export Reform, some military only items, such as fasteners for stealth applications. Controlled items are generally included on the Commerce Control List ("CCL") which is primarily a multilaterally developed itemization of items that are subject to US jurisdiction and conditioned release.

The EAR provides two licensing mechanisms for authorizing transfers: Individual Validated Licenses ("IVLs") and License Exceptions. BIS manages the licensing process and determines whether to permit the transfers of items controlled on the CCL, as well as items subject to the EAR but not listed on the CCL. BIS chairs an interagency review process that allows the Departments of State, Defense and Energy to opine on the approval or denial. The regulations

also require parties to maintain records related to activities, information and items subject to the EAR as well as some reporting, such as for certain encryption exports.

The foundation of every licensing decision under the EAR is the export classification that applies. Because multiple agencies have jurisdiction over items, identifying the correct export classification is key. Errors in classification – like the fruit of the poisonous tree doctrine in evidence – taint every decision based on that classification including, which agency controls the item, what licenses are needed and what national security or foreign policy risks exist for any transaction or activity.

1. Export Classification

The CCL includes detailed descriptions of controlled items with references to performance requirements, technical specifications and other information on an item's function. CCL listed items are assigned an Export Control Commodity Number ("ECCN") which identifies the technical parameters of the product, the reasons for control and the licensing policies that apply to the items. As noted above, proper classification forms the foundation for any export licensing decision as the CCL is not the only list of controlled items published by the US Government.[1]

Ensuring the proper classification requires a detailed technical understanding of how an item functions as well as a foundational knowledge of the EAR. In addition to the CCL, other agencies develop and manage separate lists of controlled items and the lists change frequently as technology advances. This generally requires a continuous evaluation of product development, regulatory changes, and modifications to compliance programs to ensure that gaps do not arise when changes occur. Parties, however, are placed on notice of which items are controlled based on the specific technical details used to describe any item in an ECCN or on one of the other lists – the United States Munitions List ("USML") under the ITAR or the Appendix to the Part 110 nuclear regulations.

In addition to the CCL enumerated items, the EAR also includes a basket category called EAR99 that covers items not specifically enumerated on the CCL, but which are "subject to US jurisdiction."[2] These items are not described in technical detail and are not included in the regulations in the same manner as an ECCN-controlled item. EAR99 items can include, for example:

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[1] Items could also be controlled by the Department of State, Directorate of Defense Trade Controls (DDTC) under the International Traffic in Arms Regulations (ITAR) or the Department of Energy/Nuclear Regulatory Commission/Nuclear National Security Administration (DOE/NRC/NNSA) under the Part 110 and Part 810.

[2] 15 CFR 734.3.

Item	Classification
Positive high voltage ideal diode controller (product)	EAR99
Cartographic Web Services System (software)	EAR99
G700SE-M GPS-Enabled Tactical Digital Camera (product)	EAR99
Climate Four-Dimensional Data Assimilation System (technology and software)	EAR99
ARC3-Tactile (gesture recognition software that processes sensor data) (software	EAR99

EAR99 classifications could cover any item from safety pins to constituent chemicals to the items noted above, but parties would be unaware of those classifications unless someone obtained a classification from a US Government agency (whether BIS or DDTC) or had access to classifications from a readily accessible source such as on a company's website. The lack of consistent public availability makes it challenging, at times, for parties to assess licensing obligations. The results of this gap are reflected in the number of BIS civil enforcement cases over the last 15 years that include exports of EAR99 items to sanctioned parties.

2. Licensing under the EAR

Once an item is classified, a licensing determination is required to ensure that proper authorizations are used to transfer any EAR-controlled item to a foreign person or destination. Licensing requirements apply to both CCL and EAR99 items but the reasons for control vary – for example, some items are controlled for national security reasons, others for regional security and some for nonproliferation reasons. EAR99 items have no separately itemized reasons for control and are generally able to be exported, reexported, released or retransferred without licenses based on the end user, the end use and the destination. Licensing for CCL listed items is based on the same three factors but also includes the reasons for control.

The EAR includes two types of general authorizations:

- Individual Validated Licenses ("IVLs") – Require parties to apply to BIS and await a determination from the agency prior to conducting any activity included in the application; or
- License Exceptions – Are pre-approved authorizations that require no submission to BIS, but obligate parties to ensure that all the elements of the license exception have been satisfied so that it may be used for the export, reexport, retransfer or release.

IVLs are reviewed under one of two presumptions:

- A presumption of approval; or
- A presumption of denial.

It is important to highlight that presumptions of approval or denial are not guarantees of any particular BIS decision. A license application for an export of an EAR-controlled item to a US partner or ally that is reviewed under a presumption of approval does not mean that the license will issue. It means that BIS approaches the application with an intent to approve the request unless national security or foreign policy circumstances exist.

A presumption of denial does not mean that all license applications will be denied. Presumptions of denial tend to apply for licenses involving sanctioned countries or sanctioned parties, although the reach of the presumption varies. Sanctioned parties are included on one of three lists managed by BIS:

- The Entity List
- The Unverified List; or
- The Denied Persons List.

The Entity List includes details regarding the sanctioned party and the types of restrictions that apply. For example, a party from China or Switzerland or Russia on the Entity List could be sanctioned but for only certain EAR-controlled items. Footnotes are added to Entity List designations that could indicate no item subject to the EAR may be exported to the party without a license – which would cover ECCN and EAR99 items – or it could exclude EAR99 classified items from the restrictions. These variations result in denials or, in some cases, license approvals even with the presumption. BIS may determine, for example, that the presumption can be overcome through licensing restrictions (such as provisos or limitations) or approval for a shorter time period or through specific recordkeeping and reporting requirements that keep BIS apprised of how the exported item is being used. This is how parties subject to sanctions on the Entity List may sometimes legitimately receive EAR-controlled items via a license.

Parties who submit license applications are responsible for the accuracy, completeness and support for any requested authorization and a misrepresentation or material omission can result in a separate violation of the EAR. Embedded within these obligations is the expectation that parties will conduct sufficient due diligence into the transaction activity and the parties involved to ensure that the application correctly reflects the information BIS needs to issue a license decision.

Due diligence varies depending upon a number of factors including, but not limited to:

- Countries involved
- Parties (*e.g.,* companies, educational institutions, non-profits, individuals, etc.)
- The results of screening against published US Government lists
- Whether the activity involves high risk factors identified by the US Government.

Once the agency receives an application, BIS may:

- Issue the license without conditions
- Issue the license with conditions or limitations
- Deny the license; or
- Return the license without action (which may occur either because BIS lacks jurisdiction over the items in the licenses – due, for example, to a misclassification – or because no license is needed)

Errors could occur throughout the process and BIS civil enforcement actions highlight the two most frequently cited mistakes:

- Misclassifications; and
- Failures to identify sanctioned parties

As discussed in the recommendations section, these types of errors occur for a number of reasons, but frequently because there are too many information gaps related to proper export classifications or the parties involved in a transaction. Information gaps arise because data on foreign parties may be unavailable in the home country or the US Government has information which has not been published due to countervailing factors such as intelligence gathering concerns. The verification process, therefore, is fraught with risk, some of it irremediable before an error occurs.

The importance of information availability and sharing was highlighted by both BIS and the Department of Energy ("DOE") in recent regulatory changes. For example, on May 6, 2024, DOE issued an advance notice of proposed rulemaking ("ANPRM") regarding foreign entities of concern. In the preamble to the ANPRM, and in response to a request by industry for DOE to provide a list of government officials as senior officials, DOE stated:

> "*Compiling a complete list of current and former senior government officials would prove challenging* given that the list would likely be subject to frequent change, difficult to predict and very likely underinclusive. Furthermore, *DOE does not have the resources to*

> *do so for every company that may be in the battery supply chain*." 88 Fed. Reg. 37079, 37081 (May 6, 2024)(Emphasis added)

The same limitations italicized above exist within industry. BIS also acknowledged similar difficulties but noted that it is essential that lists of sanctioned or otherwise challenging parties be published to inform the regulated industry of where pitfalls may arise. In the December 2020 amendments to the EAR adding Military End User parties to the MEU List, BIS stated:

> "Publishing a list of parties that already have been determined to be 'military end-users' allows the public to be informed of BIS's determinations in these individual cases. Therefore, *the most practical and effective approach is to publish a Federal Register notice adding these 'military end users' to the MEU List, so all potential exporters, reexporters, or transferors are informed simultaneously"* (Emphasis added) 85 Fed. Reg. 83793-83804 (December 23, 2020), at 83794.

Without significant assistance or information sharing from the US Government to identify entities or parties of concern, gaps arise.

3. <u>Enforcement</u>

BIS includes policy, licensing and enforcement offices all of whom report up to the Under Secretary for Industry and Security. Assistant Secretaries (one for Industry and Security and the other for Enforcement) oversee the processes and the Industry and Security office also has a principal deputy assistant secretary and two additional deputy secretaries to manage the policy and licensing requirements. One overall office, therefore, manages all aspects of EAR classification, licensing, and compliance.

The current Assistant Secretary (AS) for Export Enforcement Matthew Axelrod has taken a forward leaning approach to enforcement by communicating BIS' enforcement policies through memoranda, public presentations at conferences, enforcement decisions, and testimony before Congress using these avenues to inform industry, allies, and partners of the US Government's enforcement related priorities. These communications have also allowed other governments to assess the viability of the approaches discussed and formed the foundation for the implementation of various export control restrictions not only related to the Russia-Ukraine conflict but towards China as well. For example, since 2022, AS Axelrod has issued policy memos that:

- State that industry and universities must have compliance programs[3] ("Both industry and academia *must have* proper compliance systems in place to identify, prevent and mitigate export control violations.")[*Memorandum: Clarifying Our Policy Regarding Voluntary Self-Disclosures and Disclosures Concerning Others, April 18, 2023*, at p. 1]("April 18th Memo")

- Establish a two-tiered voluntary disclosure process – for "technical" violations and for more serious transgressions [*Memorandum: Further Enhancements to Our Voluntary Self-Disclosure Process, January 16, 2024*]("January 16th Memo")

- Encourage the reporting of third parties that violate or appear to have violated the EAR [*April 18th Memo,* at p. 3]

- Identify when a failure to disclose discovered violations will be seen as an aggravating factor in any enforcement action before the agency [*April 18th Memo*, at p. 3]

The increased communication informs parties of the agency's interpretations and priorities, but the speed and frequency of regulatory changes strains compliance programs and even the Government as it seeks to enforce the changing requirements.

B. The Semiconductor, Semiconductor Manufacturing Equipment and Supercomputer Regulations

In October 2022, BIS issued its first EAR rule regarding new controls on specific semiconductors, certain supercomputers, and some semiconductor equipment.[4] The regulation, and the rules that followed in October 2023 and April 2024, provide a case study for the difficulties under the current approach to the EAR and the underlying reactive manner in which new regulations are implemented.

According to Assistant Secretary for Export Administration Thea Kendler and Undersecretary Alan Estevez, the October 2022 regulation was designed to address the national security concerns that

[3] Unlike the Bank Secrecy Act, neither ECRA nor the EAR requires any organization to have a compliance program. Parties subject to the EAR are expected to manage their compliance to ensure that they meet the EAR requirements and can identify, remediate and disclose any violations however discovered. AS Axelrod's statement regarding compliance programs, therefore, highlights an apparent inconsistency with the previously stated view that compliance with the EAR was a risk-based process and parties were permitted to determine how best to manage that risk.

[4] 87 Fed. Reg. 62186-62215 (October 13, 2022), at 62187 ["These controls are being imposed through this interim final rule to address immediate concerns with the PRC's demonstrated intent and ability to use these items [certain semiconductors and supercomputers] for activities of national security and foreign policy concerns to the United States."]

existed with China's military-civil fusion policy and the rapid development of more advanced semiconductors by China.[5] To manage these concerns, BIS:

- Established new ECCNs for controlling certain advanced semiconductors and related items
- Expanded the obligations for US persons when providing support or facilitating transactions involved in advanced semiconductor and supercomputer related technologies
- Established and enhanced various diligence requirements to determine what kind of activity was occurring at facilities in China that were handling advanced research and development ("R&D") or a mix of advanced and legacy product activity; and
- Imposed new licensing requirements.

At the time, the US Government had discussed its perceived need for these changes with several allies and partners including the Netherlands and Japan, as well as the Five Eyes countries (the UK, Australia, Canada and New Zealand). The Netherlands and Japan are among countries at the forefront of advanced R&D and product/equipment manufacture in the semiconductor industry. The items these countries produce are important to the advanced manufacturing process. As the EAR is primarily focused on multilateral controls, the US believed the imposition of multilateral export controls[6] would more effectively address any perceived national security concerns.

Japan and the Netherlands, however, were at different stages of export control policy development than the United States. Because of this variance, BIS decided to proceed with the October 2022 changes a majority of which were unilateral. The revisions included phased in effective dates and a request for comments.

In mid-2024, Japan and the Netherlands took steps to enhance their export controls licensing policies and imposed new restrictions on the transfers of semiconductor equipment or related products that could be used in the manufacture of advanced semiconductors. At the same time, BIS had received extensive comments to the October 2022 regulations, which highlighted the

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[5] "The PRC Government expends extensive resources to eliminate barriers between China's civil research and commercial sectors, and its military and defense industrial sectors." *Id.* at 62187.

[6] "In the context of export controls, multilateral and plurilateral controls are typically the most effective path toward accomplishing our national security and foreign policy objectives." *Commerce Issues Rules to Reflect Export Control Coordination with Allies and Partners to Facilitate Secure Trade, December 7, 2023,* at p. 2; *see also* Press Release: *United States-Australia-Canada-New Zealand-United Kingdom Release Joint Guidance on Countering Russia Evasion, September 26, 2023;* Press Release: *Five Eyes Partners Agree to Formalize Cooperation on Export Control Enforcement, June 28, 2023;* Press Release: *Commerce Announces Addition of Iceland, Liechtenstein, Norway and Switzerland to the Global Export Controls Coalition, April 8, 2022.*

regulations' vagueness, unclear requirements, ineffective controls, and practical implementation problems.[7]

Based on these comments, BIS issued a revised interim final regulation that included significant changes to the October 2022 rule. Among the various changes, the October 2023 regulations[8]:

- Consolidated the new ECCNs into existing ECCNs and eliminated some of the October 2022 classifications
- Included responses and clarifications to open issues related to US person support and facilitation
- Confirmed the scope of licensing requirements while imposing new ones

Industry concerns remained with the compliance requirements, the changed export classifications and the diligence obligations, as well as the lack of ongoing consistency with respect to the type of support that could be provided in the advanced semiconductor realm by US persons. As a result, BIS issued yet a third rule on April 4, 2024, "correcting" and clarifying the October 2022 and October 2023 regulations.[9]

The corrected rule:

- Reimposed licensing and other restrictions on items that had been excluded (or omitted) in the prior rules
- Outlined and clarified additional diligence obligations
- Updated a number of technical performance parameters for various semiconductor ECCNs; and
- Updated the licensing policies for certain exports to particular destinations (to include Macau).

While regulations change to accommodate shifting geopolitical and geostrategic considerations, the approach to the semiconductor technology regulations highlights the significant challenges inherent in speedy actions that then need to be corrected to address essential gaps. Undersecretary Estevez, in a speech before the Center for Strategic and International Studies, noted that the Government believed it was essential to take swift and unilateral action to address the perceived national security issues. While understandable, the burden this type of action places on industry, the academic community and the supply chain, is especially acute when

[7] Regulations.gov, RIN:0694-AJ23.

[8] 88 Fed. Reg. 73424-73455 (October 25, 2023).

[9] 88 Fed. Reg. 23876-23905 (April 4, 2024).

reversals in course take place – for example, recontroling items that had been excluded from control.

C. Recommendations

With the pending Supreme Court decision in *Loper Bright Industries* and *Relentless* regarding the viability of the Chevron doctrine, BIS could find itself constrained in some of its regulatory processes should the Court decide to limit the application of Chevron. Were that to occur, BIS would need clear, consistent and tailored guidance from Congress through legislation that forms the basis for regulatory changes BIS may make to the EAR.

Congressional leadership in legislatively framing the AUKUS partnership from an export control context provides a path forward for managing other export control requirements. Streamlining licensing, ensuring proper classification, dealing with reliable partners and managing resilient supply chains apply beyond AUKUS to most of export controls and sanctions requirements. As such, Congress should consider the elements of AUKUS that apply more broadly to the EAR to enhance the various challenges that exist for both the agency and industry.

Using the AUKUS framework as a baseline, Congress could consider legislation to address the following issues:

- <u>Authorize the development one export control list</u> that includes all items from the CCL, the USML, the nuclear regulations and other export regimes and can be used by any agency with export control responsibilities. Among the considerations for this approach, definitional consistency becomes key. For example, as of the date of this written testimony, there is no one definition of AI – with legislation providing some contours while the Departments of Defense, Homeland Security, and Commerce, plus the intelligence community and the Office of the Science and Technology Policy Advisor providing others. Finding a common baseline definition can reduce confusion

- <u>Authorize the creation of one sanctioned parties list</u> for the same efficiencies that would be gained by one control list

- <u>Authorize and identify the requirements for more robust information sharing between the US Government and industry</u> on sanctioned parties, subsidiaries, affiliates, 50% owned entities and organizations for whom scant public information exists
- <u>Authorize the streamlining of licensing decision and the sharing of information regarding the reasons a specific license decision occurred requirements.</u> Too often vague "national security" or "foreign policy" grounds are asserted as the reason for various decisions. While national security and foreign policy may be the reasons the Executive branch makes

the decisions it does, those justifications provide no guidance to industry or others in order to prevent future errors in judgement. Post-hoc correction because the US Government fails to provide adequate reasoning that informs the parties for why a particular transaction is untenable may not be the most effective way to protect national security or advance foreign policy interests. Closing the barn door after the horses are gone may be an exercise in futility

Thank you for the opportunity to provide these views and I look forward to answering any questions you may have.

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OPENING STATEMENT OF PETER HARRELL, NONRESIDENT SCHOLAR, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

MR. HARRELL: Members of the Commission, it's an honor for me to testify today on this distinguished panel. And I should begin by saying that my remarks here today are my own remarks here on a personal capacity and don't represent the remarks of any institution I'm affiliated with. I've submitted a full statement for the record and I'm going to confine my verbal testimony today to just a handful of key points.

First, I want to offer two different lessons from recent U.S. export controls on both Russia, where we've enacted a quite comprehensive export control regime over the last couple of years since Russia's invasion of Ukraine in early 2022, and also in China where there's been, as Kevin noted, an aggressive focus on semiconductor-related export controls, particularly since October of 2022. One of these two lessons is a technical lesson, and one is a strategic lesson. I'm going to start with the technical lesson.

I think it's been striking to see not only how quickly Russia was able to pivot to China to support Russia's industrial base, but how effective Russia has proven in continuing to buy components made by western firms despite the export controls that the U.S. and many of its allies have put in place. Indeed, a study released earlier this year by the Kyiv School of Economics which had sent people out to recover Russian weapons from Ukraine that had been shot down or destroyed by Ukrainian forces, found that of the non-Russian components embedded in those Russian weapons recovered on the battlefield in Ukraine, fully 95 percent of the components were coming from western companies, not from Chinese companies, which represented just 4 percent of the components found on the battlefield.

Now I suspect that many of the western firm items were probably manufactured in China, potentially by contract manufacturers in China. And almost all of these items were smuggled into Russia. I think very few of the western firms involved, which include various name brand companies, including in semiconductors in the electronics space, were wittingly or intentionally continuing to sell products to the Russian military.

But the fact that Russia is able to continue to obtain such a large quantity of western items suggests to me that we really need a very comprehensive and aggressive effort between government and the private sector to work more aggressively on export controls compliance and implementation. I look back at the record after the 9/11 terrorist attacks when the Treasury Department 20-some-odd years ago, when the Treasury Department worked very closely over a number of years with the global financial sector to fundamentally transform the way in which global banks implemented sanctions compliance around the world.

I think we may need something similar to that today in the export control space if we as the United States and our allies are going to successfully rely on export controls as a major tool in foreign policy going forward. I think there's really quite a bit that could be done there. For example, physical goods, obviously export control is not only physical goods, but often involving physical controls. I think we should be working together, particularly for high value physical goods that are critical components.

To look at ways you could actually geo-tag them. Firms could actually trace where they are going and disable them if they go to a place where they shouldn't. I think that's not only relevant for Russia, but also as we think about semiconductor tools and how do we control the use of tools in China.

The second lesson from these recent export control experiences is a strategic one. I think that if we get to a point that China is about to invade Taiwan, this kind of contingency that gets talked about a lot around town, I fear that the threat of sanctions and export controls, if we're at that point where an invasion is imminent, it's probably not going to deter China from attacking. I fear that in that case, Xi, much like Putin before him, will simply view sanctions and export controls as a cost to be paid as part of military adventure.

It's not to argue against sanctions and export controls in a contingency like that, of course, we should impose them. But I think the most effective way the U.S. can deter Chinese military adventurism is by doing everything we can today, tomorrow and over the years to come to ensure that that military adventurism will fail, that they will militarily be unable to obtain his military objectives. And against that backdrop, although we have for years obviously restricted almost entirely the export of military goods to China and goods to military end users and end uses in China, I think it's time for the U.S. government to undertake a new and fresh review about what are the choke points we can pursue today to slow China's military advancement, rather than kind of waiting until China is getting ready to invade and then threatening sanctions and export controls as a response.

The second point I want to make is that the U.S. needs a comprehensive strategy when it comes to export controls to China. I very much agree with Kevin that since kind of fall of 2022, the U.S. has laid out a very comprehensive, nuanced, and what I think will ultimately be pretty effective strategy to limit China's access to high end semiconductors and semiconductor tools. This is a strategy that leverages documented choke points in the technology ecosystem. It is a pretty multilateral control, all things considered, at least with the relevant players. We have fairly clear defined objectives. I think with effective enforcement we'll probably succeed in slowing China's semiconductor and AI development.

But that's an effective strategy for semiconductors. So that's different from an effective strategy on export controls writ large. I'm optimistic that in the months ahead we may see the U.S. take a similar approach to other aspects of artificial intelligence, and maybe certain aspects of biotechnology that we've taken over the past two years with semiconductors. But I think more is needed to identify what are the technologies where we should have these kind of integrated technology-specific export controls and then execute against them.

The third point I want to make, realizing my time, I'll comment very briefly on this, is I think we need a better framework for restricting high-risk technology imports from China, and high-risk U.S.-China data flows. It's obviously been a major focus on U.S.-China data flows, including over the last couple of months with China enacting new restrictions on Chinese-owned social media platform TikTok. But the TikTok instance is actually only the most recent example of probably more than a dozen actions the U.S. has taken over the last couple of years to restrict certain kinds of Chinese technology in the United States, which includes elements of drones, includes Chinese cargo terminal operator cranes and others.

But I think that while we've seen this kind of case-by-case approach over the last couple of years, we need to pivot towards a more strategic assessment of what really are the Chinese ICT technologies we need out of our ecosystem and start more proactively going through the stack to take them out. I would be happy to speak on that more in the Q&A given I'm out of time. Thank you.

PREPARED STATEMENT OF PETER HARRELL, NONRESIDENT SCHOLAR, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

U.S.-China Economic and Security Review Commission Hearing:

"Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology"

Panel 2: "Measures to Limit the Flow of Key Technologies to China"

Testimony of Peter E. Harrell

May 16, 2024

Members of the Commission, it is an honor for me to testify on the topic of today's hearing, "Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology." The views I express today are my own and I am not here speaking on behalf of any organization.

The Commission plays an important, bipartisan role in identifying economic and national security challenges in the U.S.-China relationship and in making recommendations to Congress regarding U.S. policy towards America's leading strategic competitor. To cite just a few recent examples, the Commission has been instrumental in making recommendations on export controls, restrictions on both outbound American investment to China and inbound investment from China, trade policy, and on the risks posed by the use of certain Chinese technology, such as telecommunications technology, in the United States.

Of course, as Commissioners know well, more needs to be done to position the U.S. for today's era of strategic competition. The most recent U.S. National Security Strategy, released in October 2022, describes China as "the only competitor with both the intent to reshape the international order and, increasingly, the economic, diplomatic, military, and technological power to advance that objective."[1] China is endeavoring to modernize its military so that it can threaten U.S. allies in Asia and push U.S. military forces out of China's near abroad. Beijing is increasingly aggressive towards Taiwan, and the U.S. must be prepared for a potential military conflict in the Taiwan Strait in the years ahead. Beijing is continuing its years-long quest to secure control of critical global supply chains and to build the industrial capacity and technological know-how to dominate the essential industries of the future.

Against that backdrop, I will spend my testimony today discussing three broad topics:

- First, the lessons from recent U.S. export controls on China and Russia.
- Second, the need for a more comprehensive strategy when it comes to limiting technology flows between the U.S. and China.
- And third, the need for a better framework for restricting high-risk technology imports from China and high-risk U.S.-China data flows.

[1] The White House, "U.S. National Security Strategy," Oct. 2022, https://www.whitehouse.gov/wp-content/uploads/2022/10/Biden-Harris-Administrations-National-Security-Strategy-10.2022.pdf.

Lessons from recent export controls on China and Russia:

Over the last five years, the United States and our allies have embarked on two major campaigns of export controls. The first of these is an increasingly comprehensive campaign to control the export of semiconductors and semiconductor manufacturing equipment to China. The second of these is the sweeping campaign of sanctions and export controls that the U.S. and our allies have imposed on Russia since its invasion of Ukraine in February 2022. Both these cases offer important lessons for the U.S. as we consider the role of export controls in maintaining our strategic edge over China.

Former President Trump began the current campaign of semiconductor-related export controls in 2019 when his Administration imposed restrictions on Chinese telecommunications company Huawei in a bid to erode its growing presence in international telecommunications networks. The Trump and the Biden Administration subsequently added a number of other specific Chinese companies, such as semiconductor manufacturer SMIC, to America's targeted export control lists. Then, in October 2022 President Biden expanded this campaign by deploying an innovative set of country-wide controls on China, which the President further broadened in October of last year.

Broadly speaking, the controls that the U.S. has imposed on exports to China of advanced semiconductors and semiconductor tooling starting in October 2022 have the hallmarks of a successful export control strategy. They built on the earlier experience of export controls targeting specific Chinese firms, which were proving increasingly difficult to enforce given China's opacity and the prospect for diversion and workarounds within China. The export controls have clear objectives: slowing the development of China's semiconductor and AI technologies, both of which are quintessential dual-use technologies that China could deploy to strengthen a range of military applications. The export controls leverage chokepoints by focusing on products that China cannot readily source domestically.

I see the iterative process of the semiconductor export controls, expanding from firm-based to country-based in 2022 and then expanding again in October 2023 to cover additional types of semiconductors and equipment, as a strength, not a weakness, of the export controls regime. Export controls will almost always be an iterative process and the United States should expect to regularly update and expand export controls to address gaps and workarounds as they are identified. Starting a new export controls regime with a comparatively narrower set of controls and expanding them over time allows policymakers to identify strengths and weaknesses, address gaps, and reduce the odds of unintended consequences, which could be significant, particularly with respect to China, given China's economic scale.

The U.S. has also been broadly successful in convincing key like-minded jurisdictions that produce semiconductors and semiconductor manufacturing equipment, notably the Netherlands and Japan, as well as companies in Taiwan and South Korea, to join the U.S. in imposing broadly similar export controls, constricting China's ability to source products from non-U.S. suppliers. Admittedly, there has been significant discussion in the export controls community and in industry regarding the fact that the U.S. initially imposed controls on semiconductor manufacturing equipment before Japan and the Netherlands, and of the fact that aspects of the U.S. controls continue to go further than do allied controls: For example, U.S. allies have so far not joined in restrictions on their citizens servicing semiconductor manufacturing equipment already in China. However, the practical

diplomatic reality is that sometimes the U.S. has to impose controls first, before getting allies and partners on board: diplomatic experience shows that allies and partners may prove unwilling, for their own internal political reasons, to act until they see that the U.S. has done so. So long as the U.S. government is actively engaging with key allies to seek further alignment and has a plausible strategy to obtain such alignment, the U.S. should not be afraid to act first.

Let me now turn to Russia. In late 2021 and early 2022 the U.S. and its G7 allies sought to use the threat of sanctions and export controls to deter Russian President Vladimir Putin from attacking Ukraine. After Putin attacked in February 2022, the U.S. and our allies imposed sweeping sanctions and export controls on Russia in a bid to both deprive Russia of revenues and to degrade Russia's industrial base and capacity to wage its war of aggression. Currently, U.S. and our allies impose export controls on a wide range of products including semiconductors, manufacturing equipment, dual-use technologies, and numerous chemicals and materials, among other products.

While the threat of this campaign of sanctions and export controls failed to deter Putin and has not prevented him from waging his war on Ukraine, in my view the sanctions and export controls have been useful in eroding Russia's military industrial base. For example, a detailed analysis by the Kiev School of Economics published earlier this year found a sharp drop-off of both "battlefield goods" and "critical components" after the imposition of export controls in 2022. While there has been a significant rebound as Russia developed new suppliers, in late 2023 Russia's imports of battlefield goods remained about 10% below their pre-war levels while its imports of critical components remained about 29% below pre-war levels.[2]

Indeed, in December of last year Ukrainian President Volodymyr Zelensky stated that Ukrainian intelligence was seeing a "deceleration" in the Russian defense industry even as Russia was able to continue the war.[3] Moreover, it is hard to imagine that Putin would have turned to Iran and North Korea to provide drones, artillery shells, and other military equipment if his own defense manufacturing base was working as effectively as his military would like. To be sure, by far the most important element of defeating Putin's war of aggression is the military support the U.S. is providing to help Ukrainian soldiers on the battlefield. But a continued campaign of sanctions and export controls can help erode Russia's war machine.

When I look across these two cases, I see multiple lessons relevant to the future of U.S. export controls on China.

First, the October 2022 shift from controls focused on specific Chinese firms to controls directed at China as a country marked an important strategic pivot. The opacity of China's market, the opportunity for transfers and to divert export-controlled goods between entities within China, and China's civil-military fusion strategy all make it likely the U.S. will need to deploy country-wide export controls in future campaigns against other critical elements of China's technology sector. To be sure, entity-based export controls will always be important to call out the harmful activities of

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[2] Olena Bilousova, Benjamin Hilgenstock, Elina Ribakova, Nataliia Shapoval, Anna Vlasyuk, and Vladyslav Vlasiuk, "Challenges of Export Controls Enforcement: How Russia Continues to Import Components for Its Military Production," *Kiev School of Economics*, January 2024, p. 8, https://kse.ua/wp-content/uploads/2024/01/Challenges-of-Export-Controls-Enforcement.pdf.

[3] "Intelligence suggests slowdown in Russian military industry — Zelenskyy," *New Voice of Ukraine*, Dec. 21, 2023, https://www.yahoo.com/news/intelligence-suggests-slowdown-russian-military-214500632.html.

specific firms and as a way of restricting exports to Chinese companies operating in third countries, such as Southeast Asian countries. But I expect that the U.S. and our allies will increasingly need to impose country-wide controls to address diversion risks and to ensure that export controls are successful in advancing strategic objectives.

Second, I recommend that the U.S. and its allies minimize the time lag between signaling or announcing export controls and the actual effective date of such controls. There is significant evidence that Huawei was able to use the lead-up to the Trump Administration's well-signaled 2020 export controls against the company to stockpile western semiconductors, blunting the controls' impact in the months after came into effect.[4] Similarly, publicly available trade data suggests that last year Chinese semiconductor manufacturing firms used the months before implementation of Japanese and Dutch controls on semiconductor manufacturing equipment to speed up equipment purchases.[5] This, too, will likely undermine the effectiveness of the controls in the short term, although the benefits of stockpiling fade over time as firms run through their stockpiles. (The export controls that the U.S. and its allies imposed on Russia generally had much shorter implementation periods).

Third, the government needs to do a better job of integrating its sanctions and export controls tools. After the U.S. and G7 allies imposed export controls on Russia in 2022, Russia pivoted to China and a handful of other countries, such as Turkey, to procure replacement goods. To address the flow of dual-use goods from these countries to Russia, in December 2023 President Biden issued an Executive Order (E.O. 14114) authorizing the Treasury Department to impose sanctions against third country banks that facilitate the sale of dual-use goods to Russia. While recent trade data show that many Chinese exports to Russia are continuing, the data also suggests that the E.O. is having a useful impact: for example, earlier this year Chinese exports to Russia appear to have modestly fallen after rising for most of 2023 (albeit off of lows in 2022).[6] The U.S. government should explore mechanisms to build on this precedent to reinforce the potency of U.S. technology export controls on China. For example, an Executive Order or congressional sanctions program could authorize sanctions against companies in countries that do not participate in U.S.-backed export controls when those companies sell high-end semiconductors or semiconductor manufacturing equipment to China, as well as against institutions that facilitate such sales.

Fourth, the failure of sanctions and export controls to deter Vladimir Putin from invading Ukraine leaves me skeptical that the threat of sanctions and export controls will deter Beijing from attacking Taiwan or a U.S. ally such as the Philippines, if Xi Jinping decides that he needs to deploy his military to achieve an objective he views as essential. In those circumstances, I fear that Xi, like Putin, may view sanctions and export controls simply as a price to be paid. This is not to say that the threat of sanctions and export controls cannot change Chinese behavior; but we cannot count on them to succeed as a last-ditch deterrent to military conflict.

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[4] See, e.g., Lauly Li and Cheng Ting-Fang, "Huawei builds up 2-year reserve of 'most important' US chips," *Nikkei Asia*, May 28, 2020, https://asia.nikkei.com/Spotlight/Huawei-crackdown/Huawei-builds-up-2-year-reserve-of-most-important-US-chips.

[5] "China Buys Near Record $40 Billion of Chip Gear to Beat U.S. Curbs," *Bloomberg*, Jan. 22, 2024, https://www.bloomberg.com/news/articles/2024-01-22/china-buys-near-record-40-billion-of-chip-gear-to-beat-us-curbs?sref=HblxZSKM.

[6] See, e.g., "China's Exports to Russia Slump Amid US Threat of War Sanctions," *Bloomberg,* April 16, 2024, https://www.bloomberg.com/news/articles/2024-04-16/china-s-exports-to-russia-slump-amid-us-threat-of-war-sanctions?sref=HblxZSKM.

In my view, the most important deterrent to Beijing engaging in military adventurism is Beijing's concern that it would fail to accomplish a military objective—that, like Putin, Beijing would face either a protracted military struggle or an outright military loss. This leads me to my next recommendation: that the U.S. undertake a comprehensive review of our sanctions and export controls to identify chokepoints that can further slow China's military development.

Of course, the U.S. and our allies have long prohibited the export of military technologies to China and have restricted the flow of dual-use technologies to Chinese military end users and end users. U.S. semiconductor export controls are intended to slow China's military advancement. But China's military development does not rely only on military technologies and on semiconductors. It relies on a range of both emerging high technologies—technologies such as autonomous flight systems, quantum computing, sensors, and robotics—and on more traditional military industrial base sectors, like aerospace. The U.S. should undertake a comprehensive review of potential technological chokepoints across the Chinese military industrial base, and, working with allies, deploy export controls and other tools to leverage those chokepoints to slow China's military advancement.

A fifth lesson from U.S. export controls on Russia and China is the need for effective implementation and enforcement. In the years after the 9/11 terrorist attacks, the U.S. Treasury Department and global banks undertook a years-long campaign to radically overhaul the way both the Treasury and the private sector enforced U.S. sanctions: expanding customer due diligence; developing systems to spot, report, and, when appropriate, stop, suspicious transactions; and to harden the financial system against the flows of terrorist finance. We need a similar long-term initiative with respect to export controls to strengthen corporate compliance, improve information-sharing between companies and the government, and appropriately resource export controls offices across the U.S. government.

Indeed, there is some evidence that stopping smuggling and improving compliance by western firms could be at least as important as cracking down on third country suppliers, like China. The Kiev School of Economics' January 2024 report on export controls found that of 2800 different non-Russian components that experts recovered from from Russian weapons in Ukraine, almost all of the components—95%—originated from Western firms, with only about 4% of them originating from Chinese firms.[7] Many of these components were likely manufactured by western firms in third countries, including China, where they disappeared into shadowy networks of middlemen. But the fact that components made by western firms remain so overwhelmingly common inside Russian weapons suggests that companies and government can and should work together to strengthen compliance.

Particularly given that export controls often involve physical goods, the government and private sector should develop better physical traceability mechanisms for sensitive goods. For example, recent press reports have described the smuggling tactics that Russia deploys to source replacement

[7] Olena Bilousova, Benjamin Hilgenstock, Elina Ribakova, Nataliia Shapoval, Anna Vlasyuk, and Vladyslav Vlasiuk, "Challenges of Export Controls Enforcement: How Russia Continues to Import Components for Its Military Production," *Kiev School of Economics*, January 2024, p. 5, https://kse.ua/wp-content/uploads/2024/01/Challenges-of-Export-Controls-Enforcement.pdf.

parts for its civilian aviation fleet, which still consists largely of Boeing and Airbus aircraft.[8] Physical geolocation tracking tags with built in "kill switches" could, over time, make it much harder for Russia to procure such parts, or for China to covertly source semiconductor manufacturing equipment.

Before turning to remarks on the need for a comprehensive technological control strategy, I want to speak for a moment about the costs of export controls.

Increasing the number and variety of U.S. export controls and the scope of compliance expectations will create costs for U.S. businesses. A company spending millions of dollars on export controls compliance is not spending that money on R&D, investment, or returns to shareholders. A company that loses out on a market opportunity will not build a factory here in the U.S. to serve that demand. If the U.S. acts too unilaterally in too many export controls cases, the U.S. does risk creating incentives for foreign firms to design out U.S. components, ultimately weaking both American companies' market position and the power of U.S. export controls.

Yet while we should always weigh these costs carefully, we also should not over-weight them. Reports by Bloomberg and the Atlantic Council (among others) show that the costs of a cross-strait conflict between China and Taiwan would be catastrophic for the global economy, likely inflicting trillions of dollars of economic damage.[9] Preventing such a conflict has enormous economic value, not to mention the value of preserving the international order. A Russian victory against Ukraine would necessitate hundreds of billions of dollars in additional U.S. and European defense spending to ensure that Russia could not leverage victory in Ukraine into an attack on a NATO ally. Failing to impose export controls can carry costs, too.

Moreover, calculating costs is complicated as markets are dynamic. Cost calculations are not simply a matter of calculating the value of U.S. exports of a widget and assuming that that will be cost of an export control on that item—in many cases markets may adjust, particularly with respect to China, which multinational companies are already diversifying away from. For example, according to the Semiconductor Industry Association (SIA), approximately 29% percent of global semiconductors are sold in China.[10] Certainly, the prospect of losing access to 29% of the global market would be damaging to most firms. But as SIA notes, a large share of the semiconductors sold in China are incorporated into products assembled in China but ultimately exported to the world. As electronics supply chains diversify away from China in the coming years, it is reasonable to expect that China's share of global semiconductor sales will decline.

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[8] Chris Cook, Sylvia Pfeifer, Polina Ivanova, and Chloe Cornish, "The smuggling trail keeping Russian passenger jets in the air," *Financial Times*, May 10, 2024, https://www.ft.com/content/f8d61a5d-708f-47c4-8dbd-0e80452dea5a.

[9] *See* Jennifer Welch, Jenny Leonard, Maeva Cousin, Gerard DiPippo, and Tom Orlik, "Xi, Biden and the $10 Trillion Cost of War Over Taiwan," *Bloomberg*, Jan 8, 2024, https://www.bloomberg.com/news/features/2024-01-09/if-china-invades-taiwan-it-would-cost-world-economy-10-trillion?sref=HblxZSKM; Charlie Vest and Agatha Kratz, "Sanctioning China in a Taiwan crisis: Scenarios and risks," *Atlantic Council*, June 21, 2023, "https://www.atlanticcouncil.org/in-depth-research-reports/report/sanctioning-china-in-a-taiwan-crisis-scenarios-and-risks/.

[10] Semiconductor Industry Association, "2024 Factbook," May 14, 2024, p. 10, https://www.semiconductors.org/wp-content/uploads/2024/05/SIA-2024-Factbook.pdf.

This is why I recommend that the Commerce Department expand its capacity to rigorously analyze and model the expected costs of U.S. export controls. Last year, the U.S. Treasury Department's Office of Foreign Assets Control (OFAC), which administers U.S. financial sanctions programs, created an Office of the Chief Economist to help OFAC and the U.S. government better evaluate both the impacts and potential costs of U.S. sanctions. The Commission should recommend that Congress direct the Commerce Department to establish a similar unit at the Bureau of Industry and Security to conduct economic analysis with respect to U.S. export controls.

Towards a comprehensive strategy for export controls:

In the interest of time, I plan to offer more concise remarks on the two remaining topics I will address today: the need to develop a comprehensive strategy for U.S. export controls on China and the need to better manage U.S.-China data flows and the use of high-risk Chinese technology inside the United States.

As I said a few minutes ago, I see the U.S. semiconductor export controls on China as having the hallmarks of an effective strategy to limit the flow of high-end semiconductors and semiconductor manufacturing equipment to China. But having an effective strategy to control the export of semiconductors and certain semiconductor manufacturing equipment to China is different from having an effective export controls strategy with respect to China as a whole. The strategic goal of U.S. export controls on China, after all, is not simply to maintain the U.S. advantage in one specific technology, but rather to maintain a significant military and technological edge over Beijing. The U.S. and our allies need to do across a range of critical technologies what we have now done with respect to semiconductors: identify technological chokepoints, and then leverage those chokepoints to slow China's development across a range of critical technologies.

The first step towards a comprehensive strategy for U.S. export controls on China is to develop a more fulsome and generally agreed list of the technologies that the U.S. should work to control, given our strategic objectives. I generally agree that when it comes to export controls the U.S. should, in the words of U.S. National Security Advisor Jake Sullivan, seek to build a high fence around a small yard. But we still need to reach a domestic consensus and an agreement with our allies and partners about the specific technologies and sectors that should be kept inside that fence.

Fortunately, the U.S. government already maintains a list of critical and emerging technologies that export control policymakers should consider as the basis for such a list: The Office of Science and Technology Policy's (OSTP) "Critical and Emerging Technologies List." [11] The most recent update to this list, which OSTP released in February 2024, contains 18 technologies: including advanced computing, AI, autonomous systems and robotics, semiconductors, and advanced materials, among others. This list reflects both a consensus among the U.S. Executive Branch about the technologies of greatest concern, and includes a number of technologies where we have seen recent work with allies to increase multilateral export controls at least where there are clear military applications of a technology.

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[11] White House Office of Science and Technology Policy, "Critical and Emerging Technologies List Update," Feb. 2024, p. 2, https://www.whitehouse.gov/ostp/news-updates/2024/02/12/white-house-office-of-science-and-technology-policy-releases-updated-critical-and-emerging-technologies-list/.

In my view the U.S. government should work with allies and partners to identify potential chokepoints across the range of technologies on the OSTP Critical and Emerging Technologies list and evaluate the ones where export controls could play an important role in maintaining America's edge. Then, as OSTP periodically updates the list over time, export control policymakers should similarly update the focus of technology-related export controls. Developing effective export control strategies across this range of technologies will, of course, require additional resources, and I would urge Congress to expand resources for the Bureau of Industry and Security and other relevant export control agencies. Given that most export controls need to be multilateral to be effective, and considering the time and effort it usually takes to convince allies and partners to join in imposing multilateral controls, I second a recommendation that my co-panelist Kevin Wolf has made in his written testimony that the U.S. government appoint a senior-level diplomatic envoy tasked with building multilateral support for strong export controls.

But I think that an export control focus limited to critical and emerging technologies would be too narrow. As I said earlier, in my view the most effective way to deter China from engaging in a military conflict with one of its neighbors is to maintain a situation in which Beijing assesses it would not readily prevail in such a conflict. Consequently, in my view a comprehensive U.S. export control strategy should focus on ways to degrade Chinese defense industrial base sectors key to China's military modernization program, such as China's aerospace sector, which continues to rely heavily on western components and expertise.

Historically, one of the major objections to expanding U.S. export controls on Chinese defense industrial base sectors such as aerospace is that the U.S. would be unlikely to convince allies to impose parallel controls, and, as a result, the U.S. would simply disadvantage U.S. aerospace firms relative to their western competitors while having limited impact on China's development. I certainly agree that in many cases unilateral U.S. controls on major Chinese defense industrial base sectors would impose significant costs on U.S. companies while having limited impact on Chinese advances.

However, the deepening ties between China's defense industrial base and Russia's defense industrial base may present the U.S. with a moment of diplomatic opportunity. Having recently returned from discussions in Europe, it clear that European policymakers are deeply disturbed by recent public revelations about the depth of Chinese support for Russia's defense industrial base. This potentially opens the door to multilateral export controls that could be used to weaken China's own defense industrial base. At the very least, it is worth serious diplomatic discussions with our allies to determine what scope there might be to do so.

High risk Chinese technology and data flows

This brings me to the third and final topic that I would like to discuss, the need to develop a framework for managing the risks the U.S. faces from certain data flows to China and from the use of certain high-risk Chinese technology in the U.S.

In recent years both Congress and the Executive Branch have taken multiple important steps to address the risks posed by specific high risk data flows to China and by specific high-risk Chinese technology in the United States. Just last month, for example, Congress passed legislation that will, if upheld by the courts, require Chinese company ByteDance to divest its ownership of social media company TikTok or impose a ban on the distribution of TikTok in app stores in the U.S. This law

will help ensure that China cannot use TikTok to either collect sensitive data about Americans or covertly influence U.S. public opinion, and is consistent with U.S. restrictions on foreign ownership of U.S. media that date back more than a century. Congress has directed many U.S. government agencies to stop using Chinese drones, given the risk that they could send data back to China, and is currently considering broader restrictions on Chinese drones. The Department of Homeland Security earlier this year published an advisory about the risks that U.S. critical infrastructure firms could face from using Chinese drones. The Coast Guard is currently working to limit the use of Chinese cargo cranes in U.S. ports, given the risk that they could be used to track sensitive cargo entering and departing American ports.

The FCC has over the past year or two restricted the use of certain Chinese-made security cameras in the United States. The Commerce Department in early March published an advance notice of proposed rulemaking indicating that it may develop a rule restricting the use of Chinese connected car technology in the United States, given the potential for cameras and other sensors on U.S. cars to send sensitive data to Beijing. In February President Biden signed an Executive Order (E.O. 14117) directing the Department of Justice to establish new rules regarding the export of certain high-risk, bulk data to China and other countries of concern. The CFIUS Committee has reported that it has required data localization measures as part of the CFIUS approval process. Last month, as part of the same bill that seeks to force ByteDance to divest TikTok, Congress also passed legislation that empowers the Federal Trade Commission to enforce a ban on data brokers sharing or selling personally identifiable sensitive data to companies in China, Russia, Iran, and North Korea.

Each of these actions, individually, is important to protect U.S. data and U.S. national security. The Congress should continue to consider appropriate legislation as specific new threats arise. But the variety of actions—and this list is only a subset of the actions taken in recent years—is intended to illustrate my view that over the long term the U.S. needs to move beyond a piecemeal approach to addressing discrete risks to an integrated, proactive approach.

China has long been able to gain access to sensitive U.S. data through at least four primary vectors:

- Beijing can buy it, for example by purchasing data from data brokers or buying U.S. and third country companies that have access to sensitive U.S. data.

- Beijing can get Americans to give data to them voluntarily, for example by using Chinese apps and software that collect it.

- Beijing can introduce backdoors and other vulnerabilities into software and hardware used in the United States to covertly collect it.

- Beijing can hack into U.S. IT systems and steal it.

What the U.S. needs is an integrated approach that would address each of these threat vectors comprehensively. In my view, this includes at least five major lines of work:

- A national data privacy law that would limit the collection, aggregation, and sale of Americans' personal data. This would not only restrict Chinese companies and fronts for

Chinese companies from purchasing U.S. personal data, it would also make it more difficult for Chinese hackers to get access to bulk personal data because there would be less such data to hack in the first place.

- Continued development of cybersecurity standards to ensure that companies that store sensitive data and that operate software in critical infrastructure sectors are better able to resist malicious hacking by China and other threats.

- Targeted measures to prohibit the sale or transfer of certain sensitive data to China, building on the ongoing process to implement E.O. 14117.

- Continued use of CFIUS to ensure that Chinese companies, and companies that might be subject to Chinese influence, are not able to purchase U.S. companies and then get access to the sensitive data that those companies hold.

- A systematic approach to identifying and mitigating the risks posed by high-risk Chinese software and hardware in the United States. For example, Congress could codify and expand the Department of Commerce's "ICTS rule" and direct the Department to develop a framework and workplan to systematically evaluate which Chinese technologies in the U.S. should be subject to different degrees of restriction.

Specific actions across these lines of work are beyond the scope of my testimony today. But I would urge the Commission to dedicate a significant piece of work to data and technology security and to provide systematic recommendations to Congress in this area.

Closing

I now want to offer a minute of closing remarks. I have testified before the Commission today regarding export controls on China and on the importance of managing the U.S.-China technological relationship. I believe that export controls can play a vital role in helping to maintain America's technological and strategic edge over China and in reducing China's military potential. But if the U.S. is to maintain its strategic and technological edge over China over the long run, export controls are less important than is fostering domestic investments and technological innovations here in America and across allied countries. We certainly can and should work to trip up Chinese development across key technologies and the development of China's defense industrial base. But if the U.S. and our allies want to stay ahead in the technological and geopolitical race that will define the next decade or more, we must foster our own technological innovation. After all, we can't use export controls to prevent China from obtaining a technology that China simply invents first. My final recommendation to the Commission is that even as the U.S. focuses on export controls, sanctions, and other technological restrictions, we focus even more on the role that America's own innovation and growth will play in staying ahead of our leading geopolitical rival.

With that, I welcome your questions.

PANEL II QUESTION AND ANSWER

COMMISSIONER MILLER: Thank you, Mr. Harrell. Thank you for all your testimonies, you've given us quite a lot to chew on, and of course, we have questions. We're going to be going in reverse-alphabetical order, this time, but I will take the prerogative of the co-chair to start us off.

It seems almost every day we wake up to a headline about yet another Chinese firm getting added to the entity list, which is great. It looks like the process somewhere, somehow, is working. But of course, it's very hard to tell. Now I find it rather amusing to see the entity list so often called a black list, when of course, it's not a black list, it's just a licensing step.

But one of the reasons this process might be so thoroughly misunderstood by so many people is that the process is pretty much done entirely behind closed doors. Often the only way to learn about the licensing decisions is if some of these companies report it themselves. Others we still have no idea how they ended up. Why shouldn't the licensing process be more transparent? This is a question for all of you. And why shouldn't all, or almost all of the information, on these licensing decisions be publicly available? Mr. Wolf, if you would like to start.

MR. WOLF: Sure. I ran the entity list process for seven years as assistant secretary and it's evolved dramatically since it was first created in 1997, exclusively as a tool to identify entities engaged in weapons of mass destruction as part of the enhanced proliferation control initiative reforms in the 1990s, and each administration has broadened the scope of its tool.

But the core thing to keep in mind about it is that it is an end user control, meaning it's on a specific entity and no other country has end user controls. It's an inherently unilateral tool, and although has been since the Huawei case applied extraterritorially, in some cases if items are made from U.S. technology or equipment, no other country is going to be regulating anything that they export unlisted to any of the other listed entities.

With respect to the licensing, the SMIC and the Huawei cases are really unique. If you look at all of the 2000 or so listed entities, 99 percent of them all have a presumption of denial policy. The SMIC and the Huawei cases are really unique in the history of entity list processing of having objective policies of allowing licenses to occur for different reasons. It wasn't until Huawei that a license really had ever been granted to a listed entity because the point was to impose pressure on the company by not having access to the U.S. economy to change its behavior.

So, in terms of whether the policy should be open, it depends on whether you want to have a licensing policy in the first place, or if it's a black list. In terms of being open to the public, the standard for what should be approved or not should be quite standard, above 5G, below 5G; that should be perfectly transparent, absolutely. That's the whole point.

In terms of who submits what license for what, there are long-standing principles of keeping business proprietary information within the subject matter experts within the U.S. government and the Congressional oversight committees. This isn't really a topic for the public to consider; it's between Congressional committees and the staff. Otherwise, you discourage candor and transparency and openness in companies coming into the government and seeking permission.

So, to answer your question, the standard should be very public and transparent, but what the role is, what the purpose of the list is, is it effective given that it's completely unilateral when there should be a presumption of denial or case-by-case policy to accomplish different

objectives. But I would still advocate for when a license could be granted, that that be kept within the export control agencies in Congress.

COMMISSIONER MILLER: Thank you. Ms. Cinelli.

MS. CINELLI: So, Commissioner Miller, I agree with your initial comment about there's a misunderstanding concerning the entity list in particular. It is not a sanctions list like the Office of Foreign Assets Control. It is designed to be flexible, it has multiple standards and while there may be presumptions that apply, I think there is a misunderstanding that simply because licensing is approached with a presumption of denial, that means that every license is denied.

That is not the case, and has never been the case. And the same applies with the presumption of approval, it doesn't mean if that's the presumption there could be circumstances where it is not appropriate in the eyes of the deciding agencies that a license issue in that particular circumstance. I think what is challenging though is some of the inconsistencies.

So, to Kevin's point about the confidentiality with respect to licenses, it is in direct contravention to what the Office of Foreign Assets Control did in response to a New York Times FOIA request where they ended up releasing hundreds of pages of licenses with the names of the parties, the types of licenses, and the programs that were issued. And there didn't seem to be a similar concern, and if I were speaking candidly, getting licenses for a sanctioned party where it truly is a form of a blacklist varies dramatically in some instances from granting a license to someone who is on an entity list or perhaps an unverified list or a denied-persons list.

So, I do think it is important to have more transparency. I do think the process is opaque, although you may cite 744.11 as a standard for placing someone on the entity list and the assistant secretary, Axelrod, published a memo about how if a foreign government denies access to the U.S. government to verify whether a particular product or technology made it to where it was supposed to be, there's a process for elevating people onto different lists, and you have 60-day periods.

That is not the same as saying if someone does the following three things a license will be denied, or if someone does the next three things they will be placed on a list. And that is what industry, that type of visibility, is essential because industry is at the front lines. They're the ones making the decisions on which parties to deal with and under what circumstances, and then trying to decide what kind of licenses are needed.

COMMISSIONER MILLER: Thank you. Mr. Harrell, we're out of time, but I want to make sure you still get an opportunity to answer this question if you like.

Okay. We will move on then to my co-chair Commissioner Wessel.

COMMISSIONER WESSEL: Thank you all for being here. The intellectual power on these issues and involvement over decades is appreciated and noted, and each of you has made major contributions in this area, so it's appreciated.

I'm constantly challenged by this area because of its complexity, but also what I see on a daily basis of what I think are some inconsistencies. We've seen over the years, and please, any of the participants, the witnesses, correct me, of gaming with NAICS codes and a lot of other things that allows parties to try and get around the process and to seek to continue to engage in certain activities that I think from a broad policy perspective many in both the Executive and Legislative branch frown upon, if not worse.

What kind of gaming do you think goes on that in your view, if there is any, that would be in need of addressing and how would you do so?

Ms. Cinelli, do you want to start?

MS. CINELLI: Thank you, Commissioner Wessel, that's a very insightful question. I just want to step back for a moment from the word gaming. I think it should be distinguished from taking advantage of the flexibility of the system. So, to utilize your NAICS code example, those are self-designations, absent very select circumstances where let's say in a government contract you may have a contracting authority designating a particular NAICS code for use. That becomes a question of an industry sector or a company saying I belong in this sector. It's a little bit like what happens with the harmonized tariff code where someone says I think this particular code is much more conducive to my product than another code.

So, I'm not advocating and don't think it would be appropriate to take that flexibility away, but I do think what is missing in some of these areas is guidance on how these decisions should be made. Are there circumstances where there are specific factors that should be looked at to decide which bucket you fall in. So I'm a services provider, but there's no legal services provider NAICS code, let's say. Or I might be a consultant as well as a legal services provider, so I have three options that I can choose. But I don't really have specific guidance to say this is how you pick the best one. It's a little bit like taking law school exams, you know? You kind of pick the one that is best.

So, clarifications on how these decisions should be made, specific factors that should be examined to allow industry sector to make a reasoned justifiable decision on which category is best. I think the same thing applies in the export world because the bane of every company's existence, just to speak candidly, is export classification. That runs the gamut not only in trade areas, but in CFIUS.

It will impact outbound investment, it impacts government contracts, just across the board. And if you cannot assess what category you actually fall in, you're going to have the same kinds of problems because foot faults will occur. So, guidance needs to be crisper and clearer to allow people to make reasoned decisions.

COMMISSIONER WESSEL: I appreciate your disagreement with the gaming qualification, although I'll stand by it. Is there a way of trying to prohibit that? Again, I look at outbound, for example, and mandatory notification, and the ability then of the governmental authorities to decide what falls into the specter of needing to be addressed. And I know it's impossible to say that every single export is going to be reviewed. Is there a better way? Is there something we can do?

MS. CINELLI: So let me look at the outbound investment for a moment because Executive Order 14105 identified three areas: semiconductor and micro-electronics, quantum, and AI. It's interesting from the perspective of your question, only semiconductor and micro-electronics is sufficiently mature from a classification perspective to actually provide industry some guidance on how Treasury is perhaps going to implement the outbound investment regime, whether it's going to be a combination of notices, denials, prohibitions.

But the other two areas lack framing. They lack consistency and there really is no definition. And until those terms are defined, however they're going to be defined, it will be very difficult for industry and investors to make a decision on what may be prohibited. Make it equally difficult for the government to sustain any actions it might take in those areas. In essence, it would subject it to challenge because it's vague and it's unclear.

So, I think the first thing is to go back to foundations, Commissioner Wessel, and decide what, for example, within quantum, you want to look at. And if you're going to define it by performance characteristics then do so. By thresholds, then do so. Same thing with artificial intelligence. And then you need to look at the industry sectors.

So, the example I'll give you is pharma. Do we really want to restrict the use of AI to better the clinical trials process and share that globally? That's a policy question. There's public health, there's global engagement benefits to that, but at the same time, that type of activity can be misused because as well as helping with clinical trials, it can also be used to create designer viruses that can attack only certain types of people and that becomes a weapon. But there are different nuances in the technology, not just the application, and that needs to be identified or else we're going to remain in this reactive mode; and it will be ineffective.

COMMISSIONER WESSEL: I've gone over, our other two witnesses have thoughts they can submit for the record so that everyone has a chance. I'd appreciate it.

COMMISSIONER MILLER: Thank you, Commissioner Wessel. Commissioner Stivers.

COMMISSIONER STIVERS: Thank you all for being here today. Ms. Cinelli, I'm really interested in your recommendations regarding the authorizing a development of one export control list and one sanctioned parties list. I've tried to do research on where PRC companies are in our sanctions regime, and I've failed miserably in this endeavor. So just for organizational reasons, I'd love to see that.

But in terms of clarity to business, clarity to government officials, my first question is, what are the obstacles to doing that, you know, both political and substantive? Does it make, I mean, are there reasons why it should be separated more? Can you expand a little bit on that recommendation?

MS. CINELLI: So, thank you for that insightful question, Commissioner. I think there are reasons for why licensing decisions are different, but the list itself should be common because whether it's the Commerce Department looking to license drones or the State Department looking to license drones, it's still drones.

And drones should be defined in a common way, and then the agencies that have equities in the licensing process can go to a common list and then carry their equities into their licensing decisions. And so, I don't see a practical obstacle to having one list.

Now, on the political side, I am not at all conversant with Congress, but I do understand that committees of jurisdiction are very interested in retaining their jurisdiction. And sometimes there could be disconnects on where it might be more effective to place jurisdiction. If there could be agreement, then it would be helpful to actually have that political will demonstrated in supporting that.

COMMISSIONER STIVERS: Thanks for that. Taking that a step further, PRC companies are on a number of red flag and sanctions list. We have the Uyghur Forced Labor Prevention act entity list, the non-SDN Chinese Military Industrial Complex Companies list, the list established in NDAAs in 2019, 2021, 2023, the military end user list, the Federal Communications Commission's Covered List, the entity list, withhold release orders and findings list related to forced labor. The list goes on.

Does it make any sense? China's a unique challenge. It's different than other countries. We have a lot of political momentum, at least to address the China challenges. Does it make any sense to have a China export control and sanctions list and keep that separate, maybe from the other export controls and sanctions lists?

MS. CINELLI: I don't have a defined view on that. I think, however, that because we look at China today through the lens of today, which was very different than the lens of the 1970s, '80s, and '90s, it may not be as effective to simply say, well, we're going to put a China list because maybe in ten years we need another country list and another country list.

But I do think it's important to take a look at China, because two unique issues with China, the corporate formation process and what constitutes a private or government organization in China, is not aligned with how we see in the United States the standard corporate definitions. And so when we apply an overlay of U.S. requirements to that, we end up missing some of the issues because we say, well, this is a company in China. They're organized under the laws, but they're private.

And there have been some significant questions about what that actually means in China. Some have even gone so far as to ask, could you ever even have a private Chinese company, depending upon the constructs? So I'm not sure a separate list on China would be effective per se, but I do think that one of the challenges is, and I did a study and I have a chart on this, I looked at all 19 lists, 1260H, 1237, all the ones that you identified.

And when you put them all on a chart, there is some significant overlap in each list. Yes, there are a few that are not, and they usually tend to be subsidiaries or affiliates that meet a particular concern, like from 1260H.

But generally speaking, when you look at a company, you'll see it across ten or eleven lists. So when I look at that, the question very pragmatically is, if I'm going to see the same name and the same address on ten different lists, why do I need ten different lists?

And even consolidating that consistent overlap into a list would be a great leap forward to try to help business so that they can be the partner for the agencies, since they're at the forefront. And so, yes, I would consolidate.

COMMISSIONER STIVERS: Mr. Wolf, Mr. Harrell, any comments on that?

MR. WOLF: Very quickly. I spent seven years of my life as assistant secretary trying to create a single list of controlled items that was the core foundation of the Obama administration's export control reform effort. So I have a long list of descriptions about why it's a good idea and why it failed. Peter, thoughts?

MR. HARRELL: Well, I'll talk about the entity-focused lists rather than the item focused lists, which I think was much of a thrust to your question, and I want to agree with Giovanna. If you actually kind of map them, you often find the same entity on multiple of these different lists.

That said, and I do think that having an easier centralized search function and that is useful, I do think we have to recognize the reason for these different lists in some ways reflects actually significant policy judgments that we should impose different sets of restrictions on these different entities.

And so in particular, designating a Chinese company like Huawei on the SDN list, for example, would have substantially larger impacts than the current restrictions it faces of sort of no U.S. person investment under CMIC list and the export control list. In particular, it could make it quite challenging for telecom network operators in Europe and elsewhere who have legacy Huawei equipment in their stack to continue to use that equipment.

And so there is, I think, a deliberate judgment made with respect to Huawei. And I personally think we should be increasing the pressure on Huawei. But, you know, at the time, we're trying to balance equities. We'll hurt them by denying certain technology exports to them. It will hurt them by denying investment opportunities. But the collateral costs to sort of, you know, Deutsche Telekom and others would be challenging if we put them on the SDN list.

And I think we will find going forward, as we look to put pressure on large, globally significant Chinese companies who have global operations, we are going to need to take a sort of, you know, slicing-the-salami approach to them, which is going to result in some but not all

types of restrictions being applied to them, and potentially different companies facing themselves subject to different types of restrictions.

One thing, though, I do actually think as a default or a personal view, as a default, if we are putting an entity on the entity list, company on an entity list, at the very least I think there should be a presumption we would also restrict U.S. person investment in that company.

Because even if you can make arguments, well, maybe that company, you know, has a role around the world that we can't disrupt today without diplomatic costs, it's hard for me to envision a case where we're saying we're not going to sell you technology, but we're going to let our people invest capital in you.

COMMISSIONER STIVERS: But we're doing just that.

COMMISSIONER MILLER: Thank you. And we will look forward to getting Mr. Wolf's entire lessons-learned list into our follow up testimony. Commissioner Sims.

COMMISSIONER SIMS: Thank you all. There's certainly been, over the last few years, a growing consensus around the threat that China poses. But any kind of departure from that consensus, I have noticed, usually comes from the economic side of the house.

So, like people that focus on national security, nobody, everybody agrees pretty much on the threat that China poses. But any delineation from that, again, is that economic focused people, and I say that as a pretext for saying I was struck by Mr. Wolf, your prepared testimony. I read it all.

It talked a lot about your interactions with people from foreign countries, whether it be governor, officials, think tankers, industry folks and their perception that these export controls that the U.S. is imposing are being concocted for political reasons rather than real, justifiable national security reasons.

And I believe in your prepared testimony, you'd also talked about, and I love that you threw out like a thousand ideas. I was like, you know, wanted to riff on all of them. But one of them that was interesting was this kind of ambassador for export controls, for lack of a better way to put it, and it reminded me of during the Trump administration, the undersecretary of state for economic growth, Keith Krach, kind of performed that function with regard to Huawei.

And it made me think that sometimes in government, it takes a force of personality, somebody, like, entirely focused on something to, like, get consensus behind anything to happen. And so what I'd love to hear from all of you on is what are some ways, from a communications perspective, could we help some of these people who, particularly on the economic side of things, they don't focus on national security issues, really understand the importance of these export controls. And several of you talked about kind of an AUKUS framework in this space, whatever these things may be.

I would love to hear if you have any ideas of how we could better communicate these things and rally more consensus around them.

MR. WOLF: I'll be very brief. I agree with everything you said. Great summary of what I wrote in terms of the reaction of the allies and my recommendation for somebody focused full-time on doing nothing but the hard work of listening to the allies, understanding their systems, their quirks, their business issues, their legal constraints, what could be changed, and then working to convince them that a new way of thinking about export controls is in their security interests as well.

And so we need to pull the militaries in from each of the countries so it's not just discussions with their trade ministries and foreign ministries to be able to connect this to a security issue so that, you know, a Japanese fighter and the pilot in it knows that there's not

technology going to make the Chinese fighter more competitive against it. So it's not just about trade. That's one.

Two, it needs to be at a higher political level, I think, within each of the governments. I love the career staff at each of the agencies that I've worked with, but this needs to be escalated into a higher sort of White House to White House executive kind of function as well.

And then I've got a long list in my testimony of, you know, sort of other ideas to make it happen as well. But I want to make sure Peter and Giovanna have their thoughts on the question. But it was a great summary of what I was advocating. Thanks.

MS. CINELLI: Thank you, Commissioner. I agree with Kevin's comments about the perspective. I think one of the biggest challenges is the information sharing, for a number of reasons, on the intelligence and let's say military and defense side may not be as robust or consistent across all the allies. So they may be looking at things through a different lens than we are. And so perhaps opening that aperture to help them appreciate.

And I think that that was a foundational element of the AUKUS group where there was already sharing through the Five Eyes consortium, but there was specifically identified more granular information provided that allowed the governments of Australia and the U.K. to appreciate through a new lens what exactly was happening. And that helped to counterbalance some of the economic arguments and some of the distinctions.

I do think also to Kevin's point, the difference in the legal systems and the difference of what is considered important to each country will drive their ability to agree with us.

Just candidly, I think our powers of persuasion right now are not so great for a variety of circumstances, and I think that maybe over the last ten years they've waxed and waned for a number of different circumstances. But persuasion is really only effective if there's a common understanding of what it is that we're trying to solve. And I don't know that we've actually been as helpful in allowing allies to understand what that common understanding is that's not in 140-word X or Tweet, whatever we call it today.

MR. HARRELL: So, I agree very much with Kevin's recommendation on some kind of ambassador at large, because I think there's both the issue of how do you drive continued attention to a particular high profile item like Huawei. But there is also at least as important what Giovanna talked about, which is many of these other countries have very different legal regimes.

And if we're going to get them to ever align with us more in a legal sense, you need somebody who over a couple of years can go and prod a foreign government, which includes not just the executive branch, but also often legislatures and things like that, to really sell them on a shared vision. So, I very much agree with Kevin, Kevin's recommendation.

I think another piece of it, and part of this is, particularly having recently been in Europe, to talk about China and sanctions and export controls on China, you need to build the public narrative with our allies and partners. It can't just be government to government. We need somebody to go out to much more build the public case about what China is doing to modernize its military, around the human rights abuses, which I think often, I think are very serious and also resonate in many of our allies and partners very significantly.

But I think we need to focus more on that public narrative with our allies and partners and get out of the government to government channels. Because I think that if there's no, if you're in a country like Germany or in a country like Italy, and there are strong commercial interests, and there is one status quo with China, and there is no public narrative about the downsides of that, it's just too easy for the political leadership in those countries to default to say, well, you know, politics means we can't do what you, the U.S., would like us to do.

COMMISSIONER SIMS: Well, I'll close by saying, you know, the only way that I would have any influence over who might be appointed such an ambassador would be if there's a change in administration. And so, I will certainly nominate Mike Wessel to fulfill his lifelong dream of serving in the Trump administration as the ambassador for export controls.

COMMISSIONER MILLER: Commissioner Schriver.

COMMISSIONER SCHRIVER: Thank you. And thank you to our witnesses. Really excellent statements, and the conversation so far has been, been really fascinating.

I have two unrelated questions. I want to start with you, Mr. Harrell. I appreciate the point you made about the problematic nature of trying to deter Xi Jinping with the threat of export control sanctions. And your recommendation is to undertake a comprehensive review and see where choke points might be and where we might be able to instill a little more uncertainty into the PLA and ultimately Xi Jinping.

But since the best time to start is today, can you give us sort of a sense of where that review, you know, what are the critical areas where that might land, and where could we start today if we wanted to?

MR. HARRELL: Yeah. So, I think a lot of the focus, understandably, over the last couple of years, when we talk about export controls on China, has been in what we think of as kind of the highest of the high-tech sectors, you know, AI and quantum and semiconductors, and that's all hugely important.

But I think it has been a number of years since the U.S. government has, for example, kicked the tires on, what do we, U.S. government, with our allies in Europe in particular, what are our companies doing to support the aviation sector in China, and China's development to high end engines and things like that, that even if nominally are for civilian purposes in China, obviously have strong dual use. I think reexamining aerospace and civil aviation would be a good place to start.

We obviously have also seen China take a very large share of global shipbuilding, a lot of that's commercial shipbuilding. A lot of that is capacity they now have indigenously, but you know, are there things on the navigation side, like what can we do to throw a little bit of sand in the gears on some of their shipbuilding?

So, I think it's not just, you know, we've been so focused on the high-tech sector, I'd like to see us also kind of go back to some of those core defense industrial base sectors, and really kick the tires on, how can we pull that apart? Slow that down a bit more.

COMMISSIONER SCHRIVER: That's great.

Really appreciate the answer. Second question, different topic. I saw a single list for export controls, single list of sanctioned parties, single point of contact, ambassador, envoy. Why not single agency? I mean the Commission has addressed this in the past, but it seems that you're leading to all but, and I think, Ms. Cinelli, you mentioned there's reasons for having the licenses separated, but it seems to me a lot of the conversation is pointing me in that direction.

MS. CINELLI: So, this is probably one of the few points where Kevin and I will likely disagree. So, I find that it's essential and I want to bring for a moment my Naval Intelligence background in. One of the worst problems we saw when I was at a JIC, Joint Intelligence Command, was the ability to have groupthink to impact decisions.

So, everyone gets together, they're all doing the same thing. It's one organization, they're looking at different inputs, and apparently the people are all different, but those inputs are affected by the nature of the group. And my question, because I don't know that it would be a

concern, but my question would be how do you limit that groupthink? Right now, you have equities from different agencies that are quite diverse.

So even though Commerce and State share a foreign policy overlay and a national security overlay, because the ITAR is managed out of State, there are completely different perspectives and completely different objectives. Were you to consolidate, my concern would be that those would be diluted and you would end up with a process that's simply more bureaucracy, just consolidated, and you would lose the importance of those equities.

MR. WOLF: Again, seven years of my life was focused on creating a single agency with a single list and a single enforcement structure and a single IT system. That was the core of the reform effort. And if an item warrants control, it warrants control. It doesn't matter what list it's on.

And I wasn't advocating, we never advocated removing the inputs and the equities and the expertise from the State Department, Energy Department, Defense Department, that was all factoring into that. But in terms of administering the process for consistency, clarity, enforceability by prosecutors, understandability by exporters, one list, one enforcement agency, one website, et cetera, was something we worked on for seven years and got most of the way but never actually finished. So again, I've got a longer version, but I agree with you.

COMMISSIONER MILLER: Vice Chair Price.

VICE CHAIR PRICE: Thank you. And thank you all for your testimony today. I want to go back to a lot of recommendations, but before I do that, Mr. Harrell, I have notes all over your written testimony on the last segment on high risk Chinese technology and data flow. And I think that's just where you ended when your time was up. You said, TikTok's most recent, the most recent entity to be restricted, but we need to have more proactive… And then you ended.

So, I want to go back to that and get your full point of what you were trying to talk about. I think it was, we have to look at more than TikTok and look at different areas and how to grow that, but would love to hear exactly what you were trying to say at that point.

MR. HARRELL: Thank you very much for the chance to come back to that. I should begin by commending the Commission in this area, because if I look over the last five or six years, I actually think the Commission has done a really important job of highlighting a number of the individual risks from Chinese access to U.S. data and the U.S. use of high-risk Chinese devices, whether it's drones or certain kinds of semiconductors. In your annual reports, you've done a very useful job of highlighting a number of sort of discrete policy areas.

But I think as we look longer term, we just need to take a more systemic approach to thinking about, okay, how does China get access to American data in a high risk way, and how do we close that off? And as I think about it, I see sort of four broad ways that China can get access to American data.

They can go out and buy it. A Chinese company, in light of some recent provisions, data brokers are going to face some new restrictions on sales to China. But until very recently, until as of today, sell data to China, they just come in and buy it. And even after the recent congressional act, barring data broker sales to China will come into force, yeah, they're going to be able to set up front companies to just go out and buy, buy data.

China can get Americans to give them data voluntarily. You know, you log into a Chinese app on your phone, you hand over all your data.

China can introduce backdoors and other vulnerabilities into software and hardware that is sold here in the U.S.

And of course, they can just hack into IT systems to get access to that data.

So, I see sort of four major threat vectors for how China can get access to our data. And then I think you need to think those are the four major threat vectors. How do we comprehensively address all of these major threat vectors? And I think you can lay out a couple of different lines of effort to get there.

I actually start with a national data privacy law, which actually solves a number, hardens a number of the different vectors. It not only makes it harder for China to come in and collect it voluntarily or buy the data, it also makes it harder for them to hack the data, because if there's less data being collected in the first place and stored in repositories, they don't have as much access to hacking in.

So, I'd start there. Then I think you need a set of tough cybersecurity standards, and I commend Anne Neuberger and some of the folks at the White House who have really pushed on this over the last couple of years. Also Jen Easterly at DHS. But I think there's a lot more that needs to be done on kind of hardening the cybersecurity standards.

I want to see robust implementation of the recent executive order on the E.O. 14117 on the data transfers to China and Chinese company collection of data in the United States. I think we, we need quite robust implementation there. And then I think we need to really go through kind of in a comprehensive way, get either Commerce or DHS to kind of go through where we have a lot of Chinese technology embedded in our critical infrastructure networks.

And you see this with drones, see those cranes, but really look comprehensive at those. What are the other kind of areas we need to get them out of our critical infrastructure networks because of the potential for backdoors from the technology we're using there.

VICE CHAIR PRICE: Thank you. So, in one of your answers to Commissioner Sims, you were talking about the public not sufficiently understanding, or maybe that's my words, because that's what I wrote down when I was going through this. Does the public sufficiently understand what's at risk and why we're talking about these issues?

MR. HARRELL: I think here in the U.S., most of the public doesn't sufficiently understand what the data risks are. I do think some people have kind of the view of, I have no privacy anyway, I don't care. But I think that A, that is a minority view. I think the majority view is they don't really understand how much data is being collected about them and what can be done with it.

And even for the folks who profess not to care about their privacy, I think they don't understand what the downsides of that are. I mean, there were some striking public source analyses a couple of years ago, the New York Times did, where they bought, quote unquote, bulk data, which includes the location data from your phone.

And they could then de-anonymize it because, you know, you sort of can get, there may not be a data point name associated with the data, but you can sort of see where the phone is every night, and then you can cross reference that against real estate records and you can say, oh, well, this phone is clearly owned by, you know, John Smith, who owns, you know, One 3rd Street NE, because that's where this phone is every night.

And then you can track, de-anonymize where that phone has moved throughout its lifecycle, literally track somebody and what they've been doing. You know, who's, where have they been spending the night? Who are they with? Who are they meeting with?

I think people don't understand what these risks are. I think we need to do much more to highlight how adverse it could be for China to get access to that kind of data.

VICE CHAIR PRICE: Thank you. We're out of time, but I appreciate it. If we don't have the public commitment, we're not going to get the political will to do this. So, thank you.

COMMISSIONER MILLER: Commissioner Kuiken.

COMMISSIONER KUIKEN: Peter, I'd love to talk about surveillance all day long. One of the last things I worked on in the Senate was the 702 reauthorization. And all the meetings I took were always about how scary government surveillance was. And I always wanted to say, has anyone read the terms of service on any app they put on their phone? You just did a great job of articulating it.

Let me talk to you about the Chinese government's crackdown on tech. Do you think it's over, or do you think it's still ongoing? Peter?

MR. HARRELL: I think that it's going to continue to ebb and flow. I mean, I think China is trying to accomplish a couple of things with their crackdown on tech. I think first, there are a number of prominent entrepreneurs who they thought were getting out of line, and they wanted to kind of crack down on a number of the individual prominent entrepreneurs.

I also think, you know, we've really seen a push over the last couple of years domestically within China in a more nationalist direction. And I think they want to ensure that their tech sector is moving society, in their view, in that nationalist direction.

I think they kind of have realized, you know, over the last nine to twelve months, as they face economic weakness and sort of falling equity prices and decline in foreign investment, that they had gotten so broad with some of their data localization laws and some of their crackdown that it was kind of undermining their short term economic, short and midterm economic objectives.

But what I sort of expect will happen is that they will, you know, they're backing off a little bit. They're seeing if they can stabilize the economy, but if they succeed in stabilizing the economy, get back to growth, they're going to keep a pretty tight lid on tech going forward.

COMMISSIONER KUIKEN: Do you think, let's say they halt with respect to additional actions against certain companies. Do you think we should interpret that as one of the big tech companies in China now being compliant to sort of PLA requests, to get on board with actions and requests from the government?

MR. HARRELL: I think we have seen, yeah, I think it would be fair that most of these companies that are getting out from under the crackdown are making their peace with the Chinese government, which is going to involve, consistent with Chinese laws which require them to cooperate with the Chinese government. They're making peace with that.

COMMISSIONER KUIKEN: Okay, lists. I always love conversations about lists. Jon, or Commissioner Stivers, did a great job of running through the many lists that we've created over the last 30 years.

As I was listening to Jon, though, I was thinking in sort of your responses, one of the things that actually occurred to me is the list that we don't have. If we were going to do list consolidation, is how do we think about capabilities?

Because really, as we think about sort of the more advanced AI, as we think about quantum, as we think about other -- 6G and other technologies, it's how do we really prevent the Chinese government from getting access to these capabilities? What is your reaction to the idea of creating a capability list, vice a -- you know, the 20 lists that Jon went through?

And then how do we think -- what do you think about then creating sort of a tiered approach with respect to Five Eyes countries or NATO countries, almost like a traffic light system where you have sort of red, yellow, green. There's no way to get off the red list. The, you

know, the red light list means. And then what about a green or a yellow light list? Welcome anyone's reaction. We'll start down with Kevin.

MR. WOLF: Are you referring to the existing Commerce Control list, which has a list of the--

COMMISSIONER KUIKEN: What I'm really trying to do, Kevin, is stop thinking about the lists that we have.

MR. WOLF: Okay, well, what you've described is Commerce Control list.

COMMISSIONER KUIKEN: Yeah, to some extent. Yeah.

MR. WOLF: Which is a list of the inputs that you need for AI, quantum, advanced semiconductors, etcetera. There's several thousand page list that Giovanna was describing that has a red, yellow, green approach where an AUKUS country can go to, China, it can't, to Brazil, it depends.

And then there's the Office of Science Technology publishes an emerging and critical technologies list, which is much more abstract. It doesn't actually impose prohibitions on doing anything, but rather it's the types of technologies to study to see if there should be controls imposed.

COMMISSIONER KUIKEN: You're almost making my point for me, which just said the word thousands of pages, and that's where I lost you. So, it sounds like you would argue there's already such a list.

MR. WOLF: Well, the structure of it always needs to be updated to address the issues you're referring to.

COMMISSIONER KUIKEN: Yeah, no, that almost loses the point. Peter, what do you think? And Giovanna, what do you think?

MS. CINELLI: So, I agree with you. I think capabilities, while there is some aspect of capabilities that are addressed not only on the Commerce Control list, but the U.S. Munitions list, the Part 110 Appendix out of Energy, I think those are there. But I think what's missing is, and I look to history, back in the seventies and eighties, the Department of Defense used to publish the Military Critical Technologies list, the Developing Technologies list and the Disruptive Technologies list.

And there're binders and binders. And what they used to do is they used to look at capabilities and they would have charts in there that say hypersonics, and then it would say, here's nine countries, and there would be color coded dots that were fully or half-filled in that would tell you where the capabilities are.

They would track it to the licenses that had been issued in order to decide where there should be additional technology sent because it would either add or not change the situation.

If you look at the testimony when Senator Thompson required the review in the 1990s of the export control process, it was a seven-year study, and every year it was published, David Tarbell, who was the Defense Technology Security Administration director at the time, actually went to Congress and testified and said, I would love to continue this, but I have no budget. And literally, it was a consistent message.

And he said, as between supporting export licensing and voluntary disclosures and CFIUS and everything else, I just cannot repurpose my people to do this. And a decision was made by the policymakers that okay, that's fine. I would suggest taking a look at that list and resurrecting it. And that would be your consolidated.

COMMISSIONER KUIKEN: Yeah. The thing I learned when I was in the majority leader's office is that BIS and the sort of ecosystem of export control cops don't have the money, the people, or the technology to really do the job that they're being asked to do.

So, as we think about sort of making recommendations in there, you know, almost the top of the list needs to be people, money, and technology to do those things. My sense of BIS is that a lot of the work that they do is still on paper and not even on computers. So that is a sort of a tragedy. Am I allowed to ask one more question?

Okay, Peter, since you didn't get a chance to answer the last question, I'm just gonna give you a new one. So, we worked together really hard on CHIPS and Science. As we think about making recommendations on another sort of CHIPS and Science approach, there are three areas that I sort of routinely think about.

One is obviously AI. The second one is BIO. Third one is probably quantum and sort of quantum related technologies, whether it's in the computing space or in the communication space. You've been doing this a long time. Would be interested in sort of your recommendations if I've missed anything. And on the three that I mentioned.

MR. HARRELL: I guess, actually I'm thinking about sort of next iterations of CHIPS and Science. One thing I kind of come back to is we got to finish the deal with the and Science part of CHIPS and Science. As you well know, we got a lot of the funding for the CHIPS part through, but not so much, we're making some headway, but not so much on the and Science side.

And I do think that kind of, you know, long term, especially in the three sectors you laid out, you know, the and-science part and the fundamental research is going, on AI and quantum and parts of BIO is going to be really important. But if I'm thinking more about the industrial policy side, the CHIPS side, like where do we need to make the investments in kind of capacity here? I actually think in many ways building on the kind of what we are doing with CHIPS, but broadening it out to micro-electronics and communications technology is useful.

I think just when I think about AI, there is so much private money pouring into AI right now, and we are seeing more of that, that accelerating every year. I'm not actually sure that finding another-- in a world where our large cap tech companies and our VC companies are probably putting 100, 200, 300 billion a year into AI writ large, finding another five or 10 billion out of the U.S. government coffers. I'd put that just on the fundamental research side, not on the applied development. There's plenty on applied development.

Reality is we're not going to be making on the communications and microelectronics where there's actually a lot of CapEx to build manufacturing capacity. We're not going to be making that here or in our allies without kind of a more assertive industrial support strategy.

COMMISSIONER MILLER: Commissioner Helberg is joining us virtually. Commissioner Helberg, you're up.

COMMISSIONER HELBERG: Thank you. I'd like to focus on Mike's emphasis on capabilities. Leland rightly pointed out that the entities list is often misunderstood as a blacklist, but is in fact more of a licensing requirement. Should the U.S. consider a true blacklist that it can apply to national security threats like DJI and Chinese LiDARs and perhaps, Mr. Harrell, we can start with you.

MR. HARRELL: So, I think that, you know, and we, I think that I spoke earlier about the fact, I think when we're dealing with large Chinese companies, we probably are, for various reasons, going to want to treat them differently. That said, I am sympathetic to the idea. I'm very sympathetic to the idea that where we have a company like Huawei, which is a sort of major

national security threat, and what we have seen is limiting exports and limiting investment to Huawei, has not really succeeded in slowing its development.

Well, it succeeded for a couple of years in slowing its development as a company, but it's now kind of repurposed and is getting back to a global expansion both in its core telecom sector and in new sectors like automobiles and other things.

I think we need to move up the pressure ladder and move more towards a blacklist-type approach for a company like Huawei or towards an SDN approach towards a company like Huawei, while recognizing we're going to have to license, you know, foreign companies for which it is still in the stack.

So, I think we need to be prepared for some of these companies where we've currently been using entity lists to think about whether something like an SDN sanction or an SDN sanction minus a little bit is appropriate because we got to figure out a way to put more pressure on them than just the export control controls that we have.

MS. CINELLI: So, I think, Commissioner, it depends on what your objective is, because if you were to put a blacklist together, I think you would have difficulty with what other panels and my panelists here have said, which is a focus on multilateral. If you were to put any company on the SDN, you suddenly cut them off from the financial system, from shipping, facilitation, U.S. person, and there are primary and secondary sanctions. And if that is the objective, then having that kind of list could be effective.

It would still need to have some flexibility for the government to determine if there are reasons why you would want to engage. And the example I will give you is sometimes we want to have access to technology as a private company in order to reverse engineer and take apart. And if I can't go and buy or get a license to have the engagement to get that item, then we would not benefit from whatever knowledge might be gained from that activity.

So, I think it depends on your objective and whether we're willing to take on the ire of our partners and allies at a time when we're trying to coordinate with them a little bit more in this area.

MR. WOLF: Great comments. Just to repeat, I think there's vanishing little licensing for other than those two countries or companies that I mentionedand their affiliates for the entity list issue. But remember, export controls only regulate export, re-export, transfer of items, and in some cases foreign-made items made with U.S. technology or software.

And to echo Giovanna's point, I don't think any other country has even the legal authority, let alone yet the political will, to start imposing lists of sanctions against specific entities for the reasons that we're talking about in this case. So, this goes back to my core point of trying to convince the allies that controls over end users is in our common security interest as well.

In order to make blacklist or embargoes of particular companies for engaging in human rights issues or other activities contrary to national security more effective, it has to be more than just a U.S.-only control. They can be enhanced, absolutely, as Giovanna said, by using the dollar and the economic system in order to increase leverage.

But to truly accomplish what you're describing, it has to be more than just the U.S. who's doing it.

COMMISSIONER HELBERG: Does anyone on this panel support restricting the sale of Chinese technologies which the U.S. government has already designated as constituting a threat to national security? Like Hesai, the Chinese LiDAR maker DJI, or more recently, China's Unitree's humanoid?

I'd just like to take this conversation away from hypotheticals and the theoretical and make it a little bit more practical. Mr. Harrell, maybe we can start with you and work our way to Giovanna.

MR. HARRELL: So, I'm sorry, I couldn't hear. You were mentioning a couple of specific companies, but I couldn't actually make out.

COMMISSIONER HELBERG: Yeah, so the U.S. government has already identified a series of Chinese hardware technology companies as amounting to national security threats. And so, as a practical matter, should the U.S. government consider further tightening restrictions on the domestic sale of these Chinese technology companies in the U.S.? And the companies that I'm specifically referring to are DJI, Hesai, which is a Chinese LiDAR maker, and China Unitree, which is now mass producing Chinese humanoid robots.

And since we're coming up on time, I would just like to add one additional question for this group, which is that a huge amount of focus over the last year in DC has been on the regulation of U.S. outbound capital flows to China, which I'm strongly supportive of. I've been on the record supporting an outbound CFIUS framework.

With that being said, we have seen Chinese investments in the U.S. flood the tech sector as a way for Chinese entities to get access to sensitive U.S. technology, despite the fact that we have a CFIUS framework that's already on the books.

So, should the Congress and the administration consider ways of further tightening the screws on Chinese investments in the U.S. tech sector?

MR. HARRELL: On your question about tightening screws on U.S. tech sector, I do think there's an important kind of philosophical and policy question. CFIUS, from its origination back in the 1980s, right through FIRRMA, has maintained a case by case approach to investment review, and each case gets reviewed on the merits. There is no kind of in CFIUS per se prohibition on Chinese investment. Everything gets reviewed.

That's actually different from the approach the administration is planning to take on a couple areas on the outbound side where they're actually, rather than dealing with case by case kind of approach, they are planning, judging from the ANPRM, they are planning to have per se restrictions on certain kinds of U.S. outbound investments.

I do think that it would be appropriate to look at, given China is a huge strategic competitor, given frankly the resources that case by case review takes, and both Kevin and I sat on the CFIUS committee at different times in government, takes enormous resources to review a case. Even if you kind of know, because this is an investment, semiconductors, we're not going to want it to happen.

I think it would make sense to think of some very tailored, here are just a couple of categories of investment from China per se we're not going to allow here in the U.S. I think it would spare the CFIUS committee some burden. I think it would send an important message to the private sector.

And then it would let the CFIUS committee focus on kind of the more edge cases, often which don't involve China, but maybe involve Middle Eastern, you know, investment here in the U.S. or things like that. So, I do think it makes sense to look at that issue. You got to have a tight definition on that. You got to think about how enforcement would work. It's complicated. I don't want to oversimplify how easy it would be to do that, but I do think that's something worth considering.

COMMISSIONER MILLER: I'm keeping one eye on the clock here, and I'd like to get the other two panelists' opinions. Perhaps we'll get the follow up testimony afterwards. Commissioner Glas.

COMMISSIONER GLAS: Many thanks to you all. I'm going to try to simplify this. What letter grade would you give on the current effectiveness and the enforcement of our export controls? There was various ideas presented today in terms of recommendations, which I think the administration has authorities to do under the current statute. And obviously I support more resources for this work and the elevation of it.

But what reforms in the current statute are necessary to make that letter grade go higher in your mind? So, I'll start with Mr. Harrell.

MR. HARRELL: I'd actually like to hear Kevin's views on this first.

MR. WOLF: Well, the authority, the Export Control Reform Act, by the way, on the previous question, don't forget the ICTS authorities to address it. That was going to be what I was going to respond to.

But on yours, since the reform in 2018, there's extraordinary grant of congressional authority for the Commerce Department to impose unilateral, multilateral, plurilateral controls on items, uses, and activities. I can't think of too much additional authority other than some of the things that were being worked on in the House Foreign Affairs Committee the last couple of weeks.

To be added in response to your question, I think more needs to be done on the human rights side, but that's perhaps a separate discussion.

So in terms of statutory authorities, I think we're covering, the bigger issue is the statutory authorities of our allies and going to your effectiveness questions, allies generally don't have the statutory authority, even if they wanted to, to impose controls over exports from their countries to entities on our entity list, to impose controls over activities by their companies on unlisted items for specific end uses, such as producing or developing advanced node semiconductors in China.

So to your question, the statutory authorities we have are really quite robust and going to the core essence of my testimony, we need to convince our allies to create more nimble, more aggressive, more expansive authorities, so once the political will is achieved, then they have the authority and the resources and the people to do all the things that you were just describing to make the U.S. controls more effective and less counterproductive.

And in terms of effectiveness of what it does exist, you really have to go technology by technology, because some things are really very effective in terms of the recent controls, such as the ones for which there's already plurilateral controls on some types of advanced node tools, but the types of controls where it regulates activities of U.S. person but not their foreign competitor who's going in and filling behind and doing exactly the same thing, those are by definition ineffective.

So, and then you have to look at it over time. Most U.S. controls are very disruptive in the first year or so depending upon the technology. But once the markets adjust overseas and realize there's an economic opportunity to make something that's not subject to controls, then the effectiveness wanes over time. But you really have to go technology by technology. The speed of ineffectiveness varies. Sometimes it's 20 years, sometimes it's two days.

MS. CINELLI: So, I'm going to look at your question from the back end, meaning enforcing when there's violations, because I think that that's equally important and it's a message that's not looked at.

And I think in that situation there certainly is statutory authority, not just under the Export Control Reform Act, but also under the International Emergency Economic Powers Act. So, I don't believe that that's an issue.

I do think it is an issue of the cases that the Commerce department, for example, is choosing to bring administratively because it can contribute to a misunderstanding sometimes in industry on how these regulations are interpreted.

And while I'm not suggesting that regulatory interpretations occur only through enforcement, they are very powerful messages which regulated parties look at to make an assessment on where priorities exist and under what circumstances additional resources have to be allocated.

So, I think from the, I won't give a letter grade because in Catholic school we used to have number grades, but I will say that the administration could spend some time, any administration, taking a look at the kinds of cases they bring to help inform the community about what's important.

MR. HARRELL: I just want to echo that, you know, now it's interesting, I look back at the history and I talked in my testimony a little bit about what happened after 9/11 out of OFAC. And you can actually look historically, and one of the things the George W. Bush administration did after 9/11 was they radically overhauled the way in which they thought about bringing OFAC enforcement cases.

Prior to 9/11, they brought many more cases and they tended to have fairly small fines associated with them. And then leadership decided that what they wanted to do was drive systemic change by financial institutions and so they dramatically shrank the number of cases, which wasn't so much intentional. It was like they have the same number of resources so if you're going to do bigger cases, you got to bring fewer, but many fewer cases.

But they looked after, they went after large cases where they could impose much larger fines and use that to then prod the financial sector to invest in a very different way in compliance, sort of on a theory of previously you might have thought you violate sanctions, you pay $300,000, $500,000, $1.2 million fine. Now you might pay a $500 million fine because they brought much larger cases with many more violations.

It's working very different in terms of enforcement. I do think it is important to think through how do we want to use enforcement as a tool to drive systemic change by industries where we think systemic change might be useful.

COMMISSIONER MILLER: Commissioner Friedberg

COMMISSIONER FRIEDBERG:Thank you very much. And thanks to all our witnesses. I heard what sounded to me like two very sensible proposals, and I want to make sure that I wasn't imagining it or reading into what you've said, one from Mr. Harrell and one from Mr. Wolf.

Mr. Harrell, first to you. I understood you to say that we should be contemplating using export controls not to respond necessarily to Chinese aggression, but actually to try to slow or disrupt the development of Chinese military capabilities writ large. So, to do things that would impinge on their defense industrial capabilities.

Is that correct? And if it is, how is it different exactly from what we are doing now? That seems like a very sensible policy, but how is it different from what we're doing?

MR. HARRELL: That is correct. And coming back to a point I made earlier, I think that it would start by, I've now been out of government a couple of years, I can't speak to what sort of happened the last year and a half, but at least when I was last in, it had been at least a number

of years before we really looked at some of these more key defense sectors in China. And what is China dependent on in the aviation sector, aerospace sector, what are the kind of, not just what they're importing from the U.S., but around the world that maybe we could be begin to throw some gears in.

So, I think it really is looking actually, we've obviously long controlled U.S. exports and allies have too of military equipment to China, but really doing a refresh. And what are the kind of key, the key dual use, good choke points against an objective of doing everything we can to slow down China's military objective.

What would we do to do that? I think there's kind of a, you know, one of the things Jake Sullivan talked about in his speech back in on tech competition with China, with semiconductors, that we were going to pivot from the idea of we're going to stay two generations ahead or a couple generations ahead of China in semiconductors to a strategic concept of we're going to stay as far ahead as possible. Right?

And that just leads to different ways in which you evaluate the trade-offs of commercial interests and slowing down China's development. I think we need to do something similar with some of these defense sectors in China, where we've been allowing various dual use partnerships and things like that, but against an objective of China's strategic competitor. We want to slow them down on the military front as much as possible.

What are the choke points? And maybe we should reevaluate the commercial versus security trade off than we had a couple of years ago.

COMMISSIONER FRIEDBERG: And that's something you need to start doing now. You don't wait until the crisis.

MR HARRELL: Correct. You should be doing that now.

COMMISSIONER FRIEDBERG: I know--I know people aren't supposed to make these analogies, but I would point out this is very similar to the thinking behind export controls during the Cold War directed at the Soviet Union.

Mr. Wolf, you mentioned in your testimony--you referred to it as "Wassenaar minus one."

MR. WOLF: Right.

COMMISSIONER FRIEDBERG: And that sounds like the core of a maybe somewhat loosely institutionalized, plurilateral grouping of presumably like-minded countries that are going to agree to impose export control restrictions on a variety of products and sectors, maybe not have headquarters and a flag and a roundtable and so on. Is that what you have in mind?

MR. WOLF: Absolutely, yeah. So right after the Russian invasion, I wrote this article called "COCOM's Daughter" about the need to create a new regime in addition to the four, because the progress of the regimes was being blocked by Russia, and it was sort of an aspirational objective of a nice round table and a flag and everything.

What's happened is more of an ad hoc paralateral coalition that's evolved in the Wassenaar minus one concept, exactly. And the administration gets great credit for convincing a core number of critical allies and producer nations to start the process, which has already occurred in France, the U.K., and Spain, and soon U.S. and Netherlands and others, I'm sure will follow this year of agreements that would have been reached but for being blocked by Russia the last two or three years in Wassenaar, and using, finding, looking behind the cushions for unilateral authority to get those controls in. It's a lot more messy, it's going to be a lot more chaotic, but at least it's progress.

And I would, I'm still an advocate for going even further of expanding the mandate of what the national security objectives should be to address the points you were just asking Mr. Harrell about, because Wassenaar is really quite limited in terms of its mandate for what it can regulate and everything else that I described.

So yes, you summarized one of my core things and that is already happening, but in a much more ad hoc, chaotic way.

COMMISSIONER FRIEDBERG: Okay, just if I could very quickly, do you have a sense of who would be on board or who would need to be on board in order for this to be effective? And the second question, which I guess is related to the first, what would be the array of products that you think would be--

MR. WOLF: Great question. It's sort of, the clumping varies depending upon the technology sector. For semiconductors it's obviously Japan, Korea, Taiwan, the Netherlands, the United States with also the U.K. and France. When you get into quantum than you have to pull in Finland, you know.

And so it sort of varies with an al a carte style approach depending upon the technology. And so what I've been advocating is at a minimum that the allies adopt standards for what their export control system should have. So in this sort of a la carte approach to plurilateralism, they have the authority for list based controls outside the regimes. They have the authority for end use, end user, and services controls outside the regimes because lists of items don't always work.

But to your question, it really depends upon the technology. But we're sort of in an ad hoc way moving in that direction already. And Commerce gets a great deal of credit for convincing the allies to some degree to do more than was done a couple years ago.

COMMISSIONER FRIEDBERG: Thank you very much.

COMMISSIONER MILLER: Chair Cleveland.

CHAIRMAN CLEVELAND: Thank you. I have two, I think, pretty simple questions. Mr. Harrell, I appreciate you're talking about opening up and looking at a broader swath of industry that may represent a threat.

I'm curious whether or not in that exploration, how do you see China's recent efforts to control commercial, employment, legal, academic, medical data? How would we go about doing what you're suggesting given the increasing constrained environment that China's imposing in terms of access to information?

MR. HARRELL: I think obviously there is China's, as you know, significantly controlling the availability of data within China. I think that will simply, even more than we have in the last couple of years, have to rely on intelligence sources in order to kind of understand what those gaps are.

CHAIRMAN CLEVELAND: Do any of you see this effort to constrain data as part of a Chinese strategy to get around sanctions, to get around export controls?

MS. CINELLI: So just an observation. My concern about the constraints on the data would be that perhaps there's been a conclusion that they have sufficient data and with other applications like AI or large language modeling, that much can be done with the data they already have in an insular fashion, and we would have no visibility into that. I'm not necessarily seeing that it's circumvention type of process by that.

MR. WOLF: One of my recommendations is to study the question you posed, because with all the data security laws, both as a legal matter and as a practical matter, as a practitioner in the last year or so, it's getting harder and harder and harder to help companies comply if they can't get the data and who's doing what with what, where, when, by what.

And I think this is a growing issue that warrants a lot of analysis about the impact of licensing, what should be controlled, and how compliance programs should be structured. I don't have all the answers because it's only really just been happening in the last year or so as a practical matter, but I do think it's a serious enough issue that I listed it at one of my nine recommendations to study and have a whole standalone topic on.

CHAIRMAN CLEVELAND: Who do you think?

MR. HARRELL: I was just going to say I think some of the data measures China has taken probably reflect multiple Chinese interests. Right? I mean, they're trying to make it harder for espionage. They are probably in some sense, trying to make it harder for sanctions compliance, that kind of thing. I think the data restrictions have many driving factors behind them.

I do think that the crackdown on corporate due diligence firms is, if anything, probably principally driven by a desire to make it harder for Western firms to comply with sanctions and other similar measures like Uyghur human rights and those kinds of issues.

CHAIRMAN CLEVELAND: I have another question. If you could submit how you think that model would work, of how we look into answering the recommendation, I mean, who would do that work? How would we proceed? But do that for the record, because I'll ask you one other question.

One of the things that I find notable when we talk about export restrictions is there's never any discussion of the nuclear option, which is, in essence, if a company is restricted, that they've been denied access to Fedwire, CHIPS, or SWIFT. So I'm curious, your views on the weapon that Treasury has to control or address some of the challenges that these companies represent.

MR. WOLF: I'll just echo what Peter said, I think, because, remember, export controls regulate hardware, software, technology, and U.S. person services. And those are not always effective to accomplish an objective.

And if used judicially, I think additionally pulling in some of the sanctions tools where you have the leverage of the U.S. dollar and the banking system and SWIFT, etcetera, in order to accomplish objectives when export controls can't succeed is necessary. And I think the Russia sanctions are evidence of that.

It's a combination of export controls and the things and sanctions over the services and contracts in order to have a bigger impact. You can't overdo it like an antibiotic, you'll overuse it, it'll become less effective, but I do think that when export controls are not succeeding then to what Peter said, pulling in the financial system as a way to accomplish your objective needs to be done more often. So, yes.

CHAIRMAN CLEVELAND: So what I'm hearing is it should be sequential whereas I think in sequencing it may make it less effective. But Mr. Harrell, if you have any comments on that.

MR. HARRELL: Well, I think it is going to depend for any particular Chinese firm that you're trying to increase pressure on what--what are your goals? And if it is a Chinese firm, I mean clearly there is an element.

If your primary goal, if you're only goal, if the only goal you're caring about is maximum pressure on the Chinese firm, I think there is clearly often an advantage to surprise and just kind of coming in heavy up-front, maybe with a very short wind down period for things on boats.

On the other hand, I think we do have to be realistic that with some of these large, kind of globally systemic Chinese companies, while that might be your ultimate goal to fully get them

out of the global ecosystem, there is an existing base that you have to deal with and that is going to lead you with some of those firms to have to take a more incremental approach so that you aren't blowing up relationships with allies and other goals that you do have to keep in mind.

MR. WOLF: Also on sanctions, it would also help level the playing field where the foreign competitor is not limited by the same control the U.S. person is. And using the dollar as leverage would help level the playing field for U.S. industry in many cases.

MS. CINELLI: So I did want to key off that comment because I do think surgically using these in combination can do what Preston Dunlap called "shock the system." And I think sometimes there's a great interest in doing that.

I do think it's important though when you look at surgically what to do, do consider that the U.S. dollar, it may not always be where it is with digital currencies moving in the direction they are, with challenges in those circumstances.

I am not an economist. I'll be very clear here. But I do think as you look at these other factors, we do have to look at the ripples, because, however, there are interrelationships. You can't cut out the entire thing without possibly killing the patient. And I think that that's important.

MR. WOLF: Absolutely.

CHAIRMAN CLEVELAND: I'm not sure I see the linkage, but--

COMMISSIONER MILLER: Thank you all to the panelists. We're at the conclusion of panel two. We would very much appreciate, considering the complexity of the issues here, if we could follow up with you individually on additional questions that the Commission may have.

Mr. Wolf, we have not forgotten about your lessons learned list, which we will be following up about. And with that, we adjourn for lunch. We will be returning and restarting at 1:10 p.m. Thank you.

(Whereupon the above entitled matter went off the record at 12:32 p.m. and resumed at 1:14 p.m.)

PANEL III INTRODUCTION BY COMMISSIONER MICHAEL R. WESSEL

COMMISSIONER WESSEL: Good afternoon. Our next panel will assess the United States proposed outbound investment review mechanism and consider how best to align its scope and implementation with other economic state craft tools. We'll start with Dr. Derek Scissors, hopefully I'm pronouncing that correctly, Senior Fellow at the American Enterprise Institute. Dr. Scissors will analyze the proposed scope of controls across various types of financial flows and highlight current gaps in data collection.

Then we'll hear from Ms. Emily Kilcrease, Senior Fellow at the Center for a New American Security. Ms. Kilcrease will address the specific technologies and intangible benefits that should be covered by the investment review mechanism.

Thank you both for your testimony. I'd like to remind both of you to please keep your remarks to seven minutes. Dr. Scissors, I know that you will have no trouble making short concise comments. So with that, we welcome our former colleague back and Ms. Kilcrease, we welcome you back. Please.

OPENING STATEMENT OF DEREK SCISSORS, SENIOR FELLOW, AMERICAN ENTERPRISE INSTITUTE

DR. SCISSORS: Thanks, Mike. Emily is here and she is perfectly capable of addressing the full range of issues very well, which is nice because what I really want to do is attack elements of the financial community and their partners and the Treasury Department and the Congress. So there's going to be a lot of nasty comments --

COMMISSIONER WESSEL: Not the Commission.

DR. SCISSORS: Oh, of course not the Commission. Until you write a report.

COMMISSIONER WESSEL: Then please, proceed.

DR. SCISSORS: So the theme with my remarks is we need to include portfolio investment in the scope of our coverage. You can see it on my written testimony, you can see it in other things I've written, because that's where the money has been. We need much better data on both portfolio and direct investment--what U.S. money is supporting in China regardless of its form. We need to prohibit support of some activities and it is a very good policy debate to decide what those activities are. In my opinion, there should not be 100 prohibitions at the beginning. There should be, you know, more like ten. And then we need to have heavy penalties because one of the problems with U.S. policy is it gets circumvented and nothing happens. And we see that in other areas.

So I'm going to talk a lot about data because I like data. In this case, we don't have enough. One of the things that upsets me about this debate is people will say you cannot -- the government shouldn't be intervening in the market. It shouldn't be stopping U.S. investment decisions. But some of those same people, not all the same people, will then oppose transparency and disclosure, which is absolutely vital for market operation. So if you want to have the position that governments should not act because the government shouldn't interfere in markets, that's fine. But then you should not be opposing disclosure by firms and transparency by the USG, Treasury, or whoever else it is.

In direct investment data, we have two problems. The problem we have in a lot of data, which is the off-shore financial centers like the Bahamas and the Caymans and so on are treated as the final destinations instead of transit points. We don't actually create new assets in these areas or join in creation of new assets. The money just passes through and the sectors given are far too general. What I -- you know, what I would like and I'm pretty sure Emily and the Commission would like is data on chips and advanced equipment and you know, quantum investment. And what we have are computers and electronic products. It is not a useful category. Better than nothing, but it's not particularly useful.

In terms of direct investment, it doesn't really see much movement. In July, we're going to get new data, but right now the most recent data we have is 2022. And if you take the movement into the mainland, into Hong Kong, which is still listed separately and then to the off shores, you might get no change in the stock of U.S. direct investment in China in 2022. Just an illustration.

Portfolio investment in sharp contrast has seen a lot of movement. The financial community and others for better reasons, but the financial community wants to exclude portfolio investment from the discussion of outbound investment controls because that's where they make the money. And they're the biggest single sector involved here. There's a counter argument that is made because we don't have to worry about portfolio investment because China already has

ample funds and so money doesn't matter. Money always matters. Any time somebody says money doesn't matter, they're not telling the truth.

In this particular case, financials make the argument to their clients that they can make money in China because it's an inefficient capital market and they have better knowledge of how to pursue profit opportunities than China-based investment. Local capital allocation is poor. This is absolutely true. It's absolutely true. It also means that American money has more value dollar for dollar than Chinese money. And it will pursue firms and transactions that Chinese money won't pursue, filling in gaps that perhaps we don't want to have filled.

The other thing of course is that China actually has worst debt problems than the United States, which is sometimes hard for me to believe, but the data keeps showing that. And we should not be allowing them -- we should not help alleviate their debt problems by allowing them to spend money on more projects that could possibly be considered harmful.

So I want to back this general talk with some numbers, but I have to say at the beginning that portfolio investment statistics are actually worse than direct. The off shores are our worse problem because we named the Caymans as the largest recipient of U.S. portfolio investment at $2.5 trillion in stock, which is absurd. The number is almost zero. We only correct it once a year. It's done by the Fed on, you know, an informal basis in a paper that then Treasury reproduces. I'm not sure we have a mandate to do anything about it. In other words, it could happen -- you know, it could disappear at any time and there are no sectors. I mentioned that sector for direct investment that wasn't sufficiently specific. Portfolio investment we have no idea.

During the Trump administration, the trade war, U.S. portfolio investment averaged over the four years an increase in over $200 billion in annual stock. For the four-year total, it's $860 billion. That completely swamps any trade war effect. It is false to say that the U.S. and China had a strained economic relationship during the Trump administration. In 2021 and 2022, they declined -- the stock declined $200 billion per year. I assume it declined in 2023 given Chinese behavior, but we don't know.

Direct investment changes do matter more dollar for dollar. There's no doubt about it. They can convey how the portfolio investment doesn't. But the dollar, you know, the ratio can be 200 to one in the change. Maybe in 2022, it was. And if it's not, it's 50 to one. So at that ratio, portfolio investment matters in my opinion, in recent years more.

I'm going to get to recommendations. Emily says this in her testimony and I completely agree, executive orders are not the thing to do here. And it doesn't matter who's in charge. That's not a shot at the Biden Executive Order versus the Trump Executive Order or future executive order. We need something that's durable. Congress needs to do this. Where we disagree is entity-based restrictions where I think China can easily move assets around from entity to entity and I want either sector or technology-based restrictions.

Recommendation one: Congress should require in law that the U.S. find out where its money is going by sector, including portfolio shifts. And if we won't even find out what's going on, let's stop pretending we're making policy. Come on.

Second, there should be a small list of prohibited sectors with mandatory reviews of that list so that we keep it updated. And you know, small is in the eye of the beholder. But not -- we don't start with dozens and dozens. We don't do that. We have to figure out what we're doing first. I don't particularly want Treasury to be in charge because I don't like their track record to now. If you're just doing direct investment, Commerce is the obvious choice. If you're considering economic security more broadly, I think I have a mild preference for the Department of Defense to be in charge to make sure this is a national security issue, not an economic issue.

There are arguments, and I only have a few seconds, so I'll probably just stuff these into answering your questions, but there are arguments about difficulty in implication that I think are wildly overstated. In particular, U.S. firms don't invest in China without knowing their counter parties. Of course, they can make mistakes and we shouldn't punish them for making a mistake, but the idea that we don't really know we're investing, is that what you tell your clients? Give me $10 billion, but I don't know what I'm investing in. The firms know what they're investing in. They can disclose it and they can stop when they're told to. Thank you.

COMMISSIONER WESSEL: Thank you. Emily.

PREPARED STATEMENT OF DEREK SCISSORS, SENIOR FELLOW, AMERICAN ENTERPRISE INSTITUTE

Written Testimony before the U.S.-China Economic and Security Review Commission

Hearing on "Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology"

Witness: Derek Scissors, Senior Fellow, American Enterprise Institute

Funding Your Opponent's Technology Is Not Competing

May 23, 2024

American policy is rightly aimed at outcompeting China. Yet there are no restrictions at all on American money helping China win. There is not even the basic information necessary to decide what funding restrictions, if any, are needed for the US to prevail.

To illustrate, taxpayer subsidies for semiconductor production here are undermined by US direct investment in semiconductor production in China and portfolio investment in state-backed Chinese chip companies. When the Department of Commerce (reasonably) asks for more CHIPS funding in 2025, the Department of the Treasury will likely tell Congress there are no data on American funds supporting competing Chinese production. Sorry, good luck with your vote. The same is true for any activity the US may be averse to, from critical minerals processing to surveillance drones – American money helping China is barely monitored, much less restricted.

This failure does not only apply to advanced technology but that's where it's most stark. Export controls limit China's access to technology through sales and other transfers. The Committee on Foreign Investment in the United States (CFIUS) limits China's ability to buy technology here. These existing limits are justified by the many possible economic, military, and even human rights costs to technology transfer to China. Yet American funds can freely support development of the same technologies in the PRC. The treatment of outbound investment to date is not only self-defeating in a supposed competition, it's nonsensical in combination with other policies.

There are additional harmful Chinese activities that American funding can support. The US needs much better monitoring of what money is doing, as well as action to stop flows damaging to national interests. Even in purely financial terms, Chinese securities markets performance, Xi Jinping's policy performance, and the PRC's opacity suggest restricting funds is less risky for most investors than taking no steps. Outbound investment is overdue for rational policies, especially ones that stop offering up our capital as a substitute when our knowhow is restricted.[1]

The Available Numbers

Good policy is an accident without good information and, on outbound investment, the US falls far short of good information. Moreover, given the limited available information, many decision-makers end up focused on the wrong thing. In the case of American investment in China, the wrong thing to focus on is direct investment, which is creating a new asset or taking a notable stake in an existing asset.

This is not to say direct investment should be ignored, but it does not appear to be dynamic. At the end of 2022 (data are next updated in July), the cumulative total for American direct investment in the mainland was $126 billion. Including Honk Kong pushes that to $215 billion. Nearly $700 billion supposedly direct investment in the Caribbean islands may mask a higher true figure for the PRC.[2] The single biggest increase for the US in mainland China or Hong Kong was $24 billion, but it occurred in 2008. The 2022 increase for the mainland was a little over $10

[1] For more, see Derek Scissors, "What To Do About American Investment in China," American Enterprise Institute, May 2023, https://www.aei.org/wp-content/uploads/2023/05/What-to-Do-About-American-Investment-in-China.pdf?x85095.
2 US Department of Commerce, Bureau of Economic Analysis, "US Direct Investment Abroad," July 20, 2023, https://www.bea.gov/international/di1usdbal.

billion while direct investment in Hong Kong declined. The much larger stock of investment in Caribbean islands also declined in 2022, potentially swamping the rise for mainland China.

Beyond the obscuring role of the offshore financial centers, the public by-sector breakdowns for direct investment are too general and may mask relevant developments. Through 2022, spending on the mainland was topped by wholesale trade at near $19 billion, followed by computers and electronic products at just over $17 billion. For Hong Kong, non-bank holding companies were dominant, at over half the total. The leading categories for the offshores are also non-banking holding companies, followed by finance. Those funds in fact support activity in other industries.

Portfolio investment is the acquisition of securities with little ownership. It is certainly less valuable dollar for dollar than direct investment, for example in the potential conveyance of technology. However, the numbers involved for American portfolio investment in China have been larger since 2017, in terms of both levels and changes. This cannot be seen in Treasury's monthly investment data. Those show the Cayman Islands as the top recipient at $2.56 trillion at the end of 2022. The actual number is very near zero - the Caymans and other offshore financial conduits are only holding areas for funds headed elsewhere.

Once annually for the past few years, the Federal Reserve has determined where portfolio funds labeled as headed to the offshores actually go.[3] The Fed has shown that, at the end of 2022, the single largest final destination of money supposedly headed to the offshore financial conduits is actually the US. The money comes back, round-tripped most likely for tax reasons.

The second-largest destination for the capital assigned to the Caymans and the like is China. The true stock of direct and indirect American portfolio investment in China and Hong Kong was $910 billion in 2022, falling from $1.17 trillion in 2021. This followed a leap from $516 billion in 2016 to $1.4 trillion in 2020. In 2016, referring to trade, candidate Trump criticized the loss of American money to the PRC. Money does leave the US in China trade, with goods and services coming back. When funds leave the US as investment in the PRC, what comes back (or not) is profits for investors. Which is the worse exchange for the US*?*

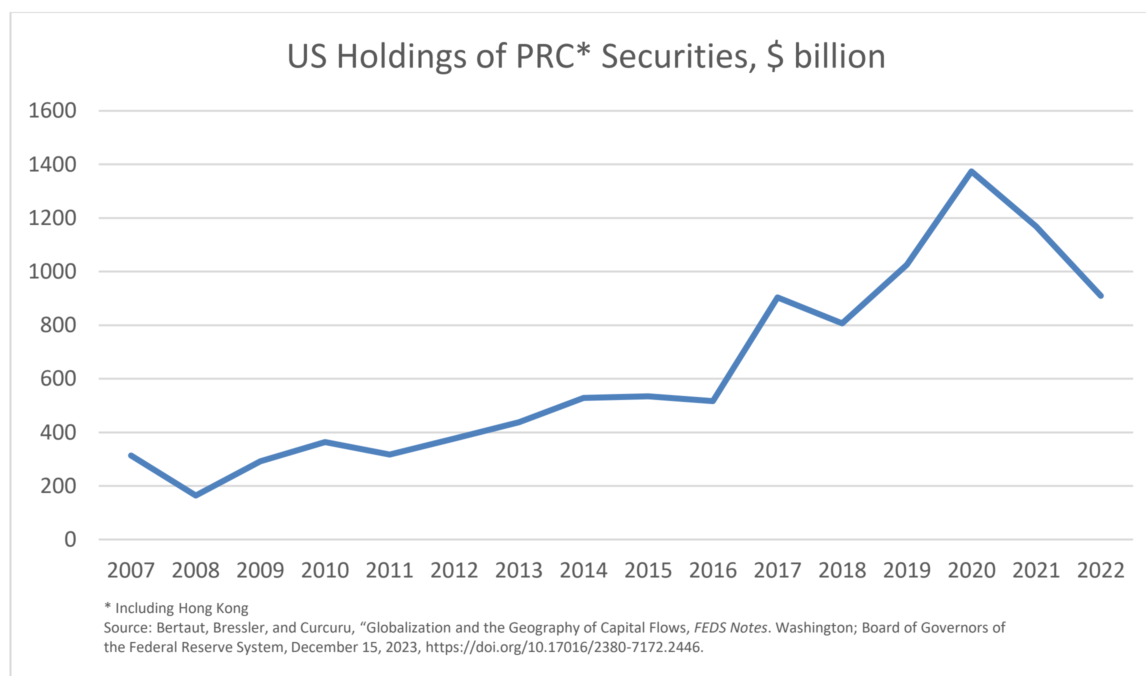
The "trade war" where China and America were said to be at each other's economic throats in fact saw the two further integrating, possibly at the expense of American national interests. Combining the trade deficit and gross US portfolio spending, the top year on record for money leaving the US is 2017.[4] The next two are 2019 and 2020. In 2020, while COVID spread from China to kill hundreds of thousands of Americans, US capital either saw huge paper profits from PRC investments, poured hundreds of billions of new dollars into the PRC, or mixed the two.

The current amount of American portfolio investment in China appears considerably larger than direct, and portfolio changes utterly dwarf changes in direct investment since 2016. But most portfolio investment is in common stock, suggesting equities markets may be more important than injections or withdrawal of funds. Alibaba's stock, for example, peaked in 2020 but lost

[3] Bertaut, Bressler, and Curcuru, "Globalization and the Geography of Capital Flows, *FEDS Notes*. Washington; Board of Governors of the Federal Reserve System, December 15, 2023, https://doi.org/10.17016/2380-7172.2446.
[4] US Department of Commerce, Bureau of Economic Analysis, "International Trade in Goods and Services," May 2, 2024, https://www.bea.gov/data/intl-trade-investment/international-trade-goods-and-services.

$570 billion in capitalization after attacks by Chinese regulators.[5] While the single largest American stake lost only $5 billion in this drop, total (notional) losses to American investors were likely in the many tens of billions of dollars. Tencent and other private Chinese firms saw less dramatic versions of the same event, meaning tens of billions more in notional losses.

This reduced the value of American holdings in the PRC. The Alibaba case and others suggest trading gains and losses may have driven the large moves in US portfolio position.[6] Against that, however, is the trend in the benchmark Shanghai composite stock index. From end-2016 to end-2020, the Shanghai index climbed barely 10 percent while American portfolio investment holdings in China soared 166 percent.[7] In 2021-2, Shanghai shares slipped 11 percent, while American holdings dropped 34 percent. Broad market fluctuations do not explain the rise and fall of US investment, point to large amounts of money first being sent then being withdrawn.



[5] Yahoo Finance "Alibaba Group Holding Limited (BABA) Stock Historical Prices and Data," May 1 2024, https://finance.yahoo.com/quote/BABA/history/?frequency=1mo&period1=1557271514&period2=1715124296 and Xinhua, "China's top market regulator imposes penalty on Alibaba Group over monopoly conduct," April 10, 2021, http://www.xinhuanet.com/english/2021-04/10/c_139871057.htm.

[6] Another sentiment measure is found in market capitalization of Chinese companies in the US plummeting from November 2021 to September 2022, US-China Economic and Security Review Commission, " Chinese Companies Listed on Major U.S. Stock Exchanges," January 8, 2024, https://www.uscc.gov/sites/default/files/2024-01/Chinese_Companies_Listed_on_US_Stock_Exchanges_01_2024.pdf.

[7] Yahoo Finance "SSE Composite Index (000001.SS) Stock Historical Prices and Data," May 1 2024, https://finance.yahoo.com/quote/000001.SS/history/?frequency=1mo&filter=history&period1=867807000&period2=1715125286.

Existing Policy?

It's oddly become controversial to say outbound investment should be monitored and restricted by a mechanism similar to CFIUS. An outbound version would be smaller and simpler than CFIUS, with no responsibility for blocking acquisition of sensitive data or land. Acquisitions will be rare, so confidentiality will be easier. Otherwise, CFIUS has sound motivating principles concerning technology and has been largely successful, not anything to shy away from.

With regard to authority over any new body, Treasury's stance is somewhat inconsistent. The August 2023 Advance Notice of Proposed Rulemaking[8] for the outbound executive order (EO) pretends purchases of public securities are beyond the pale or at least require more input, as if it was not extensively discussed for several years already. But if portfolio investment is mistakenly excluded, the main justification for Treasury jurisdiction is Treasury runs CFIUS and this should be like a reverse CFIUS. It's Commerce which provides direct investment data, and better data are necessary for policy making. A third option is Defense is given principal authority, clarifying that American objectives here are not economic. Treasury's standard view that the issue is too financially complex for other agencies is belied by its steadfast opposition to complex action.

Whatever's done is much better accomplished via durable legislation from Congress than an EO that succeeding administrations may void or decline to enforce. Neither the Trump nor Biden administrations is responsible for Congress' failure to provide such legislation, most painfully in 2020 as American portfolio investment stock in China soared while Covid spread. Congress having voluntarily set itself to the side, the Biden administration's record on outbound investment is far superior to the Trump administration's, but this is almost entirely by default.

Fast-rising exposure to Chinese securities during the Trump administration was foolish, as well as likely damaging to American security. Its unwinding cannot be due to Biden administration action because, as of May 2024 and despite constant chatter, there has not been any action. When they finally appear, the implementation regulations for the Biden EO may be better than nothing, barely. Secretary Yellen's deeds and words show desire to cooperate with China, not compete. Perhaps it's not surprising the Advance Notice asks for the most basic information,

> "Where possible, please provide empirical data about trends in U.S. investment into country of concern entities engaged {in sectors of concern}"

The Trump administration should have asked for that information starting in 2017 or 2018. This administration, rightly, raised the issue of outbound investment publicly at a senior level in July 2021.[9] Three years later, Biden's Treasury wants policy jurisdiction where it apparently did not

[8] US Department of the Treasury, Office of Investment Security, Provisions Pertaining to U.S. Investments in Certain National Security Technologies and Products in Countries of Concern," *Federal Register* 88 (August 14, 2023, https://www.federalregister.gov/documents/2023/08/14/2023-17164/provisions-pertaining-to-us-investments-in-certain-national-security-technologies-and-products-in.

[9] White House, National Security Council, "Remarks by National Security Advisor Jake Sullivan at the National Security Commission on Artificial Intelligence Global Emerging Technology Summit," July 13, 2021, https://www.whitehouse.gov/nsc/briefing-room/2021/07/13/remarks-by-national-security-advisor-jake-sullivan-at-the-national-security-commission-on-artificial-intelligence-global-emerging-technology-summit/.

bother to ask for indispensable data and hoped voluntary commentators can provide it. The most recent formal publication indicates the EO will likely accomplish almost nothing, assuming it is ever implemented. There is still no sense at all of how much American investment may be covered in terms of disclosure, restriction, or any ban. And given delays to date, implementation in 2025 is now most likely, after the election and of course optional for whoever wins.

Needed: Transparency, Plus

Treasury prefers capital to flow freely to the PRC and wants to set aside as inviolate the largest flow, which is acquisition of stocks and bonds. It does not want to document where that money might be going - no sector breakdowns are published. From 2017-2020, did the soaring amounts of American capital go to low-risk or high-risk activities? Surveillance or shoes? Were they withdrawn from the same activities in 2021-2 or did the risk profile of American portfolio investment in China change more recently? The meaning and impact of the Alibaba capitalization drop, among many other things, would be revealed by data on sector allocation.

Crucially, the level and trend of American financial support for Chinese work in synthetic biology, advanced computing, and other advanced or possibly dangerous technologies could also be revealed. Even the excessively broad categories presently used for direct investment would be an improvement. The US has never attempted to monitor what American portfolio capital supports in China. Good policy requires this knowledge, and those opposing transparency are deliberately undermining market principles and function, not defending them as they often argue.

Portfolio investment is more mobile than direct and money apparently invested in one sector can easily slide elsewhere. Some counterparties may be illegitimate, which is the responsibility of American investor if they are protecting their clients. But large-scale funds movements within China are detectable. And it is unreasonable to claim American financials raise and deploy huge sums with little knowledge of or accountability from their initial counterparties. Inauthentic counterparties will be revealed over time and barred as recipients. Greater transparency in the extent of American support of high-risk activities in the PRC should be understood as vital to the national interest. If private actors find search costs onerous, they should avoid risky investment.

While more transparency is a necessary and long overdue first step; it cannot be the only one. Proper disclosure by firms and Treasury may show that investment in high-risk sectors is low, which would be reassuring. But that’s far from a long-term guarantee, given the previous surge in outbound flows. There are certainly activities in China, from enhancing military capabilities to attempts to change behavior of “troublesome” individuals, that the US should not invest a dollar in. Implementation of outright bans should start cautiously, not for the sake of placating Beijing or American corporate and financial interests but because it’s a new US government action that will lead to unexpected outcomes, certainly in the form of attempted workarounds.

The first policy choice is what Chinese activities must not be supported. Congress has struggled with durable definitions of what’s critical, and waiting to establish an extensive list is a mistake. One possibility is starting with a consensus list of four or five critical industries, while explicitly leaving the door open to adding (and subtracting) other activities in 2-3 years. There are also other, obvious options based on existing restrictions. If a technology is subject to export controls

or to CFIUS review involving Chinese entities, it's self-defeating to allow American money to help speed development of the same technologies by the PRC. At least some should be off limits. Again the starting list of these can be short, but implementation is already years overdue.

Once scope is decided, restrictions should not be applied entity by entity. The specific entity involved does not serve as the foundation of export controls or inbound investment, for good reason. The problem is not single bad actors, the problem is the goals of the Party routed through the Chinese state. Private Chinese firms cannot choose to be safe partners, to comply with US regulations or to decline transactions with PRC enterprises engaged in targeted activities. The state will shift assets away from sanctioned entities to others even if, on a large scale, this will become fairly clear. (For these reasons, use of the Entity List is also not sensible for China.)

Targeting technologies or sectors instead of firms ties to genuine enforcement. Intellectual property is an extremely destructive example of US laws being flouted with no consequence. Export controls are circumvented, and so on. For outbound investment, multiple instances of misrepresentation by a Chinese entity should be treated as criminal, with the Specially Designation Nationals list the obvious response. Unlawful behavior by American investors should see a public warning which, if ignored, should be treated as criminal. Political incentives are high for talk, but not for any costly enforcement. But without painful enforcement provisions, the US should just stop pretending outbound investment, among other things, is a serious issue.

Trivial and True Costs

If there is no enforcement, the costs and benefits of restricting outbound investment will both be essentially zero. Truly curbing American financial support for high-risk Chinese activities would have *potentially* enormous benefits in the form of saving very large industries or even reducing American war casualties. These swamp any conceivable regulatory cost to the US government.

While benefits are potential, though, costs to enforced restrictions would be definite. There are unavoidable costs to private and public sector monitoring and public enforcement. Public costs are justified by the risks. Private self-policing costs will be small if investment restrictions are clear and eventually small even if they are not, as learning occurs. The most feared cost is lower returns but, for portfolio capital, that fear is manifestly unjustified. The Shanghai composite index was higher in January 2010 than it was in April 2024. The S&P 500 over that period rose from 1,100 to 5,000. Diversification into Chinese securities has long invited painful errors.

Even if individual investors do at some point lose returns due to restrictions, the amount would be insignificant for the national interest. For American portfolio investment in the PRC, the enormous increase 2017-2020 was obviously seeking higher than expected returns. Say half of it had been barred -- highly unlikely under any proposed outbound regime – had not then been invested in the US and thus earned far more, and thus somehow lost 300 basis points of yield. The bizarrely unlikely scenario still means not much more than $3 billion annually in lost returns. This is what parts of the financial community want to elevate over the national interest.

Restricting the far smaller volume of direct investment volumes would initially have negligible costs, which may explain why Treasury refuses to discuss the EO's dollar impact. But smaller

amounts of annual direct investment could later reverberate through the very larger quantity of sales by American affiliates in the PRC.[10] A small investment drop due to restrictions today could mean cumulative annual sales losses that eventually become substantial.

But this presumes Beijing does not, in keeping with longstanding goals of technological upgrade,[11] successfully displace the same US technology affiliates most likely to face US capital restrictions. It will certainly happen in semiconductors. New American investment in semiconductors in China could fall to zero by 2027 as domestic output reaches oversupply levels typical of the industries Beijing has tagged as strategic. Soon enough, American firms will only continue to be welcomed by either transferring advanced technology to the PRC or producing solely for export back to the US. These are the long-term opportunities they presently cling to.

Opponents of outbound investment restrictions may worry most about stocks. Authentic restrictions could well blast share prices of exposed US technology or financial firms. The slump would not last more than a year, but a great many decisions seem to be made eying short-term stock movements. Finally, it's absurd to believe the US should invest for the sake of information on PRC innovation. Private companies do not invest with this national goal in mind, nor would they share information with American policy-makers unless compelled, which would then trigger a response from Beijing. If knowledge of Chinese innovation is so valuable, the US should just hand over our innovations. This would yield excellent insight on what's next in China.

Recommendations

1) Congress should require Treasury to publish annual sector breakdowns of nationality-based portfolio investment in China. These sectors should be more specific than those provided by Commerce for direct investment. Congress should require Treasury to publish quarterly updates, without sector breakdowns, of nationality-based portfolio investment in China.

2) Congress should require Commerce should publish more detailed sector breakdowns of direct investment in China. Congress should require Commerce to investigate the possibility of nationality-based results for direct investment, where offshore financials would not be said to receive hundreds of billions of dollars and true destinations for the capital would be known.

3) Congress should put into law a short list of genuinely critical sectors, as few as three and at most six. These should be reviewed every 2-4 years. All American investment in these sectors that may assist China should be banned, regardless of locations of American or Chinese entities.

4) If a critical sector list cannot be mandated, Congress should apply the same comprehensive investment ban to all activities for which export licenses have been denied in the preceding five years and for which CFIUS has barred foreign investment in the past ten years.

[10] US Department of Commerce, Bureau of Economic Analysis, "Activities of U.S. Affiliates of Foreign Multinational Enterprises," August 18. 2023, https://www.bea.gov/data/intl-trade-investment/activities-us-affiliates-foreign-mnes.
[11] From Consulate General of the People's Republic of China in New York, "China marks PLA's 80th birthday with grand rally," August 1, 2007, http://newyork.china-consulate.gov.cn/eng/xw/200708/t20070801_4686371.htm to Wang Mingyan, "President Xi underlines need for innovation in military upgrading," March 12, 2017, https://news.cgtn.com/news/3d41544e336b6a4d/share_p.html.

5) Deliberate attempts to circumvent any ban should be treated as criminal activity by individuals and entities involved, regardless of nationality. Repeated unintentional failures to observe a ban should be punished by fines matching the value of the largest violating transaction.

6) A licensing process for outbound investment can substitute for outright bans if and only if Congress makes the Department of Defense the primary licensing and enforcing authority. (Licensing and enforcement by Treasury or Commerce would again prove unsatisfactory.)

7) As generally recognized, less complex regulation such as simple bans require fewer resources in implementation. Whatever outbound investment mechanism Congress chooses should see suitable increases in funding and personnel to ensure the legislative step is not an empty one.

The portfolio investment rush to China from 2017 to 2020 and constant sales pitches now make clear Wall Street needs little encouragement to pour money (back) in. Policy inaction from 2017 to mid-2024 makes clear Treasury will do little to discourage any future investment surge. US support of Chinese technology development and other potentially harmful economic activity is not compatible with competition. If America is to truly compete with China, Congress must act.

OPENING STATEMENT OF EMILY KILCREASE, SENIOR FELLOW AND DIRECTOR, ENERGY, ECONOMICS AND SECURITY AT THE CENTER FOR A NEW AMERICAN SECURITY

MS. KILCREASE: Thank you, Commissioners. A tough act to follow here. I don't know if I can be quite as spicy, but hopefully informative nonetheless for the discussion today. So my comments today draw from a large body of research I've conducted as an economic security researcher at the Center for New American Security, which as folks know is a bipartisan think tank focused on national security and foreign policy issues, but I'll note I'm speaking in my personal capacity today.

My research also draws from prior experience serving the U.S. public in roles at the Department of Commerce, the National Security Council, and the Office of the U.S. Trade Representative. And I will also note that some of my comments are drawn from joint work I've conducted with Sarah Bauerle Danzman who's provided a statement for the record for this hearing as well.

I've spent my career in national security roles, but always from the perspective of an economic agency. And this has shown me the importance of establishing national security guardrails on certain areas of economic activity with countries of concern including China, to ensure that the U.S. strategic advantage of open markets and open capital flows is not exploited or undermined. And the lack of any restrictions on outbound U.S. capital flows represents an unaddressed area of risk, one that Congress should move urgently to address. And I agree with Derek on that point.

As we consider the appropriate scope and design of outbound investment restrictions on the set of principles that should guide our thinking, as well as concrete policy options for your consideration. On principles, any new outbound investment controls should be scoped to investment transactions that present high national security risk arising from the transfer of nontechnical industrial expertise or intangible benefits that can fuel the indigenous development of critical technologies in China.

They should be clearly defined and understandable to private sector entities or at least the first line of compliance. They should be nonduplicative in reinforcing of existing tools, including export controls. They should be scoped proportionately to administrative capacity available to effectively administer a new mechanism while avoiding unnecessary process and bureaucracy. And last but not least, they should be designed to enable meaningful conversations with allies about adopting similar regimes as I do believe that a unilateral approach to outbound investments will ultimately hurt U.S. competitiveness without having any meaningful impact on Chinese tech development.

With these core principles in mind, let me get specific about some certain policy options that we should consider. And I offer them as a package because each addresses a particular area of risk and I think they would work best when used in tandem. None is sufficient on its own. And this includes enhanced transparency, technology-based prohibitions, and I do think entity-based prohibitions can play a role.

The United States clearly needs more transparency around U.S. investments in China and Congress should consider requiring mandatory notifications for certain U.S. investments made into Chinese companies that make high risk technologies. And these notifications should be subject to strict confidentiality protections.

Both when I was in government and now as an independent researcher, I can tell you that it's exceedingly difficult to gain detailed information on specific investment transactions made in China, particularly in the start-up space. And we need to change that. Having said that, there's a set of investments that would inarguably present national security risks and should be prohibited and we should move forward with these now.

These include investments in Chinese companies that make technologies that would be subject to the U.S. arms embargo if originating in the United States or otherwise subject to high levels of dual-use export controls. There's a common sense logic in using investment controls to ensure that U.S. financing is not eroding the efficacy of our export control programs, particularly as it relates to the transfer of nontechnical industrial expertise that can occur through an investment transaction.

Sectors included in the prohibition should include advanced semiconductors and related equipment and software in alignment with the U.S. Government's efforts to keep the United States as far ahead as possible in this critical technology area that enables U.S. military, national security, and economic functions. There's also an emerging consensus on the need to set controls on frontier AI systems based on the computing power of these systems. And my written statement provides additional information and technical resources on this point for your consideration.

Quantum technology, supercomputing, hypersonics are all other technology areas worthy of consideration. Again, with an eye to using technology-based investment controls to support U.S. leadership, enforce multiplier technologies. In addition to these technology-based restrictions, Congress should also consider entity-based restrictions. They should expand to the non-SDN Chinese Military Industrial Complex program or the CMIC program to prohibit investments of all types, not just the purchase or sale of publicly traded securities. And this can provide a well calibrated entity-based tool.

Entity-based approaches alone will not be sufficient as they are inherently reactive in nature and each individual listing requires lengthy in-depth analysis. They just don't move fast enough. But they can provide an important compliment to the technology-based prohibitions where the U.S. Government has knowledge that a particular entity is acting in a manner contrary to U.S. national security and foreign policy interests.

Finally, the ongoing debate on outbound investment controls reflects how novel this type of program would be for the United States and it's critical that there be a regular process to evaluate the effectiveness of any new program. Evaluation is an area where the United States unfortunately usually falls really short, but it's critical to ensure that novel economic security tools are meeting Congress's national and economic security objectives.

Establishing a requirement for regular evaluation and reporting to Congress, as well as public reporting on the use of outbound investment controls can play an important role in making sure we get this right. And it's essential that Congress act. Doing so can ensure the durability and appropriate scoping of any new outbound program, as well as ensuring the alignment of resources for the effective implementation and enforcement. I'll note that Congress wisely did this during the 2018 CFIUS reform process and we should look to that as a model.

Let me conclude by making two final points. First, while we're focused today on a particular set of economic restrictions related to outbound investment flows, it's equally critical that the United States not lose sight of the need for an affirmative strategy to engage in the global economy. The United States needs an economic security strategy that envisions the use of all of

our economic security tools, both defensive ones such as outbound investment controls and affirmative ones. The United States can't lead in the global economy by only playing defense.

As the Commission and Congress consider the role that outbound investment controls can play in advancing U.S. interest, we should also be thinking about an overarching economic security strategy that puts this tool in context and envisions how it will be used in tandem with other economic security and national security tools.

And second, reflecting on the name of our hearing today, which is about economic strategies for leveling the playing field, I may respectfully push back on that framing for our discussion around outbound investment controls. When we're talking about the critical technologies that can tip the balance of strategic and military power between the United States and China, our objective cannot be a level playing field.

We do not want equal competition between the United States and a competitor that we may one day face on the battlefield. Instead, in these key technology areas, the objective should be to achieve overmatch and to sustain a clear U.S. advantage in the technology areas that are essential for U.S. national security interest.

Outbound investment controls can play an important role in maintaining U.S. advantage in these critical technology areas, alongside export controls and importantly proactive run faster policies designed to spur U.S. innovation and growth. And outbound investment controls are only one part of that puzzle.

Thank you again for the opportunity to be here. I look forward to the conversation.

PREPARED STATEMENT OF EMILY KILCREASE, SENIOR FELLOW AND DIRECTOR, ENERGY, ECONOMICS AND SECURITY AT THE CENTER FOR A NEW AMERICAN SECURITY

MAY 23, 2024

TESTIMONY BEFORE THE U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Hearing on “Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology”

Outbound Investment Controls in a U.S. Economic Security Strategy

BY

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I. Summary of Testimony

Commissioner Miller, Commissioner Wessel, and members of the U.S.-China Economic and Security Review Commission, thank you for the opportunity to provide testimony. While I am currently employed by the Center for a New American Security (CNAS), I am providing testimony in my personal capacity.[1] The testimony draws from a large body of research that I have conducted at CNAS on economic security issues, as well as my prior experience serving the U.S. public as a proud civil servant in the U.S. Department of Commerce, the National Security Council, and the Office of the U.S. Trade Representative, including most recently serving as the Deputy Assistant U.S. Trade Representative for Investment. I have spent my career in national security roles, but always from the perspective of an economic agency. This perspective has engrained in me a deep appreciation for the strategic advantage that open markets and open capital flows provide the United States.

This testimony focuses on options for designing an effective program to address the national security risks that can arise from certain U.S. investments in China and other countries of concern. As the U.S. government considers establishing new outbound investment restrictions, it must account for a range of policy objectives, including the need to robustly protect U.S. national security, maintain U.S. economic and technological competitiveness, and ensure that any new programs can be effectively administered and enforced. Additionally, many U.S. investments in China do not present national security concerns and should be allowed to proceed so that investors can take advantage of commercial opportunities available in one of the world's most consequential markets. The analysis and recommendations of this testimony are provided with these objectives in mind.

A summary of recommendations for congressional consideration is as follows:

- Codify and provide resources for a targeted and proportionate set of outbound investment controls focused on transactions that may enable China's indigenous development of technologies critical to U.S. national security interests;

- Enhance transparency around investments made in China, including by establishing new requirements to notify the government of investment transactions involving high-risk technologies;

- Prohibit U.S. investments in Chinese entities that produce, design, test, manufacture, fabricate, or develop high-risk technologies, including military items, advanced semiconductors and related equipment and software, and frontier artificial intelligence (AI) systems;

- Consider additional prohibitions related to quantum information systems, hypersonics, and supercomputing;

- Expand the non-SDN Chinese Military-Industrial Complex (non-SDN CMIC) program to prohibit all types of investments in listed entities and to authorize the listing of Chinese entities that produce, design, test, manufacture, fabricate, or develop high-risk technologies;

- Exercise strategic restraint on the use of full blocking financial sanctions;

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- Encourage alignment of U.S. outbound investment policies with those of key international partners;

- Require independent evaluation of any new outbound investment authorities to ensure they are being implemented in a manner consistent with Congress's national and economic security objectives; and

- Establish, or require the executive branch to establish, an economic security strategy to guide the use of all economic security tools in pursuit of a defined set of objectives related to U.S.-China strategic competition, including how outbound investment controls fit into this broader strategy.

This testimony draws from joint work conducted by the author and Sarah Bauerle Danzman, associate professor of international studies at Indiana University and resident senior fellow with the Atlantic Council, including the report *Sand in the Silicon: Designing an Outbound Investment Mechanism* published jointly by the Atlantic Council and CNAS. The testimony also draws from prior testimony provided before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, the U.S. House of Representatives Committee on Financial Services Subcommittee on National Security, Illicit Finance, and International Financial Institutions, and the U.S.-China Economic and Security Review Commission. Citations to these prior publications, and other resources that may aid the Commission's work, are included at the end of the testimony.

II. Introduction

Certain U.S. investments in China present national security risks that are not addressed by existing U.S. authorities. U.S. firms and investors may, in some cases, be supporting the development of critical technologies in China that have important national security applications. These include investments related to chips, AI, or other technologies that can accelerate advances in Chinese military capabilities.[1] Just as U.S. law and policy have long recognized that the export of certain technologies can be counter to U.S. security interests, so too can certain overseas investments if such investments are contributing to increasing military capabilities of competitor nations. The goal of an outbound investment program is not to impose broad capital controls, but to instead address the specific transactions through which critical, non-technical industrial knowhow may transfer to China and to plug a specific gap that export controls cannot fill in the technology competition with China.

U.S. policymakers are currently debating whether and how to regulate U.S. investments in China. The administration has released an executive order, with an accompanying advanced notice of proposed rulemaking (ANPRM), outlining a targeted proposal to mandate notifications of—and in some cases, prohibit—certain U.S. investments into China's AI, semiconductor, and quantum technology ecosystems.[2] Congress has considered a range of proposals, with current efforts in the Senate coalescing around a mandatory notification program.[3] Debate remains ongoing in the House of Representatives, with the House Financial Services Committee advancing legislation that leans more heavily on traditional sanctions tools to address concerns with outbound investment.[4] A proposal from House Foreign Affairs Committee Chairman Michael McCaul (R-TX) and Ranking Member Gregory W. Meeks (D-NY) advanced a sectoral approach to outbound investment restrictions.[5] The House Select Committee on the Strategic Competition between the United States and the Chinese Communist Party, in its 2023 bipartisan report on the U.S.-China economic relationship, recommended an approach that blends both sectoral restrictions and entity-based investment restrictions.[6]

III. Need for Congressional Action

Congress has an essential role in establishing any new outbound investment authorities. While substantively the administration's executive order generally aligns with the recommendations of this testimony, implementing these authorities under executive action is not optimal over the longer term. The International

Economic Emergency Powers Act (IEEPA) provides sufficient authority for the President to establish outbound investment restrictions. However, a legislative solution would ultimately provide a more durable policy response, as executive orders can be rescinded by subsequent administrations. Legislation also avoids the mission creep that has been associated with recent use of IEEPA for a range of China-related threats, many of which present serious national security and foreign policy concerns but may not strictly speaking constitute "emergencies" as originally envisioned in IEEPA. Brennan Center research has noted that the President's use of IEEPA is "virtually unchecked," calling in to question whether the extensive use of IEEPA as a routine foreign policy tool erodes the checks and balances between the executive and legislative branches.[7]

A strong congressional role would ensure that any new outbound program is designed in parallel with a consideration of the resources required for effective implementation and enforcement. Congress's keen focus on resources during the 2018 process to modernize the Committee on Foreign Investment in the United States (CFIUS) was commendable, enabling CFIUS to effectively implement its expanded mandate. A similar resource assessment process should accompany the establishment of an outbound investment program.

Congress also has a role in determining the operational structure of a new outbound investment program. The Department of the Treasury is best situated to lead a new outbound investment program. The Treasury experience chairing CFIUS, as well as its lead role in implementing U.S. sanctions, give it unique strengths and insights when it comes to tracking international investments and global financial flows. Congress should create a new office to lead an interagency outbound investment program and place it under the leadership of the Assistant Secretary for Investment Security or the Under Secretary for Terrorism and Financial Intelligence. The outbound investment authorities should not be located within CFIUS, as this process is already under significant strain and Congress should seek to reduce rather than increase the burdens on CFIUS.[8] The Departments of Commerce, Defense, Energy, and State should also have a role, given the need to align outbound investment restrictions with export controls. The Office of the Director of National Intelligence should be tasked to provide threat assessments in support of the outbound investment program.

IV. Principles for Outbound Investment Authorities

Addressing national security risks associated with U.S. investments in China will require a carefully calibrated approach. Overarching principles guiding the development of future outbound investment programs include that new authorities should be:

- targeted at transactions of highest national security risk;
- clearly defined and understandable to private-sector entities, who will be responsible for the first line of compliance;
- non-duplicative of and consistent with existing tools, including export controls;
- scoped proportionately to the administrative capacity available to effectively administer a new mechanism; and
- designed to enable meaningful conversations with allies about adopting similar regimes, including the need to limit extraterritorial application of U.S. authorities.[9]

Consistent with these broad principles, the United States should focus on U.S. investments that: 1) convey management expertise or other non-technical industrial knowhow along with the investment (i.e., "smart money" investments); and 2) may advance the indigenous development of China's technology capabilities in areas critical to U.S. national security.

Focus on "smart money" investments

An outbound program should focus on regulating "smart money," that is an investment that conveys non-technical industrial knowhow along with capital. Purely passive investment flows are unlikely to present a high-risk profile and are most easily replaced by other sources of capital. China has ample access to capital, from both domestic and foreign sources, and thus restrictions that focus on broad flows of money are unlikely to have a meaningful impact. Instead, an outbound program should focus on the unique contribution that flows from individual investment transactions, including access to leading U.S. knowhow on how to build a successful critical technology company. Outbound investment controls can be best thought of as a complement to U.S. export controls, filling a gap related to non-technical industrial expertise that export controls are ill suited to capture. Export controls address part of the national security risk associated with outbound investments, namely the risk that investments may involve the transfer of sensitive U.S. technologies. However, export controls do not cover the risks that arise from the transfer of management expertise, non-technical industrial knowhow, or other intangible benefits.

For example, one can consider the broad range of skills and expertise needed to establish and operate a semiconductor fabrication facility that can produce high-quality chips at scale and on commercially competitive terms. Technical knowledge and technology innovation will be critical to this business, and export controls can address this aspect of potential risk associated with U.S. investments in China-based facilities. But, the operators of these facilities will also need to manage complex supply chains, maintain a skilled workforce, and develop commercial strategies for succeeding in a cutthroat global marketplace. Few companies today can master these complex operational and management requirements, and it is in exactly these areas that U.S. firms excel. These types of non-technology related benefits that can flow along with an outbound investment are not, and never would be, suitable to capture under export control authorities.

Additional types of risks may arise from investments made in the start-up or venture capital space. Research from Georgetown University's Center for Security and Emerging Technology (CSET), examining U.S. investments in China's AI sector, describes additional types of non-technical expertise that advance indigenous technology development, noting that "earlier stage VC investments in particular can provide intangible benefits beyond capital, including mentorship and coaching, name recognition, and networking opportunities."[10] These types of intangible benefits can be critical in determining the success or failure of young technology companies, which generally have a high failure rate. The CSET report noted that, while Chinese investors remain the majority of investors in China's AI start-ups, U.S. venture capital has been active in China's AI start-up field.

Focus on high-risk technology areas

An outbound investment program should focus on investments in technology areas of high national security risk. This includes technologies that are subject to high levels of export controls, as well as emerging technologies that may not be mature enough to warrant export controls but are nonetheless critical to future U.S. technological and national security advantage. In both instances, the United States should take an "ecosystem" approach and implement controls based on technical parameters of how advanced particular technologies are, limiting U.S. investments into any part of the advanced technology ecosystem. While this is inherently a broader approach, it is also a necessary one in recognition of the difficulty in separating the potential for civilian and military end uses, particularly in emerging technology areas.

Investments in technologies that are subject to high levels of export controls represent a relatively more straight forward case for policymakers. The United States maintains an arms embargo for China, which includes items on the U.S. Munitions List, items in a series 600 entry under the Export Administration Regulations (EAR), and space and military items in a series 9x515 entry under the EAR. It also maintains export controls on a wide range of dual-use technologies (i.e., those technologies that have both civilian and

military applications), implemented by the Department of Commerce and listed on the Commerce Control List. Of these, multiple dual-use technologies are subject to strict (i.e., presumption or policy of denial) licensing policies for exports to China, including for national security or regional security reasons. Leveraging these lists to scope the outbound investment program can enhance coherence across policy instruments. Additionally, the U.S. government has already determined that the technologies on these lists are important for U.S. national security and foreign policy interests, and outbound investment controls can be viewed as a reinforcing measure to ensure that outbound investment does not erode the efficacy of the export control system. A key decision for Congress will be how closely to align outbound investment with the export control system, and whether it should proceed with a narrow set of technologies from these lists for an initial phase of any outbound investment program.

Emerging technologies present a more difficult case. Often, the full applications of an emerging technology area are not known, and it is therefore difficult to impose controls on the basis of an anticipated end use or end user. At the same time, these technologies, such as AI and quantum technologies, may be central to future U.S.-China competition. Given relatively lower levels of export controls in many emerging technology areas, Congress may wish to consider whether a direct link between export controls and any future outbound investment restrictions is appropriate. Noting the need for clarity and precision in applying new outbound restrictions, should Congress determine that a bespoke list of emerging technologies is required for outbound investment control purposes, it will need to develop technical descriptions of which technologies are captured and which are not—or instruct the executive branch to do so via regulation. One guide for the types of emerging technologies to consider is the Office of Science and Technology Policy's *List of Critical and Emerging Technologies*.[11]

V. Structure of an Outbound Investment Program

Given the complexity of the investment environment in China, the United States will need a defense-in-depth approach to adequately address the national security risks associated with certain U.S. investments in China. Each of the tools described below addresses a particular area of risk, and they should be viewed as a package that can more holistically address investment risks when used in tandem.

Enhancing transparency of U.S. investments in China

The U.S. government does not have full visibility into the entire scope of investment transactions being made by U.S. investors in China. Existing data sources are often too aggregated or incomplete, providing little information on the critical technologies involved in investment transactions. It is difficult to ascertain from existing data sources what the technical capabilities are of the Chinese business receiving the investment. These data issues are exacerbated with private deal flows, including venture capital flows, which face fewer public disclosure requirements than publicly listed companies. Recent Chinese efforts to crack down on Western due diligence firms further complicate attempts to understand the investment environment. The CSET report noted above also assessed that existing data sources are insufficient to assess the full set of risks that may arise from outbound investments, a notable finding from a research institute that specializes in bringing data science to policy debates.[12]

A mandatory notification regime can fill these gaps. A notification program would need to address both the type of investment transaction covered and the type of Chinese entity that is the recipient of the transaction. It should initially include a broad scope of investment transactions, including both "smart money" and passive investments. Such a broad scope would not be necessary in perpetuity but is beneficial upfront to ensure that the government has a robust understanding of the types of investments being made. This would need to be paired with strict confidentiality requirements (*e.g.*, exemption from Freedom of Information Act disclosures) in order to build public confidence that the confidential information collected would appropriately protected.

Additionally, notifications should be required for covered investments made in any Chinese entity that produces, designs, tests, manufactures, fabricates, or develops any item or items that would controlled (or, that would require a license for export to China) under U.S. export controls if originating in the United States. Notification could also be required for any covered investments made in a Chinese firm that is listed on the Department of Commerce's Entity List.

Prohibitions of investments in high-risk technologies or sectors

While notifications can help fill important gaps in U.S. government knowledge on outbound investment transactions, the government has sufficient knowledge about certain types of investments that would unarguably present national security risks. This includes:

- Investments in arms embargoed technologies: The United States should prohibit U.S. investments in any Chinese firm that produces, designs, tests, manufactures, fabricates, or develops any technology that meets the technical specification of a technology that is subject to the U.S. arms embargo for China. Outbound restrictions can reinforce the arms embargo, by prohibiting U.S. investments that may support the indigenous development of these types of items in China. While one would hope that U.S. investment is not flowing to these types of technologies, it would nonetheless be a commonsense step to explicitly prohibit such investments.

- Investments in highly controlled semiconductor and related technologies: The U.S. government has been active in protecting U.S. leadership in advanced chips technology, in recognition of the essential enabling role that chips play across the entire spectrum of U.S. military, national security, and economic capabilities. This includes CHIPS Act investments in domestic manufacturing capacity, paired with national security guardrail provisions to protect these investments. It also includes ambitious and unprecedented new export controls on advanced semiconductors, including the equipment and software required to produce leading edge chips, most notably through the export controls initially released on October 7, 2022. Investment restrictions that prohibit U.S. investments into Chinese entities that are producing advanced chips and related equipment and software would complement these existing efforts, ensuring that U.S. investment does not counter the stated policy objective of keeping the United States "as far ahead as possible" in this critical technology area.[13]

- Investments in frontier AI systems: Frontier AI systems (often defined as general-purpose systems at the frontier of AI research and development) are showing increasing capabilities to mimic human cognitive abilities and learn new skills through ingesting and analyzing massive amounts of data. Though these systems retain many rough edges, there are already indications of national security harms that could arise from misuse, including enabling cyberattacks, spreading disinformation, conducting weapons testing, or developing novel toxins.[14] Many experts are concerned that these same capabilities could lead to catastrophic outcomes, either via accident or deliberate misuse.[15] While an overall framework for governing frontier AI systems is still being debated, there is growing consensus on the need to set certain control parameters based on the computing power of the AI system. For example, the *Executive Order on the Safe, Secure, and Trustworthy Development and Use of Artifical Intelligence* released in 2023 includes technical parameters based on computing power for both general purpose AI systems as well as certain narrow (i.e., application specific) AI systems.[16] Investment restrictions based on the computing power of the AI systems being developed can be an important element of the evolving AI governance regime. Additional analysis on considerations for setting technical controls based on computing power can be found in public comments submitted by CNAS and other researchers on the administration's outbound investment ANPRM.[17]

In these areas, the government has clear knowledge that U.S. investments would be contrary to U.S. national security interests. Prohibitions can act as a bright-line rule that provides clarity to the private sector and enables compliance, while minimizing the administrative burden of implementing the program. These types of prohibitions are intentionally designed to not require transaction-by-transaction screening (i.e., a "reverse CFIUS"), which would be a cumbersome and unnecessary bureaucratic process. Instead, a prohibition structure could operate in a manner more similar to how U.S. sanctions programs are administered, with the government setting clear bright line rules and then focusing government resources on providing guidance and enforcing those rules rather than adjudicating individual investment transactions.

Over time, additional prohibitions could be added to the above recommendations. Key sectors for consideration should include quantum information technologies (identified in the administration's executive order) and hypersonics and high-performance computing (identified in the McCaul-Meeks legislative proposal). Aerospace may also be a candidate, given U.S. and European duopoly power in this sector. Clean energy technologies, including batteries, should also be considered, as U.S. investments in this sector in China raise a host of national security, energy security, and human rights concerns. Future additions could be contingent upon congressional authorization and a requirement that expansion be subject to a robust public debate and comment process that brings in a wide range of stakeholders, including workers and non-governmental organizations in addition to private sector representatives and international counterparts. Expansion should also depend on the administrative capacity to implement a larger program, as well as an assessment of whether the initial set of prohibitions is effectively meeting U.S. national and economic security objectives.

A key question for Congress will be whether to apply prohibitions on a going-forward basis only or whether such prohibitions would apply retroactively. Precedent in the CFIUS context would suggest applying new prohibitions on a going-forward basis only, as the expanded jurisdiction authorized under the Foreign Risk Review Modernization Act of 2018 (FIRRMA) applied only to transactions made after the effective date of the regulations.[18] Retroactive application raises a complex set of challenges, including commercial damage to U.S. investors who were acting in compliance with U.S. law at the time the investment was made, the consideration of due process for U.S. investors, and the potential for litigation should U.S. investors dispute the U.S. government action. However, the government may wish to enhance its visibility into legacy investments, as prior investments in high-risk technology areas may present ongoing national security concerns, even if they were legal at the time of the investment. One option could be to adopt the approach to legacy investments taken by the administration's executive order on outbound investment, which notes that the government may seek information about prior investments.[19] Transparency around legacy investments can inform the design of outbound investment restrictions moving forward.

Expansion of the non-SDN CMIC program

The U.S. government should establish authorities to prohibit U.S. investments in particular Chinese entities, as a complement to sector-based notification and prohibition requirements. This allows for stronger action with respect to specific entities that the U.S. government identifies as acting against U.S. national security or foreign policy interests. The government has entity-based investment restrictions under the non-SDN CMIC program. However, this authority is limited to the purchase or sale of publicly listed securities. Congress should consider expansion of this program to include all types of investment transactions, including private investment transactions. It could also expand the scope of the program to authorize the designation of Chinese companies that are supporting Chinese indigenous development of national security technologies.[20]

Expansion of the non-SDN CMIC program would provide a well-calibrated and proportionate response to concerns over U.S. investment transactions. Policymakers have also considered the utility of full blocking sanctions (i.e., designations of entities as specially designated nationals (SDNs)). Caution is warranted when considering the use of SDN sanctions outside the context of an active conflict. SDN designations implicate

the role that the U.S. dollar plays as an international public good, given the centrality of the U.S. dollar in the global financial system. SDN designations essentially weaponize the centrality of the U.S. dollar, ejecting the targeted entity from licitly engaging in international financial transactions.[21] This effect extends far beyond the limited set of transactions that would be involved in U.S investment flows to China. An SDN-based approach is also highly unlikely to be matched by U.S. partners and allies, whose alignment will be critical to ensure effectiveness of any new outbound investment policies.

Recent CNAS research on the use of sanctions in a potential conflict with China found that overall U.S. economic leverage is modest, at best.[22] The strongest area of U.S. advantage is in the financial sector, given China's deep integration into the U.S. dollar-dominated financial system. Should the United States prematurely use SDN sanctions, it would erode the potency of this tool in future crisis scenarios and increase the likelihood that China will intensify efforts now to build alternative financial rails that avoid the use of the U.S. dollar. Keeping China deeply integrated into the overall financial system, while addressing discrete national security risks associated with certain U.S. investments, strikes the right strategic balance and maintains important U.S. leverage over China.

An entity-based approach based on expansion of the non-SDN CMIC program would be an important component of an overall outbound investment program, but it is insufficient on its own. Entity-based programs are inherently reactive, as they require the government to identify the problematic actor and assess whether it meets the criteria for listing. Inherently, the identification and listing process will occur after the designated entity has already engaged in behaviors contrary to U.S. national security and foreign policy interests. This presents additional challenges in the start-up space, where visibility into what companies exist and what their capabilities are is sparse.[23] Further, entity-based approaches often suffer from a "whack-a-mole" effect, in which shell companies and subsidiaries can be used to evade U.S. government restrictions.[24] Proactive U.S. policy that seeks to prevent national security harms, rather than just react to harms that have already occurred, must account for these limitations of entity-based programs.

VI. Assessment of *Executive Order 14105: Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern*

The administration released *Executive Order 14105: Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern* (the EO) in August 2023, and it reportedly intends to finalize the associated rulemaking by the end of 2024. The outbound investment controls outlined in the EO align in many ways with the recommendations of this testimony. The EO sets clear bright lines for the types of investment transactions covered, prioritizing investments in a small set of technologies that present high national security risks. However, the EO could be further strengthened by:

- Clarifying the concept of "intangible benefits:" The EO justifies the need for outbound investment controls by noting that "U.S. investments are often more valuable than capital alone because they can also include the transfer of intangible benefits," such as "enhanced standing and prominence, managerial assistance, access to investment and talent networks, market access, and enhanced access to additional financing." However, the EO does not attempt to define what activities constitute "intangible benefits" and how this concept might be used in regulation to differentiate passive investments from those investments in which the U.S. investors play a more active role.

- Limiting extraterritorial application: The EO should limit extraterritorial application of the U.S. outbound investment controls, asserting extraterritoriality only where necessary to prevent circumvention of the rules by U.S. investors. Risks associated with non-U.S. investors are more effectively addressed by aligning policies on outbound investment controls with key international partners that are also major exporters of capital and technology.

- Clarifying safe harbor provisions: As drafted, the EO does not specify how multi-stage investments, growth transactions, or potential pivots of the invested business would be covered, or whether such transactions would be granted safe harbor from subsequent prohibition or notification requirements if the original transaction was not subject to the requirements of the EO.

- Add an entity-based prohibition: The EO applies controls only on a technology list basis. The government should add an entity-based prohibition as well, to allow the government to list specific bad actors in which there is a national security imperative to prohibit U.S. investment. This approach would mirror that of export controls, where end use, end user, and list-based controls are used to complement and reinforce each other.

- Strengthen the controls on investments in AI companies: The EO standard for prohibiting U.S. investments in Chinese AI companies is overly narrow, as it applies only to the development of software that incorporates an AI system and is intended exclusively for use in military, government intelligence, or mass-surveillance end uses. An "exclusive use" standard in the context of a technology that is inherently dual use will likely lead to a null set of prohibited investment transactions. This standard should be modified to reflect the dual-use nature of AI systems. Additionally, the government should add a technology-based control to prohibit U.S. investments in frontier AI systems, as defined by computing power thresholds.

Additional analysis of the EO and technical recommendations are available at: https://www.cnas.org/publications/commentary/comments-on-provisions-pertaining-to-u-s-investments-in-certain-national-security-technologies-and-products-in-countries-of-concern.

VII. Additional Considerations

Investment controls in the context of a U.S. economic security strategy[25]

Investment controls will be most effectively implemented in the context of a broader economic security strategy. The United States needs, but does not have, an economic security strategy. The Department of Defense recently released a defense industrial base strategy, the Department of Commerce is reportedly set to release its own national security strategy, and the Department of the Treasury in 2021 released a sanctions strategy.[26] That each agency is developing and releasing its own strategies is emblematic of the larger problem: the United States does not have a holistic vision for how to utilize all of its economic tools in tandem to achieve an articulated end state in the economic and geopolitical relationship with China.[27]

Recent CNAS research put forth one framework for developing economic security strategies, including introduction of the concepts of economic domain ends, ways, and means:

- "**Ends** specify the desired end state between the U.S. economy, its partners' economies, and that of its adversary, and are derived from broader … strategic objectives….
- **Ways** are the various methods of applying economic pressure … including a range of coercive economic statecraft measures such as financial sanctions, technology export controls, and tariffs.
- **Means** are defined in terms of the United States' relative capacity in an area of strategic economic activity."[28]

While this economic domain ends, ways, and means construct was developed in the context of research on sanctioning China in the event of a conflict, the broad concepts apply equally to managing the economic security relationship today. The United States must set a clear vision for what a future economic relationship with China looks like, balancing the economic need for continued ties with the security need to de-risk certain areas of economic activity. This vision should be derived from the broader national security strategy and

focus on addressing the risks to national security that can arise from economic activities.[29] It then needs to develop specific, measurable strategies for how it can use all tools of economic statecraft to achieve the desired end state. Statements from administration officials have planted the seeds for what a potential strategy could look like, but none yet provide a clear view on how the United States should define the economic relationship with China to address growing national security concerns.[30] This is a particularly important gap, as the range of sectors that are assessed to have national security implications continues to grow and now encompasses much broader swathes of ordinary commercial activity.

The potential range of policies and programs that could be used to advance U.S. economic security objectives (i.e., economic domain ways) is broad and include tools such as tariffs and trade policy, subsidies, restrictions on the import of information technology goods and services, and government procurement requirements. How these tools are used in tandem to promote U.S. technological leadership should be a core element of an economic security strategy. Importantly, the United States cannot forgo "run faster" policies that are intended to make U.S. innovators competitive in global markets, as continued growth and technology leadership necessitates access to a broad range of customers and markets outside of the U.S. domestic market.

Semiconductors can provide a useful case study in the need for more holistic strategies. The United States has taken proactive steps to maintain U.S. advantage in advanced chips, including through precedent-setting export controls on technologies China needs to make advanced chips, as well as a large push on industrial policy to support domestic chips production and research and development. So far, so good. However, the effect of these policies is to create a structural incentive for China to double down on investments in legacy chip production, and the United States is not prepared to address a surge in imports of Chinese legacy chips.[31] Export controls would likely be ineffective, simply because China already has the technology necessary to make such chips. Tariffs, import restrictions, government procurement policies, and outbound investment controls could all play a role in addressing the import problem, though whether they can slow China's global growth without harming U.S. economic interests remains unclear. A more deliberative process for setting economic security strategy should anticipate these sorts of unintended consequences to enable more nimble and effective U.S. response to shifting market dynamics, including those shifts that are caused by actions of the U.S. government itself.

An effective economic security strategy will require breaking down of bureaucratic siloes and a sharp focus on prioritization of issues. It will require working across all the economic agencies in the executive branch and across multiple committees of jurisdiction in Congress. As officials proceed with developing economic security strategy, they must remain laser focused on addressing the most pronounced gaps in the U.S. toolkit. In addition to continual updating of export controls and CFIUS, passing legislation to address problematic vacuums in U.S. authorities, such as those related to outbound investment, is an important part of an effective economic security strategy. A stronger vision of a U.S. trade policy that advances U.S. economic and security interests is also essential.

Alignment with international partners

Outbound investment controls, like export controls or other economic security tools, are unlikely to be effective over the long term if implemented unilaterally. Capital and expertise can flow easily across borders and non-U.S. investors can quickly step in to backfill any space left by U.S. investors in the China market. Investment controls will work best if done with allies and partners that are also critical sources of capital and expertise. Certain allies and partners have established or are moving towards developing an outbound investment screening regime, including South Korea and Taiwan.[32] The European Union recently announced further progress on its own efforts towards outbound investment security programs.[33] The United States must work closely with these and other partners to align outbound investment screening mechanisms, as well as to ensure consistency between these mechanisms and existing export control and inbound investment

screening tools. Doing so will be critical for ensuring U.S. national security, as well as preventing the further fragmentation of the global trading system.

Congress can support these efforts by fully resourcing the international engagement functions of a new outbound investment program. As it did in the FIRRMA process, it can emphasize in legislation the importance of international engagement and provide specific tools, such as the ability to share otherwise protected information, that can facilitate international coordination. These efforts in FIRRMA were a success story, as the United States was able to work effectively with a broad range of international partners as they stood up or strengthened their own inbound investment screening mechanisms.

Evaluation

Outbound investment restrictions are a novel policy approach, and they may result in unintended consequences for U.S. competitiveness if not implemented and enforced correctly. In addition to front-end efforts to design a well-scoped and proportionate set of controls, Congress should also consider requiring regular evaluation of the new outbound investment program to assess whether it is meeting Congress's national and economic security objectives. Evaluation of economic security programs has a poor track record overall. Treasury has established a sanctions evaluation office, in a welcome but lonesome step as none of the other economic security programs have similar offices. As economic security tools are being used at an unprecedented scale and for a broader range of national security and foreign policy purposes, this represents a worrisome blind spot in U.S. policymaking. Congress could avoid this problem with outbound investment by establishing an evaluation function or requirement at the start of the program. Additional analysis related to strengthening U.S. economic security programs, including in strategic planning, analytic capacity, and evaluation, is included in prior testimony provided before the U.S. Senate Committee on Banking, Housing, and Urban Affairs.[34]

VIII. Conclusion

The United States faces a new era of strategic competition with China, one that presents challenges fundamentally different than prior eras due to China's essential role in the global economy. U.S. policy must account for objectives in tension with one another, including the need to de-risk economic ties that present pronounced national security risks while ensuring the openness and stability of the global economy. A well-designed, proportionate outbound investment program can contribute to these goals, but controls are insufficient on their own. They must instead be part of a broader U.S. strategy to affirmatively promote U.S. technological and economic leadership, advance democratic and open societies, and affirm U.S. interests and values. Only by taking the holistic view of U.S. technological competitiveness can the United States win the strategic competition with China.

IX. Additional Analysis

The following reports and analysis are cited in this testimony and are highlighted here for the convenience of the Commission in its future work.

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PANEL III QUESTION AND ANSWER

COMMISSIONER WESSEL: Thank you, both for the time and effort you put in for appearing. Emily, I appreciate your comment about the title of the hearing and we had a small debate with our staff and we'll deal with that later. I say that in jest of course.

I'm going to take the prerogative of the Chair and start if I can. Emily, you just said you know, that outbound as I heard you, is a defensive tool. I view it in part as Derek does as well, which is an issue of transparency and understanding. Our first panel today was also about data that will help guide policy makers. Certainly there is a component of outbound, which goes to prohibitions, et cetera, but can you comment on Derek's points about the lack of transparency overall and the visibility? You know, how can policymakers make good decisions when, you know, for many areas they are going in blind?

MS. KILCREASE: No, I completely agree with that point. I mean transparency is going to be a large part of how we try to address the risks arising from outbound investment flows. You know, when we look at for example, the startup community and you look at the available public sources of data, the business intelligence data sources, it's just incredibly difficult to try to find the specific types of companies that are being invested in, and particularly for the government to have that knowledge.

As Derek notes, the investors may have that knowledge, but that doesn't help the government that much if that information isn't flowing into government decision making processes. And I think similar problems exist when it comes to portfolio flows. And so transparency is absolutely part of the solution here and should be something that we do first because getting that additional information and transparency should inform how we think about additional steps when it comes to the prohibitions or other sorts of regulations on outbound capital flows.

COMMISSIONER WESSEL: As a former government official, did you have access or seek access to some of the existing sources of data? I refer most importantly to the MNE report that Department of Commerce does. There's also the SOI -- the Statistics of Income reporting by the IRS, both of which are restricted only to certified researchers. But as a former government official, was that -- was there any internal review sharing of that data, et cetera?

MS. KILCREASE: So let me answer this in a way that's consistent with obviously not revealing sources and methods, which I know you don't expect me to.

COMMISSIONER WESSEL: Correct.

MS. KILCREASE: But you know, when it comes to access to statistical information or information that's collected by the government, I mean government officials are still constrained by the requirements that authorize that statistical data collection. And so if it's not permitted to be shared outside the context of the authorized program, then folks in for example, the CFIUS Office or the Investment Security Office may not necessarily have access to that data if it's collected for another purpose and the authorities governing that data collection preclude sharing internally.

COMMISSIONER WESSEL: Okay. I understand the sources and methods issue, but for the data collection that BEA does, which is not a sources or methods issue, but rather a question for certified researchers. Were you able to have access to it? Did you ever seek access to it? Again, that's the data set, you know of all -- what all MNEs are doing in other markets.

MS. KILCREASE: So I believe that we used during the time that I was at Commerce, which to be clear is a little bit dated at this point, so the process may have changed, was primarily based on the publicly available date from BEA.

COMMISSIONER WESSEL: Okay, so it wasn't granular. Derek, what do you think might be possible -- I agree completely in terms of greater transparency. You and I work closely on that. Are there any existing authorities you think that could be pulled on more with the SEC and otherwise before we go to some -- having to pass some new law? I want a new law as well. We've been working on that for a number of years and it's been slow going. Other than the -- and for your comments as well on the draft outbound reg, how do you view that working and how -- what kind of action can the Administration take on its own?

DR. SCISSORS: Yeah, that's a lot of ground to cover. I don't think much of the draft outbound reg, mostly because the advanced notice of proposed rulemaking was so weak. They're asking firms hey, could you tell us what you're doing in China? I mean isn't it a little late to be asking that question as it was raised by the Administration itself in July 2021? Now you're getting around and then August of 2023, asking them the question? We of course still don't have the implementing regs. I could have written them in a week. I think some people don't want these -- the EO to be implemented. I think the start date will probably be 2025. You can write a better EO, so that's one thing you can do. The Administration chose not to do that. The Trump Administration chose not to write any EO. And it was raised to them.

I think in terms of data, we Commerce have -- gets data -- very general data from direct investors. Portfolio investments should be easier because the numbers are larger. You should be able to have more specific data categories and hide individual investors, which is what you don't want to, you know, disclose and expose individual investors. You should have more refined data sets in portfolio investment.

In terms of what more to do, and I know I've taken you over time, seven years ago we were told you couldn't get nationality data for portfolio investment and now we can. And that's not due to me, that's due to some people at the Fed and at Treasury doing very good work. I don't think we've tried. I think a simple law where Commerce doesn't tell Treasury, the Fed, Commerce, whoever exactly what to do, but just says try to find this data. And you are required to report it the way the Fed is writing a paper every year now would be a step forward. And again, if Commerce can disclose sectors, then Treasury or whoever is doing portfolio investment can also disclose sectors. This is a continuation of existing U.S. policy that I'd like to see formalized, rather than a giant new research effort where you have the implementing agency saying we can't do this so we need tons more staff or we need a ton of time.

COMMISSIONER WESSEL: Thank you. I don't see Robin, so Commissioner Friedberg.

COMMISSIONER FRIEDBERG: Thank you very much and thanks to both of you for your testimony. It seems to me you both start with a very commonsensical position, which is that it doesn't make sense for us to be trying to limit exports in technology and do other things to slow the development of certain technologies in China while at the same time permitting investment in those -- the companies that are developing those things. But then if I'm understanding you correctly, you kind of go in somewhat different directions in your prescriptions for how to deal with that.

So Derek, if I could start with you, Emily says in her testimony that purely past investment flows are unlikely to present a high risk profile challenge, ample access to capital from both domestic and foreign sources, thus restrictions on broad flows of money are unlikely to have a meaningful impact. Does that contradict what you've said? Okay. Could you --

DR. SCISSORS: Yeah, this is a big point where we disagree.

COMMISSIONER FRIEDBERG: Okay.

DR. SCISSORS: And I'm not -- I want us to disagree, so I'm not going to try to compromise. Emily is completely wrong. She's going to say something now that sounds reasonable, but don't be tricked. Look, the story there is it isn't true that China has ample funds. I mean it certainly has ample funds if it decides this is it's number one priority and money can be allocated. There's no doubt about that. It may even in the number one priority be misallocated. This has absolutely happened in semiconductors where they have blown tons of money on bad firms. The HNA Group comes to mind immediately, but there are some less high profile examples.

And then, you know, what we're also talking about is not does China have infinite money? Of course it doesn't have infinite money. It is a -- It has a -- It's possibly the worst debt performance on record over the last 14 years. And so if we -- you know, if China can fund it's first priority perfectly, which it can't, we're talking about can it fund its 15th priority? And remember, China's priorities are going to be domestically oriented. So the things that we care most about in terms of a threat to American security, that's not one, two, three. One, two, three is to control the Communist party. So we are talking about money that matters.

Now if you found that portfolio investment was not volatile, I'd think okay. But we had this huge increase during the Trump Administration and then a sizeable decrease during the Biden Administration the first two years, but it wasn't due to the U.S. We didn't do anything. It was due to Chinese actions discouraging both their own private sector and the U.S. private sector. We even now, and maybe I get this more than anyone else in the room, have U.S. financials soliciting investment. Chinese stocks are soaring. Give us money. Give us money. Give us money.

So I see a lot of volatility in portfolio investment that I find dangerous. During the rising years, the thing that upsets me, and I'll stop to give Emily time, we increased our portfolio stock in China in 2020 when we were afflicted with COVID that started with China that they lied about by over $250 billion. And we have no idea what that money did. That's not competing.

COMMISSIONER FRIEDBERG: Yeah. I mean it seems that you could expand this argument and make a case for trying to limit flows of capital to China more broadly than if they have less, they're going to face tougher choices, rather than trying to get into the business of tracking and determining where everything is going. It seems to me there might be a case to be made on national security grounds in saying we want to restrict it all together. I'd like to get your reaction, but first, I just wanted to ask Emily if she had a response.

MS. KILCREASE: Yes. So you've honed in on the one big area of disagreement between the two of us in terms of whether we should be prioritizing passive flows in at least the first tranche of an outbound screen -- excuse me, not a screen -- outbound investment control, specifically not a screen. I don't think a screen is a good idea.

You know and I would make two points there. I mean one, I think it's an issue of prioritization. I am much more worried about the risks that arise from an investment transaction that includes capital, plus that something else; the intangible benefits, or was I call it in my testimony, the nontechnical industrial expertise. I think it's this additional component of an investment transaction that is unique to U.S. inventors. Right? We've got amazing companies, amazing investors that are really going to help fuel the development of these key technologies. And key technology companies in China, that's what they worry about most. I don't think we have infinite capacity in the government to address everything. And so that's where I want us to

focus at least initially. It’s taken us long enough to kind of get to where we are, let’s focus on that.

COMMISSIONER FRIEDBERG: Okay.

MS. KILCREASE: You know I do -- with passive flows -- You know I do worry more about the backfilling and the fungibility of money, you know, noting some of the dynamics that Derek mentioned. Nonetheless, I do think particularly because it’s likely that the United States would move first and it would be a unilateral first move, it’s highly likely that there would be substitution of capital flows in the market that would erode some of the effectiveness of the U.S. approach.

COMMISSIONER WESSEL: Derek.

DR. SCISSORS: Ten second response. What American financials themselves brag about is we’re better at this than everyone else. Where are the opportunities now in global stocks if you noticed NVIDIA’s announcement yesterday? I don’t want American money finding Chinese, you know, mid-level new semiconductor producers or new AI app companies and saying we found these diamonds in the rough before anybody else. There are huge profit opportunities there, which there are, and then we’re going to send them this money. So I’m looking to block what I think are in fact the highest risk investments.

I agree with Emily that if you try to do everything at once, you’re probably going to miss high risk investments. Let’s start with those.

COMMISSIONER FRIEDBERG: Thank you.

COMMISSIONER WESSEL: Commissioner Glas.

COMMISSIONER GLAS: It’s so good to see both of you again. Dr. Scissors, I actually had a question for you. One of your recommendations is Congress should put into law a short list of generally critical sectors and keep it narrow. How would you help -- What are the parameters to which Congress should develop this list based on your analysis?

DR. SCISSORS: Yes. If you’re asking me for my opinion on what the sectors should be, I’m going to dodge that because I’ve changed my mind in the last five years. And one of the things I want to do is get a review process. I would start by going to the Defense Department and saying what are the four -- and it’s not AI, it’s what capabilities of AI and what areas? So you’re going to have to be more specific. It’s really subsectors if you wanted to use more precise language. What are the four, five, six things? If it’s a tie for six, okay, but not the 30 things that you’re most worried about. And just say okay, we’re not giving the Chinese money in this area.

So I know Congress has had a lot of trouble with critical sectors because I’ve been involved in that and probably the Commissioners have too. You start off with a short list and somebody says mine and it just goes off. But that’s why I would like DoD to be more involved in this process because I don’t -- this isn’t -- There is an economic security element as Aaron brought up, the primary element to me, the starting point is national security. So go to Defense and find out what the scariest things are.

COMMISSIONER GLAS: Do you have any thoughts?

MS. KILCREASE: I mean I agree that Defense has an important role to play in identifying those sectors. You know, when I think about the sectors that we really care about, it’s sectors that are going to matter for our national security interests, including our military balance of power. And it’s areas where there’s commercial engagement. Where there is actually some level of investment flow that’s contributing to Chinese development in these sectors.

And I do think it’s fairly clear that semiconductors and the semiconductor ecosystem is one that we need to address. And the right way to do it is to structure investment controls that

essentially mirror the approach we're taking in the export control context where we're defining based on clear technical cut lines, the types of semiconductor development that we are or are not okay with our companies being engaged in, and citing controls on that basis on an economy-wide and a country-wide basis. Getting away from this approach of trying to differentiate between the civilian and military end use in China, which is a difficult, if not impossible task. Right?

So I think that's the general framing and conceptual approach I would take. And I think you do semiconductors. I do think you could do frontier AI systems, but anything other that, you need to be much more specific in terms of what you mean by AI. And then I do think some of the efforts that have emerged out of the congressional efforts identifying hypersonics for example in quantum technologies are ones -- I don't know what that specific technical cut line would be, but I do think those are areas that kind of meet the initial two criteria that I identified of you know, matters. And if there's commercial engagement, then we should think about a control in that space.

COMMISSIONER GLAS: In the absence of congressional action on this, what is -- what are the ramifications to the American people and our national security? And how urgent is this?

MS. KILCREASE: Well, I think the easy answer is that the executive will take over. Right? I mean there is an executive process underway. An executive order, I think is -- I'm a little bit more optimistic about it than Derek is. You know, I do think it's generally taking the right approach, although it's not perfect and we've provided several comments on why it's not perfect. Right? So I think that will move forward. But I think the question is over time is whether it's a program that will work as well as it could if not given the congressional oversight and congressional attention that it really deserves.

DR. SCISSORS: And I agree with that. I'm going to paint a more specific scenario and it might be happening right now, which is we're saying we're competing with China and we have two political parties talking about I'm going to be tougher on China, no, I'm going to be tougher on China during election. And then we're going to find out at the end of 2025 that a quarter of a trillion U.S. dollars poured into China to support we don't know what. And you know, that can go on for a while and I guess it won't matter. We might see some of our industries disappear partly as a result of U.S. funding competing Chinese industries. But the thing I really worry about of course is a military confrontation where we have engaged in a pattern of helping China develop auxiliary military technologies. And while we've been talking about competing and we can't do this and then we're surprised when they have military or economic capabilities.

You know, we have been -- we've talked about it in this Commission when I was a Commissioner and as a witness. China was surprisingly fast in X, Y, and Z. Well, part of the reason is because we helped them be surprisingly fast. And so my concern is that we're going to get surprised again in a very unpleasant fashion.

COMMISSIONER WESSEL: I don't see Commissioner Helberg on the screen, so Commissioner Kuiken.

COMMISSIONER KUIKEN: That went faster than I expected. So I'm optimistic that the Senate and the House might come together on outbound investment this year. So I want to take an additional step with both of you. If as a Commission, we're thinking about implementation of an outbound regime, what are the things that Congress could think about baking in to the legislation as they draft it in terms of deadlines and other sort of -- other tools that they have available to them to compel the Executive Branch to not trip up in areas where we can easily anticipate implementational problems or challenges or interagency agenda or all of the things that we know happen in our government?

COMMISSIONER WESSEL: Emily, you want to go first or Derek, it doesn't matter to me.

MS. KILCREASE: Yeah, that's a great question. A couple things immediately come to mind. I may think certainly Congress could play at important role in making sure the right agencies have a seat at the table for this process. I actually do think that the right place to house this is Treasury. So that's a point of disagreement here. But clearly, no matter who's in charge of the process, you know, the Defense Department, the Energy Department, they have really strong roles to play, the Commerce Department, particularly as we're thinking about linking this to export controls. I think those are all agencies that must have a seat at the table regardless of where the Chair ultimately sits on that.

In terms of other steps, I mean I do think deadlines for implementing regulations is a healthy bit of discipline to include. And as I mentioned in my opening statement as well, regular reporting requirements and being specific about the information that Congress wants to see either in a public unclassified form or in a classified report available only to Congress I think will be incredibly important to make sure that Congress can conduct its oversight role.

DR. SCISSORS: I think I'm going to echo all those points, although I have different takes on all of them. There has to be enforcement of this. There is -- So Chinese stocks just as a proxy because they performed so horribly for the previous 14 years and they're going to perform horribly in the future, but nonetheless, framing about 25 percent so far this year. And you can out-perform the Chinese stock market as a whole if you go for government-backed firms. And so there's a lot of money on the table.

Oh, I can make -- I can put a billion dollar investment in and make $300 million in my first year. We have to have serious financial penalties. And if we don't, they're just going to be ignored. It's like a 10 percent tariff on Chinese goods. They don't care. They're going to roll right over that tariff. And U.S. investors are going to roll right over these regulations unless there are serious penalties to them. And again, I don't mean for, you made your first mistake. Ah ha, we got you. I mean there's a pattern here where you willfully ignore the regulations or tried to circumvent them and so on.

On disclosure, I would agree with what Emily said. I would maybe go a step farther. Maybe the Intel Committees can only see certain information, but the U.S. Government has to have information even down to exposing an individual firm. We have investment opportunities in China and investors in the U.S. who can make critical differences in those investment opportunities even if they are the only ones. And of course, they want to be the only ones. They want to be the sole provider of capital to an investment opportunity. That information by U.S. standards and there are good reasons for it not to be public, but we need Congress to see that. They need to see where these risks lie. And if that means it has to be a ringfenced intel, then fine. But we need to see even just a level of individual investors.

And then finally where we disagree on who should be in charge, I just hate the Treasury Department's record on this and it's bipartisan. It's Trump and now the Biden Administration, obvious stalling. Like it just -- they might as well be shouting from the rooftops, can we get this to the next administration in both cases. First, we don't want to gather the data. Then we're going to deny there's a problem. Then we can't deny that there's a problem, but oh, we have to do something else now. Then okay, we're getting ready in EO. Look at that EO. How long would it have taken to write that EO, two years? No.

So we had the Trump administration that oversaw this huge outflow of capital to China and didn't want to talk about it all. And we have the Biden Administration that brought up the

issue middle of 2021, a few months after inauguration and then hasn't done anything. And so my main problem with Treasury is their track record since 2017.

COMMISSIONER KUIKEN: Emily, you've been in the Executive Branch. From an implementation perspective, what tools would be helpful to people that would be implementing this type of regulatory regime, you know would be helpful. And then how can Congress potentially bake those into the legislation?

MS. KILCREASE: Yes. I think one of the most important things is going to be access to financial intelligence. That's actually one of the main reasons why I think putting this in the Treasury Department as opposed to the Defense Department makes more sense because they have that expertise, they have that institutional muscle of tracking international financial flows from a sanctions perspective. Right? So there's -- there's a little bit of expertise there I think is important.

So part of it is do they have the access and the intelligence capabilities to really enforce? I agree with Derek that the enforcement and ability for the government to confirm that these regulations are being applied is important. There's going to be a level of just sheer resources and staffing that needs to happen. It's the boring stuff that nobody likes to talk about, but is absolutely critical. Access to business intelligence databases, et cetera, a wide range of sources so that they're not relying just on information from industry and investors as they think about whether their regs are being complied with.

DR. SCISSORS: Can I just -- just one little thing.

COMMISSIONER KUIKEN: Let me actually -- Derek, interrupt for a second.

DR. SCISSORS: Sure, go ahead.

COMMISSIONER KUIKEN: I would encourage you when you talk about this to not say just the intel committee. We have a lot of experience in Congress where we give Chairs ranking members access and one staff designee. And we do it in all kinds of areas. And so as you think about restricting data information, you can restrict it in a way that allows for committees of jurisdiction to still have sort of privacy. So just I'd encourage you to sort of think about it in a slightly different way.

DR. SCISSORS: So that's fine. I was giving an example to make sure we weren't saying everybody who wants to see this can see it. But I don't have a particular attachment to a particular committee. I do want to say one thing. Firms should disclose where their money is really going. They don't invest in the Cayman Islands. They know they don't invest in the Cayman Islands. It's absurd that we let them get away with saying they're investing in the Cayman Islands. The single most important thing would be for firms to just tell us what they're investing in and that's a pretty simple tool to have.

COMMISSIONER WESSEL: Co-Chair Miller.

COMMISSIONER MILLER: Thank you. There was a lot of overlap in your testimonies in terms of recommendations for Congress. But I thought some of those interesting discussions relate to your ideas around reverse CFIUS, which you do not agree on. Dr. Scissors says it would be "smaller and simpler than CFIUS" while Dr. Danzman calls it "much more complicated," and Ms. Kilcrease calls it "cumbersome and unnecessary." So there seems to be some fundamental disagreements. You have a reverse CFIUS.

In addition, there's a broader discussion on reverse CFIUS in which some people who are opposing the idea say it's too tough or too aggressive. And others say that it may not be aggressive enough because what you need are flat prohibitions and just smaller notification on the side.

I wonder if you can elaborate on the idea of reverse CFIUS. What are the problems? What should we do here?

MS. KILCREASE: Yeah. When I -- when I say reverse CFIUS, really what I'm talking about there is a process that sets up a screening requirement where transactions are coming into the government for an up or down vote. That is a really cumbersome process. It takes CFIUS way longer than it should to grind out those case by case, transaction by transaction reviews. And I don't think it's necessary in the outbound investment context.

There are a set of transactions that we just know are not going to get approved. And so it will be much more efficient from an administrative perspective and I think better for the private sector if they have that clarity and certainty. And we just say like if it's below 14 nanometers, you're not going to be like allowed to invest in China in that company. I think that eases the compliance burden on both sides -- both on the private sector and on the government.

So that's what I mean when I say don't do reverse CFIUS. It's purely about how do we create a mechanism that is efficient, that's clear, that's easy to comply with on both sides. And so it's not about whether we're being aggressive or not. I think we should set aggressive standards. It's more about the process of setting that standard and the administrative capacity to oversee it.

DR. SCISSORS: I mean I mostly brought that up because I don't understand the tagging of CFIUS as this bad thing. I think CFIUS has worked very well, especially since the very successful, which we were both involved in, reform process, 2016 bipartisan passed the House 400 to three effort. And so when people say oh, you want to do a reverse CFIUS, my initial reaction is, and CFIUS is a good government review. Is it perfect? No, of course not. But mostly I'm objecting to the idea that this government oversight of inbound investment is something that we would never want to do elsewhere when it's a successful, in my mind, program.

I don't actually want to just take CFIUS and flip it around. I mean we're not going to be restricting data the same way. There's all this fuss over land purchases, which I think is overblown, but whatever. It' doesn't apply to outbound. And so it's not the same kind of organization. My point about objecting to this is it's being used as a negative, but CFIUS is a government success. And if someone thinks reverse CFIUS means obviously you should reject it, I want to hear what they say about CFIUS. You know, I think we're going to find out them saying I don't care about national security at all. And then okay, well that's really what's going on here. It's not about CFIUS. It's about you just think national security should get out of your way.

COMMISSIONER MILLER: All right. And let's drill down a little deeper still. Ms. Kilcrease, you refer in your testimony to problems inherent using exclusive use standard in the context of the murky civil military divide. Is there any legitimate rationale you can think of for utilizing this standard? Or has it simply become a device for people who don't want to see restrictions on outbound investment through an exclusive use standard knowing that they're creating huge carve outs that essentially nullify the entire idea?

MS. KILCREASE: Yeah, I mean I can't speak to the intent of the drafters on that. But my view when I read that was that it would essentially end up in a null site. If you're creating a standard that says that we're crafting restrictions only that apply to AI systems that have an exclusive use for military purposes, it's just completely ignoring the inherently duel use nature of these systems and the fact that we don't fully know what all of their applications will be.

So if you look at particularly the frontier AI systems right now, they're incredibly powerful, getting more powerful by the second. And there's going to be a range of applications that we can't fully anticipate today. And so if you use that very narrowly crafted standard of

exclusively used, you're missing that. You're not going to capture those frontier AI systems. And so I do think that narrow scoping is problematic and will lead to basically no controls.

DR. SCISSORS: I don't really have anything to add to that except slurs, which I apparently am really good at. It's intentionally disingenuous. I mean the idea that oh, if there's any AI use on the commercial side, you can't consider it is just saying I don't care what the national security risk is again. But dressing it up in something that is, you shouldn't get in my way to make money. And this is the core battle here.

There are going to be costs. I talked about them in my testimony. I've talked about them before. I think they're exaggerated, but there's no question there's going to be costs. The issue is what's the national security risk? And I mean I don't know what the national security risk is from advanced AI, but we're taking big chances by the United States by saying well, as long as it doesn't have an exclusive military use, I think it will be fine. That seems to be blatantly irresponsible.

COMMISSIONER MILLER: Thank you.

COMMISSIONER WESSEL: Vice Chair Price.

VICE CHAIR PRICE: Thank you. And thank you both for coming today. I want to go back to the line of questioning that Commissioner Glas began on and that gets back to the critical sectors. So Dr. Scissors, I want to go back to that. You said that you had evolved over the past few years. Can you talk about that a bit?

DR. SCISSORS: This is making me seem like I was stupid six years ago. You know, let me start with the defense of my position. We should have reviews. You cannot mandate critical sectors for all time. Right? And there is this battle over how important steel is. Right? Well, in 1945, steel was really, really important. I think it's less important now. But for sure when you have fast moving technology development, which we have in the U.S. and China tries to emulate, you're going to have to have a review process.

I'll say again to avoid embarrassing myself, Congress was obsessed with 5G telecom not long ago. We don't hear that much about 5G telecom now. If we had been restricting investment in 5G telecom in 2017, I would want to change that. More specifically, the capabilities -- Emily has already referred to this, what we think of as advanced AI today is going to change. What we think of as advanced CHIPS has already changed. This is an area that I got wrong. So that's what I mean, I want an upgrade -- update process. I think everybody agrees on advanced computing. And the thing that I completely swung and missed on, and I still don't know enough to talk about on is the biotech side.

I just don't know enough to say oh, well these aspects of synthetic biology are worth restricting right now. I mean the Chinese are gathering a ton of genetic data. I don't -- I know a fair amount of about semiconductors. I don't know whether they're gathering genetic data that we should be afraid of and this is something we shouldn't help. So the bio side is the part I got wrong. I don't know how to include it now, but I do think in events to advanced computing, the obvious area has to do with biology. And I just don't know how to elaborate on it.

VICE CHAIR PRICE: That makes a whole lot of sense, but how would you construct this so that, that continual review looks at different sectors and could moderate accordingly?

DR. SCISSORS: So that's again where I would start with a DOD lead, which is DOD is going to tell us what they're most worried about. They're looking out some years. They're not looking at current capabilities necessarily. There are people in the room who help DOD look out some years as best we can. So you know, if they're in charge of a review committee saying hey, we used to be -- this is possible. We used to be most worried about hypersonics, but now we've

switched to worrying about something else. We can't really imagine taking hypersonics off the list. But again, 5G would have taken priority over synthetic biology in 2017 and I don't think we think that now.

So I'd have DOD run it. I'd definitely have input from other sectors, certainly Commerce because there's economic technologies built into Commerce's mandate. And I would do this every like three years. And there's no change that has to be required, but there should be change to be evaluated. And I would expect there to be change at the subsector level that we both talked about, which is okay, what is a worrisome quantum capability? Right? Well, okay. This was worrisome and now it's completely out of date and now this is worrisome. So that's the kind of decisions we're making where we keep quantum computing, quantum information science on the list, but we've refined what we mean by quantum information science.

VICE CHAIR PRICE: Thank you. And Ms. Kilcrease, you had very specific sectors in your testimony. How do you look at this in terms of changes and moving forward?

MS. KILCREASE: Yes. I do include specific sectors, but I also make the point which I think is right, which is that, you know, we can look to some of our existing processes, mainly export controls where we have a process -- a standing process to identify technologies of national security concern and place controls on them. So as a baseline, we should think about mirroring investment controls to match those export controls. Right? Like we don't even have that now for arms embargos technologies, which seems like a huge loophole.

So as a starting point, I think aligning the investment controls with the existing export control process makes a lot of sense. We've got those lists. We're pulling in existing government expertise. And that lends some kind of inherent coherence to these policy instruments. It has the added benefit that these are technologies that international partners will also be familiar with and in many cases have already agreed that there's a national security risk. Right? So I think that puts us on a better footing when we start to have those international engagement conversations.

You know, from there, we can think about whether there's additional layers of protection on key technologies. But even when we talk about semiconductors for example, you know, the way I describe that in the written statement is actually just a longer way of saying mirror what we're doing in the export controls context and match those thresholds. So I think that's a general starting point that makes a lot of sense. And then we can think about whether there's gaps specific to investment transactions that we need to fill.

VICE CHAIR PRICE: Thank you both.

COMMISSIONER WESSEL: Commissioner Schriver.

COMMISSIONER SCHRIVER: Thank you. Thank you and nice to see you both again. Can Americans and American investment firms invest freely in Cuba, North Korea, Iran, places like that? I work on China. I have no idea.

MS. KILCREASE: I mean I would argue that they're highly constrained by U.S. sanctions programs.

DR. SCISSORS: I would argue they're largely constrained by U.S. So the difference is they're profitable in China. And until recently, China -- our perceptions of China; the risks, the national security concerns were different as recently as five, seven years ago. So that's the difference; profitability and changing and evolving perceptions, I would argue. Are you aware -- I've heard anecdotally that funds that are -- that are sort of staying away from China security; the China-free, the non-China funds are performing quite well. Do you have any sense of that or any anecdotal evidence yourselves or are you sticking with "I just do China"?

DR. SCISSORS: Which funds --

COMMISSIONER SCHRIVER: Pension funds that have said we're divesting from Chinese security.

DR. SCISSORS: Well, I mean the peak of Chinese stock market was in 2007.

COMMISSIONER SCHRIVER: Right.

DR. SCISSORS: The most popular Chinese stocks in the U.S. were explicitly attacked by the Chinese government, you know, causing their market capitalization to crash, which is the -- you know, probably the single main reason for the decline in U.S. portfolio stock in 2021-2022. I mean over a period where the Chinese stock market has declined in value 40 percent, ours has risen 400 percent. So of course staying away from China in the long term has been a better bet for a long time. But again with finance, if you're thinking about a quarters worth of investment, if you have a sale point in China that isn't, I'm going to be here until 2040, there's money to be made, sure. And right now, China is out performing. So are funds that have divested doing well? Yes, they're definitely doing well. But that's not going to reduce the draw of China at all times.

COMMISSIONER SCHRIVER: Well no, I was trying to build an argument, but you're --

DR. SCISSORS: So it's just like when I was a Commissioner and I cut you off. Sorry.

COMMISSIONER SCHRIVER: But it seems to me that some of the arguments about we should be free to make money wherever we want to make money, there are other opportunities to make money. Anyway.

Is it also the case, I'm going to pivot a little bit to a different topic, but I think they're related -- If all this money is going in and we don't know where it's going, right, is it also the case that it could be exacerbating other things we care about like supply chain integrity? I mean presumably if China is taking a dominating position in some emerging technology or some sector where they're, you know, threatening to squeeze out all competition, is it possible that our money is also fueling that? Dr. Scissors or --

DR. SCISSORS: So I'll try to be quick cause we both want to answer this. To me, supply chains are the biggest U.S.-China economic issue now. In 2020, I thought it was outbound investment because money was pouring into China when they essentially, you know, unintentionally attacked us. But now I think it's supply chains and of course, outbound investment has a role in supply chains. We've seen that for all these bills. It gets pushed into the bill.

The problem is supply chains are an enormous topic and outbound investment, you want to start with something you can do. And this gets back to Aaron's point, if we're going to ban everything, okay, now we solved the problem. I would not like to consider supply chains in the first round of outbound investment policy that Congress makes because I just think it leads to an explosion.

That is not to say supply chains aren't important. And in particular to reinforce this point, supply chains below the level of the scariest technology are important. If you're talking about something that's connected to advanced computing like display technology, that's not the real capability that we have to worry about, you know, top level. But it's still a supply chain. We don't want the Chinese supplying everything or becoming indispensable to that supply chain. And they, you know, in that example and for lots of others, they have subsidized their way into either an indispensable or a commanding position. So I absolutely think the point is important.

The reason I want to separate outbound and supply chains is supply chains is a giant issue that doesn't necessarily focus like pharmaceutical supply chains. It's not necessarily about advanced technology. In outbound, we need some sort of discipline.

MS. KILCREASE: Yeah, I generally agree with that. And I would argue that while supply chains are incredibly important, I think the outbound investment controls is too blunt of an instrument to solve that particular problem. And using an outbound investment control won't necessarily make it commercially viable to have those supply chains anywhere else. So I would much rather see us use tools in our domestic market, whether that's, you know, subsidies, industrial policy, government procurement, we have a whole range of tools that we can think about to encourage the supply chains to move in the right direction unless we're talking about these, you know, high end advanced technologies that should be the subject of outbound investment controls.

COMMISSIONER WESSEL: Commissioners Sims.

COMMISSIONER SIMS: Thank you. I have a couple of questions, one for both of you, one for you, Dr. Scissors. The first one I'd love to hear from both you -- and one of the things you hear sometimes as an argument in favor of there being some benefits to U.S. companies being allowed to invest directly in Chinese companies, in addition to just flat out making money. The second benefit being that you gain some sort of visibility into what they're doing, especially in the tech sector. And I love that, Dr. Scissors. I'm with you. I think it's a false argument, but I'm curious to hear you guys kind of elaborate on why that's a false argument or not a compelling argument at least.

MS. KILCREASE: I'll start and then Derek can get feisty after this because I suspect he has views. I think it's a question of trade-offs. You know, I have no doubt that there is -- there are benefits that investors or companies from the U.S. gain from having that sort of access that's conveyed by an investment in the China market and that, that's important. But I weigh that against how much that Chinese company in the broader trainees tech ecosystem is benefitting from the involvement of the U.S. investor and all the associated benefits that it brings. And how much that investment and that engagement is fueling that tech development in China. And so if you're weighing those two things, you know, I am more worried about the continued fueling of the indigenous tech development than I am of the loss of visibility.

DR. SCISSORS: I mean the first possibility is that you don't learn anything, right, because Chinese firms are opaque with their own government. They try to hide things from their own government, which can have these officers of the firms killed. So they don't necessarily share honestly with the American investor.

And then the second thing is the same American investor who says we can learn really important things says I don't want to tell you that I'm not investing in the Cayman Islands. Like really important things do we think they're going to share with us. And if there was cooperation from the American investor side, what would happen is the Chinese would absolutely cut them off. All right?

So the process by which this is supposed to happen doesn't actually make any sense in China. It's mythical. But the thing that kills me about this is okay, you want the most visibility on the Chinese ecosystem, give them all our technology. That's how you get the most visibility. This is an exaggerated version, which is like this whole hearing. I'm an exaggerated version of what Emily says.

The cost -- There's an reduction to absurdity here, which is don't focus on the fact that we're helping China to develop a really interesting technology. Focus on the fact that we're learning about it. Right? No, that's second order or third order. So first of all, you're probably not going to learn very much. Second, you're probably not going to want to share it with the U.S. Government because you don't want to share the most basic things about your investment with

the U.S. Government. But third, the idea that learning about Chinese technology advances is more important than the technology advances is ridiculous.

COMMISSIONER SIMS: Agree. The second one is for you, Dr. Scissors specifically. We're talking about monitoring portfolio investments as a part of outbound controls. One of the things that I've noticed in your research is that your estimates for potential losses are tiny compared to the big scary numbers that float around Wall Street. And I was curious if you could elaborate on why that is?

DR. SCISSORS: Well the first thing is, and we have this during my brief stint on the Commission, we had to deal with this with the staff doing research on market capitalization of Chinese companies in the U.S. market capitalization is not a real thing. And so you say like well, Alibaba's market capitalization dropped $400 billion. Okay, but none of that is real until you sell the stock. That's notional. Those gains are notional. The losses are notional.

So when people start telling me about drops in market capitalization of Chinese firms, my first instinct to be honest is to go "Yeah". But second, it's not real money. And money -- people losing money because Chinese firms are dropping in their investment. And I'm like well, you should have known better. The actual money when you do calculations is dominated by the question that Randy raised, which is where has been the best investment opportunity over almost any extended period of time? Not the last four months, but the last year, the last two years, the last five years, the last ten years? It's not in China.

And so I'm not, you know, at all sympathetic to the idea that I can say well, here's this amount of money, and I'm going to say we're losing 2,000 basis points in return, when Chinese returns are terrible. So that's the -- there are two differences. First of all, I don't count market capitalization as real money. And second, the actual returns in China are worse, you know, through almost any time period than the returns in the U.S., much less if there are high returns anywhere else.

COMMISSIONER SIMS: I'll close by saying this. I think it is unconscionable that until 2023, it was allowed that portfolios could have even the Thrift Savings Plan that U.S. military members are putting their money into could be investing in Chinese state-owned companies. I mean it's just crazy to me that, that was the case until 2023. And this monitoring of portfolio investments is a part of any kind of outbound investment controls I think is really important. I hope the Commission will continue to make some recommendations in that space.

COMMISSIONER WESSEL: Commissioner Stivers.

COMMISSIONER STIVERS: Thanks. Good to see you both here today. It's probably low hanging fruit, but it's bewildering to so many of us that there isn't alignment between the export control regime and our -- and investment restrictions. Is that so difficult to do? Is it just a question of we need to prohibit investments in sanctioned or red list companies? Or is it more complicated than that in terms of getting to an alignment, Dr. Kilcrease?

MS. KILCREASE: I mean there is some alignment. Right? When you look at the CFIUS process, they define their critical technologies through reference to export control statutes. And when you look at the -- at least the -- you know, the executive order from the Administration, they don't specifically make that linkage, but you can see there's some spiritual alignment between what they're talking about in Yale and you know, when you look at the specific controls in the ECCN. So I do think there's some efforts to move in that direction.

I think the question is how iron clad is that alignment? And clearly the efforts on the Hill, legislatively like have not made that tight linkage. Right? And so I do think e-linkage makes a lot of sense again to set a baseline, to set the foundation for the types of technologies that we've

already said that we care about. So we might as well have those investment controls act as a compliment and bootstrap to the export control process to make sure that U.S. capital isn't undermining that process.

But we should also think about whether there's a gap there. And I've written about this in other context where there are certain investment transactions when you think about what that is -- what an investment transaction is, it is a bit broader than an export than a technology transfer. Depending on the direction of the investment flow, you might be talking about, you know, person to person contact. You might be talking about governance of a particular institution. So we should think about whether there's, you know, a plus up that we do above and beyond the export control system. But as a general perspective, you know, I do think that having that alignment makes a lot of sense and will make compliance a lot easier as well.

COMMISSIONER STIVERS: Thanks for that.

DR. SCISSORS: Can I also respond?

COMMISSIONER STIVERS: Yes.

DR. SCISSORS: I'll try to be brief. I certainly agree with Emily and that's why I've been talking about it because she's been saying it very well, that export controls are very useful information on how to proceed with outbound. The reason I don't bring it up very much is I like the idea of small yard high fence that the Administration talks about all the time. That's not what they did in the E.O. It's also not really what export controls are. Export controls are actually a pretty big yard and unfortunately there are a lot of holes in the fence. Most export controls overwhelmingly by transaction are licensing requirements, not actual blocks and that's not a -- that's not the fence I want. I want more like a wall. So I think export controls should absolutely be used to inform outbound. I don't think we should have outbound investment initially prohibitions on everything that we control for exports, but I do think we should have prohibitions, not licenses.

COMMISSIONER STIVERS: Can you extrapolate on that last point that you made? I mean why wouldn't we -- if a company is on a sanctions list and is subject to export controls for some reason, whether it's forced labor, for its national security, why -- is there any scenario where we'd want to allow U.S. investment or venture capitalists to be investing in these companies?

DR. SCISSORS: So I think there are two scenarios. The first is just the starting scenario, which we both referenced, which is let's not go from zero to 100. Right? Let's make sure we have good outbound prohibitions, you know, on the most important things, but when we start expanding them. This is partly an answer to your question, Aaron.

You know, but the second thing is the MNE list for example is not a ban, it's a license app. It's a license process. And I guess we could have an outbound licensing process. I don't really want to do that. I'd rather start with something clear and easy to follow for everybody concerned, but that's why I don't -- I think the export control model is very informative on the technologies involved. But I think the export control model process is not what I want. I want something that is narrower and much more severe.

We keep getting these stories for example about how China is invading chip controls. And I'm not blaming -- I blame BIS for a lot of stuff, but I'm not blaming BIS for like oh, why don't you have perfect enforcement of everything? There are going to be holes in enforcement. Right? And you have to close them over time. But I'd much rather have okay, you know, you can get a license to deal with this entity.

We're not going to start with outbound investment there. We're going to start with outbound investment with entities and hopefully sectors and technologies that we think are worse, you shouldn't be able to get a license, we're not going to let you transact with them at all on the financial side. And we're going to punish you very severely if you repeatedly break this rule.

MS. KILCREASE: I may differ a little bit on that. You know, when we're thinking about entity-based restrictions and the role that they can play in outbound investment -- and if understand the intent of your question, I think we should be asking for those companies that are on the entity list, you know, forget about the licensing -- you know, those issues. Right? But if we put them on the entity list because they're a threat to U.S. foreign policy or national security interests, we should be asking whether anyone should invest in them. Right? That is a very logical question.

It's a little bit different when you talk about like an SDN designation because that's going to swamp an outbound control. Right? Like you're not going to be able to invest because it's a much broader restriction under the SDN. But I do think whether it's -- I don't think it's necessarily an automatic cross listing process because I think there's some utility in having flexibility and, you know, an escalation ladder there. But I do think we should be thinking about building in kind of some automatic process to consider. If there is a company on an entity list, should we also specifically list them on an investment control list on an entity basis as a compliment to the technology controls simply because we've already determined that they're acting our own interest. So we should prohibit that investment.

DR. SCISSORS: I totally want to reply to that one.

COMMISSIONER STIVERS: Go ahead.

DR. SCISSORS: Okay. I just -- you know, it's not that what Emily is saying doesn't make sense. It's that the entity list itself doesn't make sense. Right? I mean these are bad firms. About, you know, 75 percent of the applications that get licensed, you know, to deal with these firms go through. And your position is transfer technology is the real risk here. So the hole -- you know, there's a hole -- the hole in the entity list is worse than the outbound investment problem. Right? We're still allowing transactions with entity list firms. If we're going to still allow them where they could transfer -- we could transfer technology if they go through a licensing process, I don't see how outbound restrictions should come first. What should come first is plugging the hole on the entity list, then applying it to outbound.

COMMISSIONER WESSEL: Thank you, both. And Emily, thank you for agreeing to be on a panel with Derek.

(Laughter.)

MS. KILCREASE: To be fair, I didn't know when I agreed.

(Laughter.)

COMMISSIONER WESSEL: Oh, okay. I think in the end future we will provide -- have to provide advanced notice. Seriously, thank you both. We will adjourn for ten minutes before our next panel and may have follow up questions in writing, so thank you.

(Whereupon, the above entitled matter went off the record at 2:20 p.m. and resumed at 2:27 p.m.)

PANEL IV INTRODUCTION BY COMMISSIONER LELAND R. MILLER

COMMISSIONER MILLER: Our fourth and final panel will assess the United States ongoing efforts to collaborate with allies and partners to address China's non-market practices, economic coercion, and technology transfer.

We'll start with Dr. Deborah Elms, Head of Trade Policy at the Hinrich Foundation. Dr. Elms will address U.S. engagement in the Indo-Pacific, including trends and recent developments for regional trade negotiations.

Next, we'll hear from Mr. Pepe Zhang, Senior Fellow with the Atlantic Council's Adrienne Arsht Latin America Center. He will discuss efforts to incorporate Latin America and the Caribbean into U.S. industrial initiatives via new and existing trade deals and development organizations.

Finally, we'll hear from Ms. Julia Friedlander, CEO of Atlantik-Brucke. Ms. Friedlander will analyze the challenges posed by individual EU member state priorities and how the United States can engage with initiatives like TTC and the Minerals Security Partnership.

Thank you all very much for your testimony. I ask all our witnesses to please keep their remarks to seven minutes to preserve time for questions and answers. Dr. Elms, we'll begin with you.

OPENING STATEMENT OF DEBORAH ELMS, HEAD OF TRADE POLICY, HINRICH FOUNDATION

DR. ELMS: --from Singapore, in the middle of the night on the important topic of crafting a sensible economic strategy for the U.S. engagement with the Indo-Pacific region. Asia is not just China. My testimony today looks at the Indo-Pacific reactions to the changing trade and economic policies that are being driven in part by the United States and in part by China. This region matters. When announcing its strategy in 2022, the Biden Administration noted that the Indo-Pacific accounted for over half of the world's population, 60 percent of the gross national product, and two-thirds of global economic growth.

American engagement with the Indo-Pacific is at an important crossroads. First, because the rapidly changing economic and trade policies have put pressure on allies and partners in the region. Second, because many American initiatives such as a turn away from multilateralism and a rejection of traditional trade agreements, run counter to the ongoing trade integration activities undertaken by friends and allies in the Indo-Pacific. IPEF, as I'll discuss more in a minute, is simply not seen as an adequate replacement for sustained economic engagement from the United States.

Finally, the range of unilateral actions taken under executive orders has continued to increase. Although many of these actions have been aimed at China, the impact has been felt across Asia. Singapore has a new Prime Minister, Lawrence Wong, who in his inaugural address last week effectively captured the mood and the spirit, I think across the region, when he said, "The great powers are competing to shape a new, yet undefined global order. This transition will be marked by global tensions, as well as protectionism and rampant nationalism everywhere. It will likely stretch for years, if not decades. As a small country, we cannot escape these powerful cross currents. As an open economy, our livelihoods will be hit with multilateralism fractures. As a diverse society, we will be vulnerable to external influences that tug us in different directions. We must brace ourselves to these new realities and adopt to a messier, riskier, and more violent world. We seek to be friends with all, while upholding our rights and interests."

I think this captures a sentiment that is felt beyond just Singapore in the Indo-Pacific. And I think it's important for members of Congress to bear that in mind. U.S. actions taken within the last decade have dramatically shifted economic engagement in the Indo-Pacific, including a draw from trade agreements, abrupt shifts in positions taken in regional and multilateral settings, unilateral actions like tarot freight adjustments, and significantly expanded use of national security exceptions and justifications. Nearly all have had an impact on the countries in this region, even if they were not the original intended targets of policy changes.

Instead of traditional free-trade agreements like the TPP or Transpacific Partnership, the United States has offered its friends and partners economic engagement through four IPEF pillars. IPEF is a poor substitute. It does not provide the Indo-Pacific with the similar levels of commitment or responsibility. While the membership group includes some of America's closest friends in the region, alignment with the United States interests has not been automatic. While all are willing to discuss engagement without market access in the form of tariff reductions or other market liberalization or investment protection actions, the IPEF process has brought on its own, its frustrations and challenges for participants.

While it's certainly possible that the completed pillars on supply chains, clean energy and tax, and anti-corruption will lead to substantial economic engagement. It is equally plausible that these initiatives will simply fizzle out. IPEF is a framework that requires ongoing investments of

time and money to create tangible outcomes. The U.S. may or may not continue to invest resources in future initiatives.

Economic engagement with the United States in the Indo-Pacific is essential for national security. With minimal recent freight integration in the region, China has been steadily building the trade dependencies of other Indo-Pacific economies with China as the trade data in my written testimony indicates. Bolstering U.S. competitiveness as a trade partner in the region is not something to be done with half measures. It requires concrete continuous and observable actions.

My recommendations to Congress, and I'll mention just a few, include recognizing that traditional American strike such as this large consumer market, highly competitive and active global companies, as well as leadership in foreign direct investment can easily damaged by poor policy choices. You have to understand that friends and relatives -- I'm sorry -- friends and allies in the Indo-Pacific can be affected by U.S. decision making even when those policies are not directly targeted or intended for the broader region.

Support multilateral solutions for achieving consistency in key economic policies as they help companies and consumers in the United States and across the Indo-Pacific. Avoid undermining key multilateral principles like nondiscrimination that support American and Indo-Pacific participation in the global economy. Exercise caution when changing domestic rules like de minimis as this provision supports the participation of micro, small, and medium-sized enterprises, MSME's, which are the backbone of the economy across Asia.

Please clarify U.S. actions and positions on digital trade, including domestic settings for personal privacy, reconsider the role of trade agreements as a key element or economic cooperation, especially for new and evolving elements like digital trade or trade and climate. Use caution in promoting national security exceptions to economic measures. Carefully review trade and economic policies that are aimed at one party to limit the impact and the potential damage on other Indo-Pacific partners. Promote economic integration with the Indo-Pacific as a mechanism for achieving inclusive growth, economic development, and national security for the United States. And finally, promote trade and investment with the Indo-Pacific as a critical tool for achieving broader security objectives.

I look forward to our conversation today. Thank you.

COMMISSIONER MILLER: Thank you, Dr. Elms. Mr. Zhang, you're up next.

PREPARED STATEMENT OF DEBORAH ELMS, HEAD OF TRADE POLICY, HINRICH FOUNDATION

Hearing: Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology

May 23, 2024

Written Testimony
"Indo-Pacific Reactions to the Changing Trade and Economic Landscape"

Dr. Deborah Elms

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I would like to thank the Commission for the opportunity to testify here today. It is indeed an honour to address members of Congress from Singapore on the important topic of crafting a sensible economic strategy for US engagement with the Indo-Pacific region. Trade and economic engagement are key elements to support US security.

Asia is not just China. My testimony today looks at Indo-Pacific reactions to changing trade and economic policies. This region matters. In announcing its strategy in 2022, the Biden Administration noted that the Indo-Pacific accounted for over half of the world's population, 60 percent of global gross domestic product (GDP), and two-thirds of global economic growth.[1]

American engagement with the Indo-Pacific is at an important crossroads. First, because rapidly changing economic and trade policies have put pressure on allies and partners in the region. Second, many American initiatives, such as a turn away from multilateralism and the rejection of traditional trade agreements, run counter to ongoing trade integration activities taken by friends and allies in the Indo-Pacific. IPEF is simply not seen as an adequate replacement for sustained economic engagement. Finally, the range of unilateral actions taken under Executive Orders has continued to increase. Although many of these decisions have been aimed at China, the impact has been felt across Asia. I will discuss each item in turn.

I will finish with recommendations of what the US can do to manage economic engagement more effectively with the countries in this region, including suggesting that Congressional input to economic policymaking is necessary. Economic integration of the US with the Indo-Pacific is essential for national security. With minimal recent American trade integration in the region, China has been steadily building the trade dependencies of other Indo-Pacific

economies with China, as the trade data in the appendix indicates. Bolstering US competitiveness as a trade partner in the region is not something to be done with half measures. It requires concrete, continuous, and observable actions.

For specific policy recommendations, Congress should:

- Recognize that traditional American strengths, such as its large domestic consumer market, highly competitive and globally active companies, as well as leadership in foreign direct investment, can be damaged by poor policy choices;
- Understand that friends and allies in the Indo-Pacific can be affected by US decision making, even when policies are not directly targeted or intended for the broader region;
- Support multilateral solutions to achieving consistency in key economic policies as these help companies and consumers in the US and across the Indo-Pacific;
- Avoid undermining key multilateral principles like non-discrimination that support American and Indo-Pacific participation in the global economy;
- Exercise caution in changing domestic rules like de minimis, as this provision supports the participation of micro, small and medium sized enterprises (MSMEs);
- Clarify US policies and positions on digital trade, including domestic settings for personal privacy;
- Reconsider the role of trade agreements as a key element of economic cooperation, particularly for new and evolving elements like digital trade or climate and trade;
- Seek to join ongoing regional trade agreements like the CPTPP, RCEP, or DEPA or craft similar regional arrangements;
- Use caution in promoting national security exceptions to economic measures;
- Review carefully trade and economic policies aimed at one party to limit the impact and potential damage to other Indo-Pacific partners;
- Promote economic integration with the Indo-Pacific as a mechanism for achieving inclusive growth, economic development and national security for the US; and
- Promote trade and investment with the Indo-Pacific as a critical tool to achieving broader security objectives.

The Importance of US Economic Leadership

The United States has been the most important contributor to global economic structures since the end of World War II, showing patient leadership and stewardship of economic institutions to support US and global economic growth and development. America emerged from the ashes of the war as an economic powerhouse, responsible for a dominant share of

global trade in goods and services. Foreign firms were able to access the booming US consumer market as a key driver to spread economic growth. American firms ventured out and quickly became the world's largest international investors with an especially sizable economic footprint in Asia.

The gap between the United States and the rest of the world has narrowed over the ensuing decades, leading to increasing unease in the US about the continued fitness of economic structures and the value of continuing trade and investment integration. While this Commission is largely focused on US relations with China, my testimony looks at US economic engagement with the broader Indo-Pacific, particularly as many ongoing and proposed policies vis-à-vis China also have implications for the rest of the region.

Singapore's Prime Minister Notes Changing Conditions

Singapore's new Prime Minister, Lawrence Wong, effectively captured sentiments from the region in his inaugural speech last week. He said:

> "The great powers are competing to shape a new, yet undefined, global order. This transition will be marked by geopolitical tensions, as well as protectionism and rampant nationalism everywhere. It will likely stretch for years if not decades. As a small country, we cannot escape these powerful cross-currents. As an open economy, our livelihoods will be hit when multilateralism fractures. As a diverse society, we will be vulnerable to external influences that tug us in different directions. We must brace ourselves to these new realities and adapt to a messier, riskier and more violent world…We seek to be friends with all while upholding our rights and interests."[2]

Dramatic Adjustments in US Economic Policies

Wong notes that great powers, particularly China and the United States, have been engaged in growing competition to shape a new order. Both sides have taken steps that have affected the economic and security landscape in the Indo-Pacific. Rather than focus on what China has done, my testimony focuses more on US policy decisions and makes recommendations of what Congress should consider going forward.

US actions taken within the past decade have dramatically shifted economic engagement in the Indo-Pacific, including withdrawal from trade arrangements, abrupt shifts in positions taken in regional or multilateral settings, unilateral actions like tariff rate adjustments, and significantly expanded use of national security exceptions and justifications. Nearly all have

had an impact on countries in the region, even if they were not the originally intended targets of policy changes.

For example, President Donald Trump withdrew the United States from participation in the Trans-Pacific Partnership (TPP) on his first full day in office in 2017. His administration also began imposing a wide-ranging set of economic restrictions on various countries in the region, including substantial escalations in tariffs for specific products like washing machines, steel, and aluminium or against China under Section 301 justified by reasons of national security and unfair trade practices. The Appellate Body of the World Trade Organization (WTO) was left to wind down completely with the US blocking the replacement of outgoing experts, effectively halting multilateral dispute settlement. Most of these policies have been continued under the Biden Administration, along with a growing list of new tariff actions, investment restrictions, export controls, and screening activities. Much of this activity has been aimed at confronting China, but many decisions have impacted the wider Indo-Pacific.

The United States has also stopped negotiating what are now called "traditional" trade agreements focused on market liberalization and binding legal commitments for a set of agreed rules covering topics like goods, services, and investment. Instead, the Biden Administration launched the Indo-Pacific Economic Framework (IPEF) which was intended to demonstrate a new approach to managing economic affairs with 13 partners in Asia.

Unexpected US Policy Shifts

The net effect of these actions has presented challenges to countries in the Indo-Pacific, including toward some of America's closest friends and allies, as the Singapore Prime Minister's speech highlighted. The Indo-Pacific is a trade-dependent region that has relied on US promotion of global economic commitments dating back to the 1950s. But the region is being buffeted by a growing use of exceptions and the application of US domestic economic tools first promulgated during the Cold War that have lain largely dormant for decades.

While the dominant American narrative—as necessary to counter a growing threat from China—to justify the use of these actions may appear to be consistent and coherent when viewed from within Washington, countries in the Indo-Pacific do not always share the same interpretation of actions nor share similar reactions to US initiatives. Even among America's closest partners, support for specific initiatives varies.

These reactions are driven by a range of differences. The Indo-Pacific is a diverse place, with countries that are large and small, rich and poor, high-tech and not. But nearly all have very high trade links to both the United States and China. For most of the Indo-Pacific, in fact, trade in goods is increasingly dominated by bilateral flows to China and not to the United States, as the trade data in the appendix indicates. The assessment of the threat posed by China is simply different in the region. Views of China can vary by sector and can fluctuate over time.

The region is also increasingly wary of US economic actions. The speed of change in Washington on economic policy has been dizzying. In one recent example, the US withdrew provisions from the table in a key policy area of digital trade, in the Joint Statement Initiative on Electronic Commerce in the WTO, citing the need for "policy space." After decades of lectures from the US about how "policy space" should be avoided, with participants strongly urged to sign up to legally binding commitments on trade, this about-face was a significant shift.

US actions using national security exceptions have challenged trade policy norms. The global system has had exceptions in place to manage trade tensions in times of conflict and war. The United States has taken an increasingly wide number of actions, including changes to investment screening and export controls, on the basis of national security concerns.

Away from Multilateralism

The US has also moved away from robust support for global trade arrangements. Asian firms, as well as American firms operating across the region, have built their export operations based on a set of consistent rules, underpinned by having recourse to dispute settlement at the WTO. The multilateral system has allowed smaller players to experience better market access as well as economic non-discriminatory treatment, without being at the mercy of more powerful members. The risk of multilateralism fractures is seen as significant enough that PM Wong noted the consequences to Singaporean livelihoods in his inaugural address.

A lack of American interest in signing comprehensive trade agreements is also a problem for Indo-Pacific countries as they struggle to reform and modernise their economies. Their policymakers need free trade agreements to support domestic policy adjustments and reinforce commitments for international engagement. Allowing the multilateral system to fray increases the risk of failed states and domestic backlash to trade.

Lack of commitment to the multilateral system is driving regulatory divergence. China's proactivity in standards-setting bodies risks a bifurcation of critical standards for telecommunications, energy, agriculture, and technology.[3] Faced with a choice of following regional or American rules, Indo-Pacific partners may increasingly choose to stay local.

Tariff Rate Escalation

Many of the actions taken by the US against China have also had unintended consequences for the rest of the region. Tariff rate hikes against Chinese imports under Section 301, for instance, also affected trade between the region and China and from the region to the United States. While some countries like Vietnam benefitted from supply chain changes driven by tariff escalation, the short-term dislocation has caused challenges for many firms in the region, including US firms operating in the region.

Tariff adjustments for one product usually entails changes in business operations across the whole of a supply chain. A 25% tariff hike for finished electronic products may also mean economic dislocations for companies that contribute raw materials, parts or components, even if these were not directly addressed by the new tariff policy. In some instances, suppliers were unceremoniously dumped from production processes and replaced with new vendors. These changes can appear in third or even fourth tier suppliers, many of which are located across the Indo-Pacific region and may not have even realized they were part of an affected US-China supply chain at all.

The US appears to be viewing tariff rate hikes as an increasingly legitimate policy tool. The consequences, however, could be long lasting. The use of tariffs as a means of punishment further undermines the multilateral trading system. It encourages others to do the same, accelerating the collapse of global norms supporting trade flows. Raising tariffs on one party or on one product can produce significant collateral damage to others. An increase in tariffs on facemasks, for instance, can change the economics of delivering facemasks for vendors elsewhere, making it more or less competitive to supply finished products. Tariff adjustments for completed masks can also alter markets for fabrics, elastic, and even packaging.

Trade is a key pillar of security and rising economic uncertainty results in greater security risks.

CPTPP: Alive and Kicking

It is not just changes in the level of American support for multilateral solutions to economic issues or rapid adjustments to existing trade arrangements that have caused challenges

across the Indo-Pacific. The withdrawal of the US from the Trans-Pacific Partnership (TPP) put significant pressure on remaining members. Many of the provisions were specifically written and designed by the United States for its own domestic purposes. The removal of the Americans from a carefully crafted agreement negotiated across an eight-year time frame created significant stresses on some governments to maintain most of the TPP language and commitments without receiving potential benefits from US participation.

Despite these challenges, members managed to make minimal adjustments to the agreement and bring it into force as the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) in 2018. It has now expanded with the addition of the United Kingdom to include 12 members with more in the queue to join.

The CPTPP provides member state companies with extensive coverage, with nearly all tariff lines, including agriculture, currently receiving duty-free access; nearly complete services market opening; strong investor opportunities and protections; robust intellectual property rules and enforcement; broad e-commerce commitments; access to government procurement contracts; and a dispute settlement mechanism that has ruled on its first case.

The US drafted the rules in this agreement to suit its domestic interests and to build a robust economic leg to the overall regional security architecture. Current members adjusted 21 provisions after the US withdrew, but otherwise left the document and all member schedules and commitments unchanged. CPTPP members may opt to craft entirely new rules, particularly as larger economies accede, and new trade related issues become prominent in negotiating agendas. The United States should be part of the process by rejoining the CPTPP and giving American firms based in the US an opportunity to share in the benefits provided by the FTA.

Trade agreements are an important mechanism to bind the US to partners in the Indo-Pacific. They grant access to the lucrative American market in exchange for a long list of objectives, including stronger labor and environmental provisions as well as regulatory consistency across a range of topics like product safety standards, effective protection and enforcement of intellectual property rights, or digital policy. Strong, carefully negotiated, and crafted trade rules can help limit the risks of non-members gaining preferential access to the US market. Trade agreements like the CPTPP should be seen as a way to provide clear and tangible benefits to friends and allies in the region.

IPEF as a Framework, not a Trade Agreement

Instead of traditional FTAs like the TPP, the US has offered its friends and partners economic engagement through four IPEF pillars. IPEF is a poor substitute. It does not provide the Indo-Pacific with similar levels of commitment or responsibility.

While the membership group includes some of America's closest friends in the region, alignment with US interests has not been automatic. While all were willing to discuss engagement without market access in the form of tariff reductions or other market liberalization or investment protection actions, the IPEF process has brought its own frustrations and challenges for participants. The US has consistently been better at describing what IPEF is not, rather than what IPEF is and, even in the concluded pillars of the agreement, the Framework architecture does not inspire confidence in the types of outcomes or deliverables that participants may receive.

While it is certainly possible that the three completed pillars on supply chains, clean energy, and tax and anti-corruption will lead to substantial economic engagement, it is equally plausible that these initiatives will fizzle out. IPEF is a framework that requires ongoing investments of time and money to create tangible outcomes. The US may, or may not, continue to commit resources to future initiatives.

Unfortunately, the process of concluding IPEF did not lead members to believe the US will prioritize economic engagement through the Framework. While participants worked hard and were active across multiple rounds in different locations with a goal of concluding the agreement in time for the US to host APEC in November 2023, there was no ceremony to announce the conclusion of any of the pillars and the trade pillar was not ready for even an informal, hastily called announcement. Instead, some participants in IPEF experienced deja vu as the United States left them standing at the economic alter once again, having pulled out of the expected closing announcements at the last minute.

Public pronouncements are important milestones for Indo-Pacific leaders and ministers, with carefully choreographed ceremonies seen as a suitable end to a resource-intensive process of negotiations. After this failure of diplomacy in San Francisco, two of the pillars will now be formally signed in Singapore in June 2024. Negotiations for the trade pillar are meant to be ongoing, but no schedule for talks has been announced.

A lack of clear Congressional support for IPEF and other economic arrangements has been identified by Indo-Pacific participants as a substantial risk. IPEF was launched through an Executive Action, and it could be revoked with similar ease. America's partners would prefer

the stability offered through Congressionally approved actions as a bulwark against sudden policy shifts in the future. Congressional participation in IPEF and similar economic initiatives also helps support financial resourcing for future activities.

Modest Supply Chain Shifts

As the US friends and partners in the region look to the future, it is increasingly unclear what sorts of trade and economic policies America might opt to use. There are few options at the moment that the Americans might take that could be viewed from inside DC as "too harsh" on China. This may appear desirable from Washington, but it is of increasing concern to US partners in the Indo Pacific as they do not share similar views on the dangers posed by China nor of the risks that emanate from reactions in both Washington and Beijing to unfolding events in the region.

The US says that China is an unreliable economic partner, which is hard to deny given China's commitment to using industrial policy to control target sector supply chains and trade coercion to silence critics. But having left the TPP and having serious challenges getting IPEF across the finish line, it is hard to view American economic engagement into the region as a consistent US priority. Hence, even the closest allies and partners are uncertain about the commitment that Washington will maintain towards economic integration with the Indo-Pacific.

Because the level of uncertainty surrounding future economic policies continues to rise, firms have been making relatively modest changes in their supply chain operations and footprints. The need for American business to diversify supply chains and avoid dependence on a limited number of suppliers or customers has been obvious for some time, with US-China economic tensions and the Covid-19 pandemic disruptions reinforcing the message. However, diversification can also come with costs, as firms typically must carry additional inventory, invest in new or expanded operations, or use less efficient suppliers. Hence, firms have been reluctant to make wholesale changes to supply chain footprints, even in the wake of increasing policy rhetoric urging companies to make dramatic adjustments.

There are likely to be even more stresses placed on supply chains in the near term. Companies that heeded US administration warnings to reduce dependence on China may find their new operations are not lowering uncertainty as much as anticipated. For example, firms that did choose to adjust procurement and manufacturing to near shore in Mexico, Vietnam, or Poland may discover that future US actions place these investments at risk. As even the staunchest US friends have discovered, unilateral policies, like the imposition of Section 232 on steel and aluminium, can find targets anywhere. As a result, firms of all

nationalities are looking to diversify by finding new opportunities and becoming less dependent on the American market. Once they switch to new markets for their goods and services, they may not return, leading to fewer options for American consumers and firms and less investment in the US.

Foreign Direct Investment

Foreign direct investment has always been substantial across most of the Indo-Pacific economies. There are both push and pull factors at play. The use of increasingly onerous rules governing trade with the United States, for instance, has driven some firms to add or expand operations out of China and into other markets. But some apparent "winners" of diversification, like Vietnam, have also been actively courting inbound investment, including by crafting a web of ambitious trade deals. Hence it can be difficult to determine if the pull factors of new market access and investment protections has driven new trade and investment patterns or if the growing risks of trade sanctions, investment screenings, and higher tariffs from the US has pushed firms to relocate or expand.

Many of the arguments made about changes in manufacturing or investment are conducted in a vacuum. There is insufficient interest in collecting the kind of data that is necessary for solid policymaking. Instead, assumptions about what should be or must be happening on the ground seems to be substituting for careful analysis. There appear to be markedly fewer American individuals and firms traveling across the region, particularly in China, or being based for extended periods of time in the Indo-Pacific. Language skills that are critical to understanding the complexity of the region are being eroded.

While the American market remains the largest and most lucrative for most firms across the Indo-Pacific, access is getting harder. The potential reduction or elimination of trade rules like de minimis may make it impossible for small firms in the region to find a foothold in the US market.[4] Having flourishing micro, small and medium sized enterprises (MSMEs) is critical to achieving greater economic growth in every economy. American small businesses source from the Indo-Pacific to distribute products in the US consumer market, so e-commerce has become a vitally important mechanism to anchor the Indo-Pacific to the United States. Yet the obstacles to successful online business for American MSMEs continue to grow, including changes in data flow rules, adjustments to border rules, new restrictions and requirements for online platforms, and increasingly onerous requests for information about products and services.

Indo-Pacific Economic Integration Continues with RCEP

It is important to recall that US policy does not take place in a vacuum. While America has not been engaging in traditional trade agreement negotiations, most of the region has continued to promote trade and economic integration with other partners. This includes the entry into force of the Regional Comprehensive Economic Partnership (RCEP) in 2022. RCEP, which includes 15 participating members (Australia, Brunei, Cambodia, China, Indonesia, Japan, Korea, Laos, Malaysia, Myanmar, New Zealand, Philippines, Singapore, Thailand, and Vietnam), is a comprehensive agreement covering trade in goods, services, investment, intellectual property rights, e-commerce, development and cooperation.[5] The total legal text runs to nearly 500 pages, accompanied by 14,000 pages of individual member schedules that outline specific commitments.

RCEP builds on five existing trade agreements between ASEAN members (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam) and their Dialogue Partners in the region (Australia, China, India, Japan, Korea, and New Zealand). Most of the so-called ASEAN+1 deals have recently undergone upgrades. ASEAN-China, for instance, has just been revised for a third time. Each adjustment has included an expansion of included tariff coverage with reduced or eliminated tariffs on nearly all products, plus additional services and investment commitments. Most RCEP members also have bilateral trade and investment agreements between them. Some of these arrangements have also been broadened and deepened over time.

Because RCEP has built on ASEAN's existing agreements across the Indo-Pacific and a dense network of bilateral arrangements, early utilization of RCEP within and across Southeast Asia has been muted. Often, the ASEAN+1 agreement currently provides better tariff benefits, for example, than RCEP although as RCEP comes into full implementation, the differences will narrow and firms will likely switch to using RCEP preferences instead of ASEAN+1.

RCEP allows cumulation of the content or inputs to production of goods, making it much easier for firms to qualify for lowered or eliminated tariffs across Asia for trade within Asia. Qualification under the rules of origin is also relatively easy, meaning that trade in the region for most raw materials, intermediate goods, and finished products can benefit from RCEP.

RCEP is increasingly being used by firms in Northeast Asia for trade, as China, Japan and Korea had no prior FTA linkages with one another.[6] Companies in these three member countries are also very familiar with the benefits of trade agreements for lowering tariff costs, supporting trade in services, and facilitating investment. Their past experiences using FTAs

means that firms were quick to understand and apply RCEP preferences to their trade practices.

Trade in Asia for Asia using RCEP is also set to expand, with a growing list of potential applicant countries looking to join. Currently, Bangladesh, Hong Kong, and Sri Lanka have expressed the greatest level of interest. India participated in the entire negotiating process for RCEP before declining to proceed to membership, but could ask to rejoin in the future.

Many Pathways for Economic Engagement in Asia

RCEP is not the only FTA game in town. The seven Asian members of the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) currently enjoy tariff-free coverage for most tariff lines, including agriculture, as well as nearly free access for services trade and strong investment access and protection.[7] The agreement is set to expand in 2024, with the entry into force of the schedules for the United Kingdom, bringing the total number of CPTPP members to 12 (Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, UK, and Vietnam).[8] CPTPP members are also grappling with a long list of accession applicants, including Costa Rica, Guatemala, China, and Taiwan, making it likely that additional members will be added in the future.

Indo-Pacific members are also busy working on other trade arrangements. The agreement between the European Union and New Zealand came into force earlier this month.[9] The EU has also been busy expanding its existing ASEAN FTA network with Singapore and Vietnam to include additional FTAs with Indonesia, Malaysia, and Thailand.[10] The EU already has FTAs with Japan and Korea and has been working on trade deals with Australia and India.

Officials in the Indo-Pacific region are also actively involved in negotiating, signing, and implementing a range of new thematic trade arrangements, including several digital agreements and some on sustainability and climate. The Digital Economy Partnership Agreement (DEPA) has entered into force between Chile, Korea, New Zealand, and Singapore with Canada and China working on accession.[11] Singapore has already signed Digital Economy Agreements (DEAs) with Australia, Korea, and the United Kingdom and is currently negotiating with the EU on an EUSDTA.[12] The ten members of ASEAN are working on an upgrade to their 2018 E-Commerce Agreement to become the Digital Economy Framework Agreement (DEFA) in 2025.[13]

Singapore and Australia have signed a Green Economy Agreement.[14] New Zealand has helped lead 13 rounds of negotiations with Costa Rica, Fiji, Iceland, Norway, and Switzerland to create the Agreement on Climate Change, Trade and Sustainability (ACCTS).[15]

While the US has grown increasingly skeptical of trade and economic integration, the Indo-Pacific has not. Indeed, officials have shown willingness to consider new forms of cooperation and have recognized the dangers of regulatory divergence. Many of the newest trade arrangements explicitly include mechanisms for ensuring that future economic policymaking consider experiences and interests of trade partners in the region.

Lawrence Wong highlighted the risks of heightened protectionism and nationalism, pointing out that rising geopolitical tensions may endure for years or decades. Like countries across the region trying to manage economic buffeting, Singapore will need to stay nimble and leverage opportunities for collaboration and integration with a diverse range of partners while considering its own rights and interests.

Recommendations for Congress

The US has been the most important actor in shaping the global trade and economic landscape for decades. A commitment to open trade and economic engagement has helped most of the Indo-Pacific economies experience sustained growth.

However, a wavering commitment by the United States to the principles of multilateralism, absence of US involvement in the key regional economic architectures of CPTPP or RCEP, and a renewed enthusiasm for harsh, unilateral trade actions has made relations between the US and Asia more complicated. Many of the decisions taken by the United States, across the past two administrations, in particular, have had profound consequences for the region.

Although many policy changes were driven by a desire to address Chinese practices, these actions have had an impact across the region. In some instances, Indo-Pacific economies have benefitted from adjustments that have led to more inbound investment, including from Chinese firms seeking new economic activities. In others, changes like the sudden and dramatic escalation in tariff rates for US-China trade has led to unwelcome disruptions in supply chain activities across the region. Standard setting in the region has proceeded with minimal US involvement.[16]

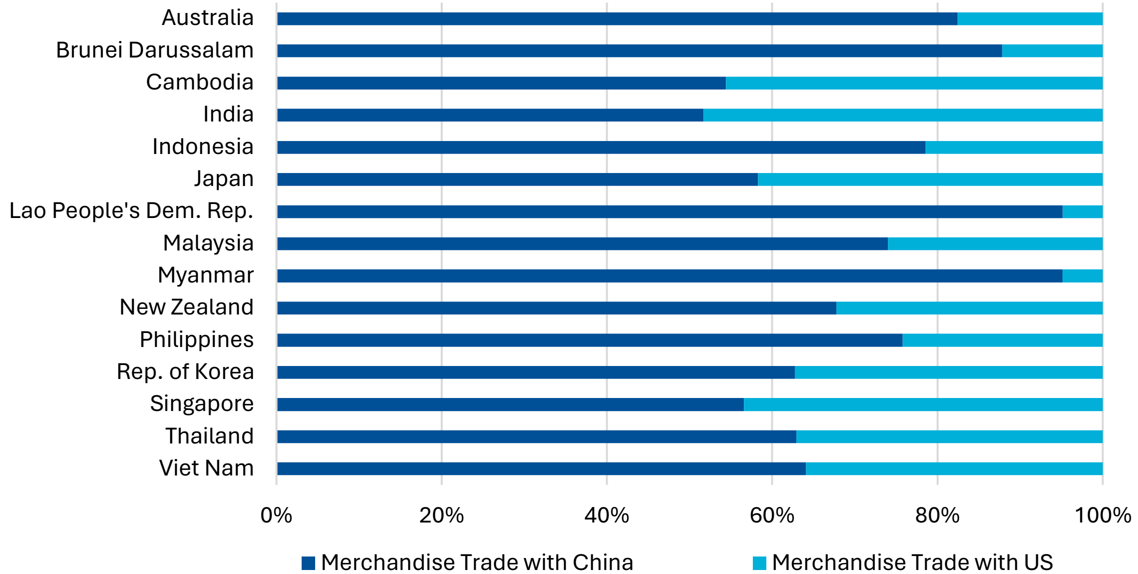
US trade policy has been increasingly driven directly by the Executive Branch, which has made it easier to announce and implement rapid shifts in policy direction. It would be better to have trade objectives supported by members of Congress, to help ensure that future initiatives are more sustainable. Certainly, from the perspective of most Indo-Pacific partners, having Congress at the table in setting broad policy parameters can help lower their risk and reduce uncertainty in working with the United States.

For specific policy recommendations, Congress should:

- Recognize that traditional American strengths, such as its large domestic consumer market, highly competitive and globally active companies, as well as leadership in foreign direct investment, can be damaged by poor policy choices;
- Understand that friends and allies in the Indo-Pacific can be affected by US decision making, even when policies are not directly targeted or intended for the broader region;
- Support multilateral solutions to achieving consistency in key economic policies as these help companies and consumers in the US and across the Indo-Pacific;
- Avoid undermining key multilateral principles like non-discrimination that supports American and Indo-Pacific participation in the global economy;
- Exercise caution in changing domestic rules like de minimis, as this provision supports the participation of MSMEs;
- Clarify US policies and positions on digital trade, including domestic settings for personal privacy;
- Reconsider the role of trade agreements as a key element of economic cooperation, particularly for new and evolving elements like digital trade or climate and trade;
- Seek to join ongoing regional trade agreements like the CPTPP, RCEP, or DEPA or craft similar regional arrangements;
- Use caution in promoting national security exceptions to economic measures;
- Review carefully trade and economic policies aimed at one party to limit the impact and potential damage to other Indo-Pacific partners;
- Promote economic integration with the Indo-Pacific as a mechanism for achieving inclusive growth, economic development, and national security for the US;; and
- Promote trade and investment with the Indo-Pacific as a critical tool to achieving broader security objectives.

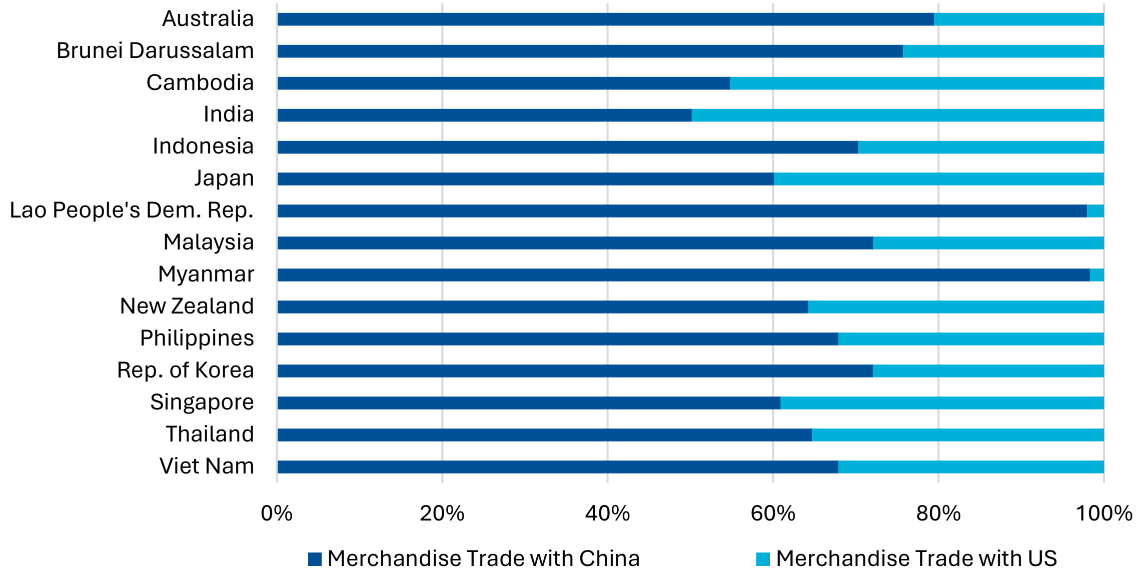
Appendix

Figure 1 – Share of trade (%) with the US and China for selected Indo-Pacific Countries in 2023



Source: Data from UN Comtrade

Figure 2 – Share of trade (%) with US and China for selected Indo-Pacific countries in 2013



Source: Data from UN Comtrade

Table 1 – Share of exports to China for selected Indo-Pacific countries in 2017 and 2023

Country	Exports to China in 2017 (% exports to China & US)	Exports to China in 2023 (% exports to China & US)
Australia	90.33	91.04
India	57.47	17.52
Indonesia	54.26	72.52
Japan	70.75	51.43
Malaysia	58.82	68.50
Rep. of Korea	63.58	57.47
Singapore	50.99	43.57
Viet Nam	24.45	43.65

Table 2 – Share of imports from China for selected Indo-Pacific countries in 2017 and 2023

Country	Imports from China in 2017 (% imports from China & US)	Imports from China in 2023 (% imports from China & US)
Australia	62.83	68.67
India	83.51	74.58
Indonesia	67.01	86.77
Japan	67.99	67.41
Malaysia	76.42	81.80
Rep. of Korea	60.32	69.68
Singapore	89.80	64.46
Viet Nam	72.62	93.34

[1] https://www.whitehouse.gov/wp-content/uploads/2022/02/U.S.-Indo-Pacific-Strategy.pdf
[2] https://www.channelnewsasia.com/singapore/pm-lawrence-wong-first-speech-prime-minister-full-4338286
[3] China Standards 2035 | China's quest to shape the world through standards setting (hinrichfoundation.com)
[4] https://www.hinrichfoundation.com/research/article/trade-policy/killing-msme-access-to-global-trade/
[5] https://www.mfat.govt.nz/en/trade/free-trade-agreements/free-trade-agreements-in-force/regional-comprehensive-economic-partnership-rcep/
[6] China and Korea had a 2014 shallow bilateral FTA in place. http://fta.mofcom.gov.cn/topic/enkorea.shtml
[7] https://www.mfat.govt.nz/en/trade/free-trade-agreements/free-trade-agreements-in-force/cptpp/
[8] https://www.dfat.gov.au/trade/agreements/in-force/cptpp/comprehensive-and-progressive-agreement-for-trans-pacific-partnership
[9] https://www.mfat.govt.nz/en/trade/free-trade-agreements/free-trade-agreements-in-force/new-zealand-european-union-free-trade-agreement/

[10] https://policy.trade.ec.europa.eu/eu-trade-relationships-country-and-region/countries-and-regions/association-south-east-asian-nations-asean_en
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[15] https://www.mfat.govt.nz/en/trade/free-trade-agreements/trade-and-climate/agreement-on-climate-change-trade-and-sustainability-accts-negotiations/
[16] China Standards 2035 | China's quest to shape the world through standards setting (hinrichfoundation.com)

OPENING STATEMENT OF PEPE ZHANG, SENIOR FELLOW, ATLANTIC COUNCIL'S ADRIENNE ARSHT LATIN AMERICA CENTER

MR. ZHANG: Commissioner Miller, Commissioner Wessel, and distinguished members at the U.S.-China Economic and Security Review Commission, thank you for the opportunity to testify at this hearing about U.S. global economic strategies and partnerships, including competition with China.

My testimony aims to contextualize and localize this global conversation by focusing specifically on the regional perspectives and development in Latin American and Caribbean, which I'll refer to as LAC for brevity. My testimony is divided into two parts; overview and recommendations. I have three key points to share within the overview section about where things stand today. And then I'll provide recommendations on three levels, which are policy, resources, and strategy.

So for the overview, the first of my three points is that LAC is a relevant region worthy of greater U.S. policy attention, resources, and policy continuity. This region offers several valuable advantages for the United States, especially in terms of supply chain resilience, geographic (Audio interference) -- which is irreplaceable, the competitive wages offer by many countries in the region, the fact that there is an overwhelming majority of democratic and peaceable states friendly with the United States, which is also not always the case elsewhere, and more importantly diverse group of governments and companies that can contribute to the enhancing hemispheric production.

And this adverse group includes a manufacturing powerhouse like Mexico. Dynamic small open economies with proven economic success such as the Dominican Republic, Panama, and Costa Rica, and commodity exporters in South America like Brazil, Chili, Argentina that are increasingly influencing global agendas on food, security, energy, and climate transition. A critical mineral for example would be a region that holds about two-third of the world's lithium reserves and 40 percent of its copper.

My second point in this discussion is to describe the ways in which China has become a major economic player in the region, especially in South America and its implications for the U.S. China's economic relations with the region grew exponentially in the last three decades, mainly through four areas of engagement; trade, investment, official lending and infrastructure, focus on illustrating a trade area. This is the most relevant one out of the four, especially for this panel, with a few data points.

So in the last 25 years, bilateral trade between China and LAC has multiplied over 20 times, near 500 bill in a year. For comparison, 500 bill is about 60 percent more than what China trades with Africa. China has become in that process by far the largest trading partner for countries like Chile, Peru, and Brazil, accounting for over 30 to 40 percent of total exports. For comparison, that is a very high level of concentration dependence relative for example to U.S. Germany, and to EU, which is under 10 to 15 percent of total exports to China.

So what are the implications of all of this to the United States? Given the time of this panel, I'll just highlight one thing in particular, if countries in the region see China as the leading source of their economic growth, certain U.S. geoeconomic tools that require most of that in coordination with the regional allies will become less effectively. And I'd like to emphasize here that pragmatism in not ideological preference is what mainly drives international economic engagement in much of this region.

And this pragmatism leads me to my third and final message in this overview part, which is LAC very much welcomes economic engagement from the United States, including America's partnership for economic prosperity or APEP. And also the fact that the U.S. remains the region's most important economic partner at an aggregate level, being its largest trading partner and largest source of investment, largest source of remittances, which for context, many countries in the region remittance is consistently a largely source of external financing than investment.

But also the aggregate analysis had some very important nuances and heterogeneity within the region. For example on trade, we can talk about how Mexico on a massive scale with the U.S. and Mexico trade relationship is really the only factor keeping the U.S. inspired for the region's overall largest trading partner. In South America as I described earlier, trade relationship has really shifted decisively in favor of China.

Now moving onto the recommendations about how the U.S. can and should expand economic partnerships and leadership in Latin American and Caribbean, specifically on issues related to supply chain. One overarching goal with highlighting here is that this is really about in many ways, making this hemisphere more economically competitive, resilient, and better integrated with the United States. And a lot of that should be centered around or at least framed around the issue of development, because development is how you win hearts and minds in this particular region.

So I'll talk about three levels, policies, resources, and strategies that I mentioned earlier starting with the policy level; three things. Trade policy, industrial policy, and development policy. And on the trade policy instruments, which include both tariff and non-tariff measures, I think you know, tariff reduction and UFDAs are pretty challenging in the current political environment. So the name of the game here is to make the most of the existing U.S. trade toolbox and trade network. Unfortunately, the U.S. has 12 FDA partners in this region. And in fact, it only has eight outside the region.

So there's scope to modernize some aspects of these regional agreements and make them more interoperable. For example, I'd love to see more ways to smartly facilitate hemispheric accumulation rules of origin for some strategic sectors and products. Obviously, more can and should be done around non-tariff measures such as harmonizing hemispheric regulatory and phytosanitary standards, streamlining custom procedures, improving connectivity infrastructure. All these measures help to reduce the cost and time of interregional trade flows, which boosts the efficiency, competitiveness, and importantly scale of hemispheric production in exports.

In my mind, the issuance is another way of saying regionalized supply chains in many ways. And we can have regionalized supply chains without regional integration. Here it's important to highlight that LAC is a region that has a consistently low level of interregional trade compared to a lot of the regions, including Asia and Europe that are covered on this panel. And here I see an opportunity to drive hemispheric integration under a U.S. vision.

Then on industrial policy, which is a critical piece for building out some form of again U.S. led hemispheric partnership and supply chain integration. Specifically, I'm talking about the U.S. ability to induce and invest in industrial upgrading in LAC. Let's talk about U.S. policy intensive. For example, the CHIPS ACT established a $500 million international technology security innovation (ITSI) fund for State Department to capacity of foreign governments on semi-conductor supply chains. Some of the countries are currently eligible for ITSI funding throughout those in LAC, which I think is a pretty good first step in the right direction.

The U.S. can also -- should also do a lot of nurturing when it comes to near shoring. The reason I say "nurture" here is because we eventually want competitive, self-sustaining companies and production capacities in LAC that do not rely on perpetually U.S. subsidies. One ambitious idea here is to formulate time-bound U.S. interagency roadmap for hemispheric supply chain development in certain sectors, products, or supply chain segments, if you want to be specific, in coordination with original partners in the private sectors of course. Some elements of this road map should include local workforce development, which is a key part of APEP, infrastructure development, U.S. supportive promissory regional led initiatives such as U.S. TDA, alliance for democracy, development of democracies, business council, supply chain working group.

Third and final policy recommendation is about development policy. And I think development policy is in my view, the most important and perhaps underrated, underutilized tool within the U.S. policy toolbox. And like I said earlier, development is really what wins hearts and minds in a region that's very economically pragmatic. The use of a do well could strengthen a wide range of foreign policy tools. And we can talk about financial instruments from USAID, DFC, U.S. TDA, whatever region are our U.S. clients. We can talk about Washington-based international financial organizations, which are distinctive assets for U.S. development and foreign policy in Latin America and the Caribbean. And that includes development and operations from bank or across a wide range of sectors or liquidity in macro stabilization programs through IMF support.

One thing these programs -- these organizations do very well is counter cyclical support, which countries really appreciate in times of crisis as we started during the pandemic. And a footnote here is that Chinese policy banks put a lot less in this counter cyclical space abroad. There's also a lot of known financial developments to assist, which I won't go into in detail due to limitation of time here, but we talk about capacity building, operational support, and a lot of issues across commercial laws, government procurement, independent journalism, illicit finance, natural disaster preparedness, and response, which really support regional development in a pretty broadly defined way.

Finally, just quickly mention, you know, the two other levels I talked about, which is the resource level recommendation, strategic level recommendations, which are fairly connected to each other. From a regional perspective, a consistent criticism of U.S. foreign policy towards the region over the past two or three decades is that Washington has overlooked this region to accommodate priorities elsewhere. And that's reflected in the resources dedicated in this region. So I echo Dr. Elms' comment about IPEF in this case. I think we see that also in the IPEF scenario.

Congress can play a huge role to make sure that there is going to be resources dedicated to this region to prioritize this policy level channeling more attention and resources. I think something important to mention here in addition to, you know, supporting different agencies within the U.S. Government, different multilevel organizations that are based in Washington is also to have a vision towards the economic development under U.S. leadership in the region.

And there, I'll just quickly mention finally by wrapping up my testimony that the recently introduced America's Trade Investment and Americans Act is a promising endeavor on a strategic level. It talks about economic engagement. It talks about new resources. And there's an element of Legislative and Executive Branch coordination which is important. They're trying to build a bridge towards the Biden's Administration's efforts by fast tracking APEP members Eligibility for Americans Act. So I see that as being an innovative experiment and hopefully

something that could come fruition from this sort of coordination. Thank you, Commissioners. I look forward to your comments and questions. I’m sorry for running over.

COMMISSIONER MILLER: Mr. Zhang, thank you. Ms. Friedlander, you’re up next.

PREPARED STATEMENT OF PEPE ZHANG, SENIOR FELLOW, ATLANTIC COUNCIL'S ADRIENNE ARSHT LATIN AMERICA CENTER

HEARING BEFORE THE U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

"Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology"
– Panel IV: Coordinating Strategy with Key Trade Partners
May 23, 2024

Pepe Zhang
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SUMMARY

At the Commission's request, this testimony evaluates U.S. economic engagement with Latin America and the Caribbean (LAC) – taking into account competition and comparison with Chinese efforts, where applicable – and provides recommendations for improvement. Specifically:

- Pages 2-4: The testimony provides an overview of China's rise in LAC's economic context.
- Pages 4-7: It then describes recent U.S. economic engagement – with an emphasis on the Americas Partnership for Economic Prosperity (APEP) – as well as regional reception and needs across three areas:
  - Greater U.S. policy attention
  - More U.S. resources
  - Enhanced policy continuity
- Pages 7-9: Based on the above, the testimony prescribes three policy tools and pathways to enhance U.S. economic engagement with the region, related in particular to supply chains:
  - Trade policy: tariff, non-tariff, and complementary measures
  - Industrial policy that induces self-sustaining and whole-of-ecosystem supply chain enhancements
  - Development policy: financial and non-financial development assistance and cooperation
- Pages 10-11: In conclusion, it distills the preceding analysis into nine recommendations to the Commission and congressional and other stakeholders across three levels:
  - Policy level: Recommendations regarding trade policy, industrial policy, and development policy tools
  - Resource level: Recommendations to unlock more resources for specific U.S. government agencies and efforts and multilateral development organizations
  - Strategic level: Strategic recommendations to ensure U.S. policy attention, resources, and continuity towards LAC

I. THE RISE OF CHINA IN REGIONAL ECONOMIC CONTEXT

The Latin American and Caribbean region (LAC) has registered on average a modest 2-2.5% annual growth rate over the past 30 years, among the slowest in the world. To varying degrees, most countries in the region saw considerable improvements in monetary and fiscal policymaking. But they continue to face structural challenges such as limited productivity gains, socioeconomic inequality, and low levels of foreign investment. In the same period, the lack of significant new domestic growth drivers – coupled with waves of trade liberalization efforts around the world and several regional economies' growing export success – prompted LAC efforts to enhance and diversify economic engagement with international partners.

Against this backdrop, China swiftly emerged as a key economic player in LAC, especially in South America, across four main areas: trade, foreign direct investment (FDI), official lending, and infrastructure development.[i]

II.1. Trade

Trade represents the most significant area of Chinese economic engagement with LAC. The dramatic expansion in bilateral trade underscores the growing economic interdependence between these two regions. Over the past 25 years, trade between China and LAC has multiplied over 20 times to nearly $500 billion in 2023. China has become by far the largest trading partner for countries like Chile, Peru, and Brazil, accounting for over 30-40% of their total exports. By comparison, this is three to four times higher than China's share of total U.S., German, or EU exports (<10%).

Trade flows remain robust in the other direction as well. LAC consumers increasingly favor Chinese goods and services, including high value-add technology products such as cell phones and automobiles or services like TikTok. One important caveat on China-LAC trade is that sizable differences exist across LAC subregions: South America (mostly commodity exporters) is much more dependent on trade with China than Central America, Mexico, and the Caribbean (Figure 1).

Figure 1: China's % participation in LAC subregions' trade in 2005, 2020, and 2035 (projected)[ii]

		2005	2020	2035
Imports	Caribbean	4.6	7.6	11.6
	C. America	6.3	11.9	16.1
	S. America	6.5	17.0	24.0
	Mexico	6.6	17.1	22.5
Exports	Caribbean	1.7	0.9	1.9
	C. America	1.5	1.2	2.0
	S. America	5.9	21.6	25.5
	Mexico	0.7	2.5	6.1
Trade	Caribbean	3.5	4.5	7.4
	C. America	4.5	7.2	10.0
	S. America	6.1	19.2	24.8
	Mexico	3.8	10.1	14.3

II.2. Investment

While Chinese investment cratered globally starting 2016, particularly in major markets like the EU and the U.S., it has shown smaller decline and relative resilience in LAC. This is attributable to at least two regional factors: still-attractive assets and valuations and a friendlier regulatory environment for Chinese investors (compared to heightened scrutiny in advanced economies).

Brazil is the largest recipient of Chinese investment in LAC, and China is Brazil's top investor. In 2021, Brazil received a record $5.9 billion in Chinese FDI, surpassing the $4.7 billion China invested in the U.S. in the same year – remarkable considering that the Brazilian economy is 1/10 the size of the U.S.'. In terms of sectors, Chinese FDI and M&As in the region traditionally concentrated in energy, mineral, and utilities, but have been diversifying into new areas such as ICT and manufacturing.

II.3. Lending

Chinese official lending to LAC peaked between 2007 and 2016, averaging $10+ billion annually. But it has since declined significantly as part of a global retrenchment in Chinese government lending overseas. As Beijing's cautiousness continues, new activities in this space will likely involve renegotiations and restructurings of existing loans rather than new disbursements. Venezuela, which represents less than 5% of regional GDP, has been the top recipient (~40% of stock) of Chinese official lending to LAC.

II.4. Infrastructure Development

Chinese construction firms have actively participated in LAC's infrastructure development through public tenders, winning numerous high-profile projects and at times outcompeting U.S. and European firms. The visible, tangible nature of infrastructure projects (roads, ports, stadiums, hospitals, etc.) contributes to China's growing economic presence in the region. As well, they help to alleviate excess capacity in China's domestic industrial and construction sectors.

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China's economic engagement is generally seen as a growth driver and therefore well-received by regional stakeholders. For some South American nations, trade flows and business cycles have already become more aligned and synchronized with China's than with traditional partners' including the G7 economies (Figure 2 & 3). Such strong economic linkages have potential implications for the effectiveness of U.S. policy. For instance, the U.S. may find it increasingly challenging to leverage certain geo-economic tools (e.g., US-led coordination of multilateral sanctions) against China in the region. In general, most LAC countries already avoid being caught up or publicly choosing sides in the U.S.-China competition.

Figure 2: Major trading partners' participation in LAC Trade 2000-2035 (projected)[iii]

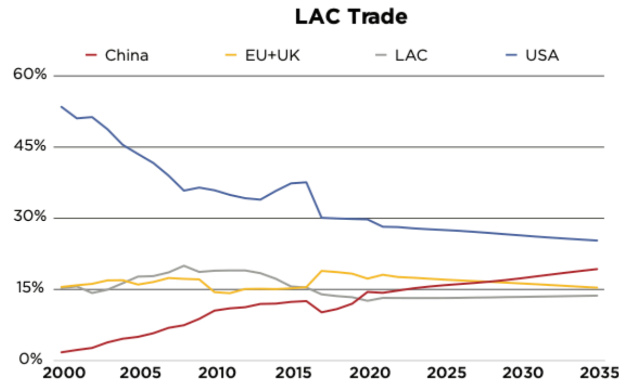
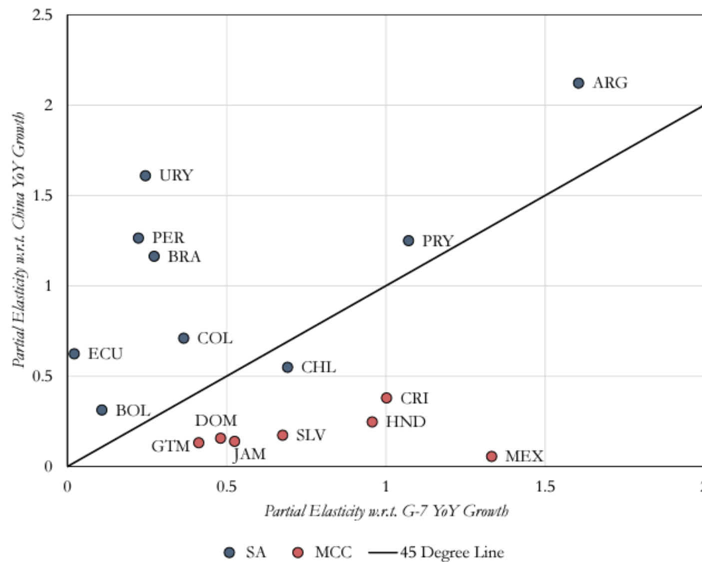


Figure 3: G7 vs Chinese growth impact on & correlation with LAC economies[iv]



Note: Above 45-degree line = a country's growth is more responsive to China than to G7. SA stands for South America. MCC stands for Mexico, Central America, and the Caribbean.

II. RECENT U.S. ECONOMIC ENGAGEMENT AND REGIONAL RECEPTION

II.1 Recent U.S. Economic Engagement including APEP

Despite China's growing economic footprint in South America, the U.S. remains LAC's most important economic partner in aggregate terms. LAC trades more with the U.S. than it does with any other country on the back of stronger-than-ever commercial ties between the U.S. and Mexico. In 2023, the size of U.S.-Mexico trade alone (~$800 billion) far exceeded the size of China's trade with the entire LAC region (~$500 billion). The U.S. also maintains an expansive, outsize network of existing trade agreements in the hemisphere, boasting 12 FTA partners in it (and only 8 outside). Additionally, the U.S. is consistently the largest foreign investor in the region, followed by Spain. The potential for investment and collaboration in strategic and emerging sectors is significant: three out of the seven countries eligible for

U.S. government support through the International Technology Security and Innovation (ITSI) fund – created under the 2022 CHIPS Act to strengthen
semiconductor and telecommunications supply chains – are located in LAC.

With a handful of ideological exceptions, countries in the region largely welcome pragmatic international economic engagement including with the U.S. The latest flagship U.S. regional economic policy initiative is the Americas Partnership for Economic Prosperity (APEP), announced by the Biden Administration in June 2022 during the Ninth Summit of the Americas in Los Angeles. APEP's four main priorities are to foster regional competitiveness, resilience, shared prosperity, and inclusive and sustainable investment in LAC. It currently has twelve members: Barbados, Canada, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, Mexico, Panama, Peru, the United States, and Uruguay.

APEP is structured around three tracks (foreign affairs, finance, and trade), with respective working groups led by individual countries. The working groups cover a wide range of topics, with the initially established ones addressing eight: entrepreneurship, digital workforce development, clean hydrogen, rule of law, sustainable health infrastructure, sustainable food production, water and basic sanitation, and space. Notable announcements so far include: an USAID Entrepreneurship Accelerator with initial support from Canada and Uruguay, digital technology workforce development including the first APEP Semiconductor Workforce Symposium held in Costa Rica, and innovative development finance cooperation with the Inter-American Development Bank on climate and migration issues.[v]

A significant component of the Americas Partnership for Economic Prosperity (APEP) is its focus on hemispheric trade and supply chain resilience. In particular, the first APEP Trade Ministers' Meeting in March 2024 emphasized three key priorities: trade facilitation and digitalization of customs procedures; conducting a gap analysis of critical value and supply chains; and trade for the benefit of SMEs and underserved communities. Sector-wise, APEP has initially targeted energy, semiconductors, and medical supplies as priority sectors, largely consistent with the four product categories identified by the Biden Administration's Executive Order 14017, as well as broader U.S. inter-agency efforts on friendshoring/nearshoring.

II.1. Regional Reception

APEP and other efforts of U.S. economic engagement are generally well received in LAC. But they can be improved in three ways from a regional perspective:

II.2.a. *Policy Attention*

A main criticism of U.S. foreign policy towards LAC over the past two decades is that Washington has overlooked the region to accommodate priorities elsewhere. More recently, the symbolism of hosting two highest-level hemispheric political events in the U.S (the 2022 Summit of the Americas and the 2023 APEP Leaders' Summit) helped to mitigate such perception to some extent. But systematically shoring up U.S. commitment to the region will demand a strategic rethink of what is at stake.

The U.S. economy has much to gain, buoyed by a more prosperous and stable neighboring region. And it has even more to lose in an economically unstable Western Hemisphere, with secondary effects such as migration challenges already impacting U.S. domestic politics.

In terms of nearshoring/friendshoring, LAC offers several valuable advantages that the U.S. would do well to leverage and reinforce, in an era of global supply chain reshuffling and heightened geopolitical uncertainty:

- geographic proximity;
- competitive wages;
- an overwhelming majority of democratic, peaceful, and friendly states (albeit imperfect);
- a diverse group of governments and companies interested in working with the U.S., from the manufacturing powerhouse in Mexico, to dynamic small open economies with proven macroeconomic and sectoral successes such as the Dominican Republic, and South American commodity exporters that are increasingly influencing global food security, energy, and climate transition agendas.[vi]

II.2.b. *Resources*

Another key regional observation regarding U.S. economic engagement concerns the need for more concrete follow-up actions and adequate resource allocation. This is often considered a byproduct of insufficient U.S. policy attention described above. For instance, APEP experienced a perceived hiatus between being announced during the 2022 Summit of the Americas and regaining momentum around the 2023 APEP Leaders' Summit. Since the Leaders's Summit, however, countries have quickly ramped up technical work and senior officials' meetings, with a view to achieve tangible progress ahead of the second APEP Leaders' Summit, to be held in Costa Rica in 2025.

With respect to resources, members have understandably expressed interest in accessing economic opportunities, U.S. investment, and financial support through APEP. For the time being, a substantial part of such support will likely be mobilized through innovative partnerships, including with different U.S. government agencies, extra-regional allies, APEP members themselves, the Inter-American Development Bank especially its private sector arm IDB Invest, and potential resources from the recently introduced Americas Trade and Investment Act ("Americas Act"). Going forward, a clearer definition of APEP's governance structure, membership criteria, and pathways to resources can more effectively unleash opportunities for the benefit of APEP members.

II.2.c. *Policy Continuity*

Economic and political relations between the U.S. and LAC risk becoming more unpredictable amidst electoral cycles across the Americas, including the upcoming 2024 U.S. presidential election. Potential elections-induced policy shifts, if more drastic than normal, could undermine U.S. interests. For instance, as regional partners grapple to navigate and reconcile different U.S. administrations' flagship LAC policy initiatives, they do not face similar struggles with China and its Belt & Road Initiative.

In this context, the Americas Act recently introduced by Senators Bill Cassidy (R-LA) and Michael Bennet (D-CO) alongside Representatives Maria Elvira Salazar (R-FL), Adriano Espaillat (D-NY), and Mike Gallagher (R-WI) brings about a remarkable opportunity to ensure long-term U.S. policy continuity and coherence in LAC. This bipartisan and bicameral legislative effort proposes a comprehensive vision for U.S. economic partnership with the region, underpinned by trade, investment, and supply chain integration, as well as significant new resources. Moreover, in a rare and much needed display of legislative-executive coordination, the Americas Act built a bridge to the Biden administration's efforts by fast-tracking APEP members' eligibility for Americas Act resources.[vii]

III. TOOLS AND PATHWAYS FOR FUTURE ENHANCEMENTS

To bolster economic integration between the U.S. and LAC with a focus on supply chain integration, it is vital to better utilize, innovate, and explain specific U.S. policy tools to regional partners. At a high-level, such tools should play to the unique strengths – and take into account the limits – of the U.S. economy, U.S. government, and their hemispheric ties. Where possible, they should be complemented by targeted capacity building that fosters stronger, self-sustaining local economies in LAC, as well as a more symbiotic economic relationship with the U.S. Specifically, such tools may span across three interconnected areas: (a) trade policy; (b) industrial policy; and (c) development policy.

III.1. Trade Policy

Trade policy instruments include both tariff and non-tariff measures.

- *Tariff:* The scope for using traditional trade agreement/tariff instruments is limited, due to ongoing domestic backlash against expanding foreign access to the U.S. market. In the absence of new FTA negotiations, U.S. and hemispheric partners are focusing recent efforts on making the most out of the existing U.S. trade toolbox and network. One example is legislative measures that aim to surgically insert smaller economies (such as Uruguay, Ecuador, and Costa Rica) through existing preferential trade arrangements, while creating pathways towards eventual bilateral FTAs in some cases.

- *Non-tariff*: More can and should be done in the realm of non-tariff measures, such as harmonizing hemispheric regulatory and phytosanitary standards, streamlining customs procedures, and improving connectivity infrastructure. These measures help to reduce the cost and time of intra-regional trade flows, thus boosting the efficiency and competitiveness of hemispheric production and exports. Here, the U.S. can play a leadership role, facilitated by its existing FTAs with 12 countries in the region.

Greater interoperability – tariff and non-tariff – among U.S. trade ties with hemispheric partners is a practical way to advance the regional economic integration agenda in LAC, which has stalled in recent decades due to political polarization within and across countries. With intra-regional trade representing only 20% of LAC's total trade (the lowest and slowest-growing of all world regions), nearshoring – or regionalized supply chains – in the Americas cannot meet its full potential.[viii]

- Complementary coordination measures and special considerations may include: modernizing policies and regulations to better address digital trade, intellectual property, and labor standards concerns; accumulation of rules of origin for strategic sectors and products; an ambitious plan towards eventual interoperability with FTAs in the region currently not involving the U.S; an inclusive focus on integrating smaller, dynamic economies (many of which are strong U.S. allies) that may otherwise face hurdles to enter regional/global supply chains, due not only to price but scale competition vis-à-vis Asia, etc.

III.2. Industrial Policy

Beyond conventional trade tools, enhanced industrial policy is needed to strengthen productive capabilities and integration within the Western Hemisphere. Well-designed tools (U.S. policies, incentives, investments, and signaling) in this area should focus not on creating one-off success stories, but inducing self-sustaining and whole-of-ecosystem supply chain enhancements.

- *Whole-of-ecosystem:* One of the main advantages of China/Asia-based manufacturing today is its complete, sophisticated supply ecosystems, where a wide range of specializations and suppliers are available along entire value chains upstream and downstream. If the ultimate U.S. policy objective is to replicate these ecosystems in the Western Hemisphere, policymakers can extract helpful lessons from Asia's Flying-Geese-Paradigm industrialization. In this paradigm, Japan as a "leading goose" invested in, shared knowledge about, and induced industrial upgrading in the rest of Asia. By doing so, it made Japanese/Asian exports more cost-competitive, while creating positive spillover effects that led to self-sustaining regional supply chains and additional comparative advantages. The U.S. – and by extension, the North American free trade area – should serve as a similar leading goose in the Western Hemisphere.

However, the whole-of-ecosystem approach may prove challenging or take considerable time and investment to materialize in certain sectors/products, e.g., when regional partners or the U.S. itself does not possess the specializations or technologies needed. In these cases, collaboration with trusted extra-regional allies and surgical interventions to tackle skills gaps or supply chain chokeholds can help to accelerate the process.

- *Self-sustaining:* Public sector investment and assistance through the Inflation Reduction Act (IRA) and the CHIPS Act are a first step in the right direction to push supply chains into the region ("push factors"). Efficient coordination with regional partners is important for financial, capacity, and competitiveness reasons. Many regional governments, while interested, may have limited fiscal space to develop these supply chains independently or have limited technical/industrial capabilities to qualify for U.S. support (or learn how to qualify).

Creating U.S. inter-agency roadmaps for hemispheric supply chain development, with private sector input, will be vital to building such capabilities in LAC to pull/attract investments (a key "pull factor") and ensuring long-lasting success. Importantly, the roadmaps must also introduce a healthy degree of domestic competition, possibly through a sunset provision. Some of LAC's unsuccessful industrialization attempts in the last century – characterized by import-substitution industrialization as opposed to East Asia's export-oriented industrialization – generated uncompetitive firms and resource misallocation, offering a cautionary tale.

A U.S. strategy designed to advance supply chain push and pull factors should also include: local workforce development (a key element of APEP) and infrastructure development (from logistical to energy conditions necessary to ensure export competitiveness); synergy with U.S.-led sector-specific initiatives (such as the Minerals Security Partnership); bilateral high-level dialogue mechanisms (similar to the U.S.-Mexico High-level Dialogue, the U.S.-Guatemala High-Level Dialogue, etc.); U.S. support of regional initiatives such as the Alliance for Development in Democracy (ADD) Business Council's Supply Chain Working Group, etc.

III.3. Development Policy

Development policy tools increase supply chain competitiveness and broader economic resilience in LAC by nurturing additional pull factors conducive to nearshoring, such as: project bankability, macroeconomic stability, physical infrastructure, skills and productivity, disasters preparedness and response.[ix] The U.S. has several unique tools at its disposal, both financial and non-financial, to support regional economic development.

- *Financial*: The most direct financial instruments of the U.S. development toolbox are provided by U.S. agencies such as USAID, DFC, USTDA, and EXIM. With varied priorities and operations, they can offer financing to advance US commercial and foreign policy interests while supporting local development needs. A growing focus and challenge for some of these agencies is to mobilize the private sector. For instance, on the investment side, although U.S. companies have successfully led the U.S. to overtake the EU as LAC's no.1 foreign investor, opportunities exist to unlock additional private sector investment if the agencies are authorized to more easily and substantially mitigate certain country and project risks.

The Washington-based international financial institutions (IFIs) are another distinctive asset for U.S. development and foreign policy in LAC. For example, the COVID-19 pandemic demonstrated once again that these organizations are more willing and capable – than their Chinese policy bank counterparts – to provide counter-cyclical support to LAC countries in need. Such support took place through the IMF's liquidity or macro stabilization programs, as well as development operations from the IDB or the World Bank that directly boosted governments' recovery and growth efforts, improved public infrastucture, health services, or skills training, or indirectly freed up additional fiscal resources for development. Though often underappreciated, the IFIs' close coordination with the U.S. Department of Treasury (their largest shareholder) contributes to hemispheric economic stability and development.

- *Non-financial:* Numerous U.S. agencies drive development in LAC through a wide array of non-financial assistance and cooperation, including training programs organized or contracted by the Departments of Commerce, Treasury, State, Energy, and others. These programs build capacity among LAC public sector, private sector, and civil society beneficiaries, covering specific technical issues such as commercial laws, government procurement, independent journalism, illicit finance, etc.

Additional examples include the Department of Defense and U.S. Southern Command (SOUTHCOM)'s security cooperation with countries affected by rising crime and violence, or their operational support for natural disaster preparedness and response in small, disaster-prone Caribbean Island states. While these efforts may not be economically focused by design, they generate immense economic value, by protecting lives, jobs, supply chains, the investment climate, and government balance sheets. They also foster goodwill. The fact that the U.S. remains the region's partner of choice in these non-economic areas reflects the multi-dimensional, symbiotic nature of the U.S.-LAC relationship. Hemispheric policymakers would do well to further explore these areas as complementary pathways toward greater economic integration.

IV. RECOMMENDATIONS

In summary, and with the Commission's mandate in mind, I propose the following nine recommendations to advance U.S. interest and leverage U.S. strengths in topics covered by this testimony on three levels: policy level, resource level, and strategy level.

<u>Policy Level</u>

In coordination with the Executive branch, Congress can help innovate and utilize U.S. policy tools across three inter-connected areas:

1) *Trade Policy*: Use tariff, nontariff, and complementary measures to strengthen hemispheric trade and integration under U.S. leadership, without resorting to politically thorny market access issues. A key element here is to leverage the U.S.' existing preferential trade agreements with 12 regional partners, as well as their resulting economic linkages and technical interoperability.

2) *Industrial Policy:* Nurture nearshoring push factors (U.S. policies and incentives) and pull factors (regional competitiveness conditions) to build self-sustaining, whole-of-ecosystem productive capacity in LAC for certain sectors/products/supply chain segments. This includes formulating time-bound, U.S. inter-agency roadmaps for hemispheric supply chain development, in coordination with regional partners and the private sector.

3) *Development Policy*: Enhance financial and non-financial (technical/operational) assistance from various U.S. government agencies and Washington-based international financial institutions to strengthen economic development, resilience, and nearshoring pull factors in LAC. The goal is to create more competitive regional economies as well as more symbiotic economic partnerships with the U.S.

Resource Level

Congress can unlock resources pivotal to implementing and supporting the policy-level recommendations above, for example:

4) *Increase resources to deploy more foreign service, development, commercial officers* in ways that (a) advance U.S. foreign policy and commercial interests in LAC across the trade, industrial, and development policy areas outlined above, including through Americas Partnership for Economic Prosperity (APEP)-related initiatives; (b) supporting regional development needs and capacity building; (c) deepen regionalized China expertise and capability, particularly through the Department of State's Regional China Officers (RCO) program.

5) *Increase resources for public diplomacy efforts* that better specify and highlight the value of positive U.S. economic engagement in LAC. This includes measurable impact of U.S. policy actions recommended above, as well as non-governmental U.S. accomplishments and facts, e.g., the U.S. consistently remains by far the region's largest investor and trading partner in aggregate terms.

6) *Optimize budgetary or financing rules for organizations like DFC and EXIM* so they can meet the growing and evolving needs of the beneficiaries, expanding progress made in the Better Utilization of Investments Leading to Development Act of 2018 ("BUILD Act").

7) *Approve/Allocate resources to DC-headquartered international financial organizations – including the Inter-American Development Bank Group and the World Bank Group – for future capital increases and replenishments.* These organizations are well-positioned to provide high-quality, impact-driven development assistance to LAC. Additionally, they can complement bilateral U.S. efforts, as evidenced by the recently announced IDB Invest-DFC co-financing framework.

Strategic Level

Through its legislative, policy, financial, and oversight authority, Congress can play a key role in guiding the strategic direction of U.S. foreign policy towards LAC, in particular:

8) *Draw more attention and resources to LAC*. U.S. Government including Congress must work to recalibrate regional perceptions of U.S neglect and advocate for a more active role for the U.S. in leading hemispheric economic integration. LAC has much to offer as a reliable partner in an evolving global context, and it is in U.S. national interest that this neighboring region realizes its full potential. The recently introduced Americas Trade and Investment Act ("Americas Act") is a promising endeavor in this regard.

9) *Ensure coherence of U.S. economic engagement with LAC*. At a time when domestic political polarization across the region and in the U.S is making hemispheric relations less stable and effective, Congress can play a key role in informing a high-level, bipartisan, and coherent U.S. strategy towards LAC that better transcends electoral cycles. Recent executive-legislative efforts to connect the Americas Partnership for Economic Prosperity (APEP) and the Americas Act are an encouraging signal in this regard.

ENDNOTES:

[i] Much of the data in this section comes from: Zhang, Pepe, and Felipe Larraín. "China Is Here to Stay in Latin America." Americas Quarterly, January, 2023. https://www.americasquarterly.org/article/china-is-here-to-stay-in-latin-america/.
[ii] Prazeres, Tatiana, David Bohl, and Pepe Zhang, China-LAC Trade: Four Scenarios in 2035. Atlantic Council, May 2021. https://www.atlanticcouncil.org/in-depth-research-reports/china-lac-trade-four-scenarios-in-2035/.
[iii] Prazeres, Tatiana, David Bohl, and Pepe Zhang, China-LAC Trade: Four Scenarios in 2035. Atlantic Council, May 2021. https://www.atlanticcouncil.org/in-depth-research-reports/china-lac-trade-four-scenarios-in-2035/.
[iv] World Bank. "Leaning Against the Wind: Fiscal Policy in Latin America and the Caribbean in a Historical Perspective." LAC Semiannual Report (April). Washington, DC: World Bank, 2017. https://documents1.worldbank.org/curated/en/841401495661847413/pdf/P162832-05-24-2017-1495661844209.pdf
[v] White House. "Fact Sheet: President Biden Hosts Inaugural Americas Partnership for Economic Prosperity Leaders' Summit." The White House, November 3, 2023. https://www.whitehouse.gov/briefing-room/statements-releases/2023/11/03/fact-sheet-president-biden-hosts-inaugural-americas-partnership-for-economic-prosperity-leaders-summit/.
[vi] Zhang, Pepe, and Otaviano Canuto. " Global Leadership for Latin America and the Caribbean." Project Syndicate, September 2023. https://www.project-syndicate.org/commentary/latin-america-caribbean-global-leadership-food-climate-finance-by-pepe-zhang-and-otaviano-canuto-2023-09.
[vii] "S.3878 - Americas Act." 118th Congress (2023-2024). Accessed November 16, 2023. https://www.congress.gov/bill/118th-congress/senate-bill/3878/text/is#toc-idbd7b93971b294b1fa02e3ad10158a324.
[viii] International Monetary Fund. "How Latin America Can Use Trade to Boost Growth." IMF Blog, November 16, 2023. https://www.imf.org/en/Blogs/Articles/2023/11/16/how-latin-america-can-use-trade-to-boost-growth.
[ix] Other nearshoring pull factors include: regulatory and legal certainty and simplicity, physical infrastructure, export promotion and facilitation, effective public institutions, innovation capacity, etc.

OPENING STATEMENT OF JULIA FRIEDLANDER, CEO, ATLANTIK-BRÜCKE

MS. FRIEDLANDER: Thank you. And I'm conscious that I'm the last person to testify today, so I'll speak a little bit more extemporaneously.

Greetings from my office in Berlin. I am the CEO of Atlantik-Brücke. As you mentioned before, it is a nonpartisan, cross sectoral professional network, in some ways, the strongest professional network in Germany. It happens to be a transatlantic one.

So in my everyday work, I work with European and German politicians, industry representatives from finance, journalism, and academia. And I can say, with full certainty, that the long-term competitiveness of the European economy, of the transatlantic economy, this is often code for China. It's pretty much the most important topic that we deal with today.

I've been here for two years, but prior to that, I was in Washington for 15. I started my career as an economist with the Central Intelligence Agency, working mostly in the eurozone crisis, moved to the Treasury Department to work on sanctions, policies, and then I was detailed to the NSC Europe for 2017 to 2019. I was at the Atlantic Council with Pepe for two years, subsequently founding the Economic Statecraft Initiative.

The -- when I mentioned that this was the -- that China and competitiveness is the topic of the day here in Germany, this wouldn't end the -- in talking about a transatlantic context, this wouldn't have been the case five years ago. When I started at the White House and I had visitors from Europe, they would say what's the topic of transatlantic economic agenda. And when I said I think it's going to be China, they looked at me like I sort of had a third eye in my forehead. And of course, given the change in national discourse in Washington and in Europe, this is hard to imagine today, right? Then, when in 2017, when I started, many of these topics were new for me as a foreign policy professional and an economist within the U.S. government.

Since then, the U.S. and European assessment of China, right -- and sort of as a former intel analyst, I like to start with how do we assess the problem before we get to the solution -- is running on parallel tracks. Many of the issues that we highlight -- subsidization, intellectual property theft, forced joint ventures, human rights violations -- these are all essential parts of the German and the European assessment of China.

Of course, the perennial complaint that U.S. policymakers have about Europe, many member states, including where I sit, in Berlin today regarding Russia prior to February 2022, when there was a large analytical gap about the risks that Russia posed to the European continent, that is not the case with China at all. So, again, we've had we experienced over the past five years a revolution in how Europe thinks about China.

This is also in light of the fact that they are -- that Europe is in large part an export-based economy, something we've complained about for a long time. It's that exports remain too much a part of the balance of payments compared to domestic demand and investment in Europe. A lot has to do with the eurozone crisis. If we remember, China was actually part of the solution to rescue economies that had excess capacity and capital stock when demand from southern Europe dropped off when many countries entered crisis.

China's gross trajectory -- and again, I performed some of these studies -- outperformed what we thought that Europe would need to sustain economic growth and GDP growth. So China became part of the solution in at the same as IMF and EU rescue plans did. And of course, part of those rescue plans mandated that many crisis countries privatize industry and public services, and China was there at a moment of need.

So the European Commission, last year, produced an Economic Security Strategy. This reads a lot like some of the foundational documents we have in the U.S. government. The most novel instrument that we have there is something called an anti-coercion instrument, which actually is, in many ways, an equivalent to our Section 301 authority: how do we respond asymmetrically within WTO rules, of course, to economic coercion, if that's an embargo of agricultural goods or an embargo of Lithuania, as the Chinese did after the Lithuanians offered to open the Taiwanese Representational Office. They even targeted tariffs by the United States.

I think the main issue that I would pose here and I can go in time, I can go through some of the differences in how they implement investment screening and export controls and the like is to look at the intellectual bandwidth that we give each other give ourselves in the U.S. government. Whether it's economic security, it's national security, or a small yard, high fence, there's a malleability intellectually between that what we do for national security and what we do for economic security.

So what do we do something in a purely foreign policy context? And what do we do to protect competitiveness and maintain the level playing field in trade? This is, for the U.S., sometimes academic.

There are some things that fall under national security, such as a Huawei ban. There are some things like parts of the Section 301 -- like the Section 301 report which showed that we are responding to unfair subsidization and dumping of electric vehicles into the international market. That's a trade mechanism. Most things lie in the gray area in between sensitive technologies. Many things that were are advanced technologies that we would like to gain a competitive advantage in also have military intelligence application.

So there's the view that that's a difficult line to follow. For Europe, the European Union, that is a legal distinction between what the European Commission can do and what is delegated to national authorities. So trade itself responding and again, the European Commission is most likely going to implement tariffs on China in the coming weeks in response to the dumping of electric vehicles. There are no such trade competency that the Commission can employ on its own as opposed to member state obligations and national security, which where export controls and CFIUS fall under.

Now, there is a revolution in CFIUS as well. Up until a couple of years ago, only four member states in the European Union had investment screening mechanisms. Now all of them do as a result of a mandate from the Commission and the Council as well. But that, of course, means that member state governments are going to have jurisdiction over those cases, and there are only some instances where the European Commission itself can exercise jurisdiction over those.

So I'm -- well, I'd like to go to -- and for the comments is the idea of how we approach the competitiveness gap with Europe. There's no illusion about what China -- the risks that China poses to the European economy as a whole. What you do about it has a lot to do with maintaining the European competitive edge, which includes the integration of European capital markets and includes selected industrial policy, and it involves maintaining the TCC.

I think that there is going to be a lot of back and forth about how we implement this -- the line between national security and economic security, but the best way to support European counterparts and to also push them is to encourage competitiveness of their industry in line with Western standards. Because, again, as Europe is able to develop native industry in corroboration with us means that that will fall within the small yard that we talk about and establish Western standards as a global standard.

So I look forward to questions from the Committee and to speak with my esteemed colleagues here today. Thank you.

PREPARED STATEMENT OF JULIA FRIEDLANDER, CEO, ATLANTIK-BRÜCKE

U.S.-China Economic and Security Review Commission

Hearing on "Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology"
Thursday, May 23, 2024

Julia Friedlander, CEO, Atlantik-Brücke, Berlin, Germany

Thank you to the Commission for the invitation to speak with you on European economic relations with China. I am joining you today from my office in Berlin. I currently serve as the chief executive officer of the Atlantik-Brücke, or "Atlantic Bridge," a professional network founded over 70 years ago to bind the German Federal Republic into the West. For context, we are a non-partisan, cross-sectoral and membership-based organization. Our core activities are financed solely by membership dues and private donation. I myself have served as an economist at the Central Intelligence Agency, as an advisor on Europe in the Treasury Department's Office of Terrorism and Financial Intelligence, and from 2017-2019 I was detailed as a Director to the National Security Council staff, where I handled European foreign policy and economic affairs. I subsequently founded the Economic Statecraft Initiative at the Atlantic Council, where I remain affiliated, prior to my move to Germany. In my current position, I work with German and European leadership across industry, finance, politics, journalism, and academia. Adapting—and even revolutionizing—the Continent's approach to competitiveness—often code for China—is a predominant topic among our ranks.

This would not have been the case five years ago. When I first arrived at the White House in 2017, European counterparts were surprised to hear my assessment that the U.S. would place China high on the transatlantic economic agenda. Remember, it was new to Washington as well, as hard as that might be to believe considering the current nature of our national discourse. The pace of policy changes on China have evolved on both sides of the Atlantic in parallel, and at lighting speed within the course of our joint economic history. If I compare the divergent risk assessment between the US and many European capitals regarding Russia prior to Putin's renewed war against Ukraine in 2022, the shared US and European reality regarding China is an entirely different paradigm. During this testimony, I will provide an overview of the policy trajectory at the EU level and in key European capitals; describe where there is strategic alignment but how practical divergence based on economic exposure, institutional differences and capacity restraints will affect policy outcomes; and conclude with recommendations for US policymakers.

The Difference a Decade Makes

The EU economies, collectively, are export-dependent, relying on global consumption to buoy growth and support generous social services. Boosting domestic demand and investment, as a component of balance of payments is a long-term concern in Europe, and certainly a talking point for generations of US Treasury officials. It is important to compare this to the consumption-reliant economy in the United States before beginning a conversation on Europe and China. Prior to the eurozone crisis in 2012, markets were found closer to home within the

European single market. However, when several economies fell into sovereign debt or banking crisis and put into question the validity of the euro itself, debt relief and cash injections from the IMF and EU institutions were a key part of the solution; China was the other part. Those watching shifts in trade and financial flows at the time calculated how fast economic growth would need to expand among the BRICS nations, as we called them, to absorb the sudden excess capacity of European goods and capital stock. India and Brazil grew steadily, but minimally—it was the expansive growth trajectory in China that stabilized markets for European—and especially German—exporters. The formula of revenue generated as gross national income combined with relative wage restraint at home ensured that, unlike in the United States, low barriers to trade with China did not markedly affect employment levels in heavy industry. And in other parts of Europe, Chinese investment came as a reprieve because Troika programs mandated the privatization of state-owned enterprises, critical infrastructure, and public services.[1][2][3]

That was ten years ago. The portrayal in media outlets or international policy circles of European governments or industry as naïve to the risks of China's distortionary behavior, is painting with a broad brush. Last Spring, the European Commission published its economic security strategy, outlining risks including non-market behavior, broadscale subsidization, forced joint ventures, and intellectual property theft.[4] China is labeled as partner, competitor, and rival. The most novel and most heavily debated element of the strategy is a so-called "anti-coercion instrument"[5] that allows European authorities to react asymmetrically to coercive behavior by a third party, responding potentially to such events as a Russian import ban on European agricultural products,[6] a Chinese embargo of Lithuania,[7] or even unilateral tariffs by the United States.[8] For those Americans consulting with the Commission during its drafting period, it was clear that European counterparts were establishing an equivalent to the US Section 301 authority.

Brussels Bubble versus Capital Pride

A China economic strategy for the US and its closest partners asks its drafters to draw the line between actions we take to protect our national security, and those that we take to secure our economic interests. Within such phrases as "economic security is national security," or National Security Advisor Jake Sullivan's "small yard, high fence" the United States has established a good deal of intellectual malleability within the universe of government strategy and public messaging. Some cases will be clear-cut: removing Huawei hardware from telecommunications systems is a matter of data security and counterintelligence, not to the advantage of US providers; raising tariffs on Chinese electric vehicles, on the other hand, is not a national security matter but a response to unfair, distortionary trade practices, whereby government subsidy has forced China to dump vehicles at artificially low prices into the international market. But most cases in the modern economy are not clear cut—the line

[1] https://www.ft.com/content/53b7a268-44a6-11e4-ab0c-00144feabdc0
[2] https://rhg.com/research/tipping-point-germany-and-china-in-an-era-of-zero-sum-competition/
[3] https://www.bruegel.org/sites/default/files/wp-content/uploads/imported/publications/20140219ATT79633EN_01.pdf
[4] https://ec.europa.eu/commission/presscorner/detail/en/IP_23_3358
[5] https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:L_202302675
[6] https://www.europarl.europa.eu/RegData/etudes/BRIE/2016/581971/EPRS_BRI(2016)581971_EN.pdf
[7] https://www.politico.eu/article/european-union-china-world-trade-organization-dispute-lithuania/
[8] https://www.bbc.com/news/business-67758395

between competitiveness in future technologies and intelligence or military application has grown increasingly muddled. Weeks before the release of the Administration's latest 301 findings,[9] the Commerce Department issued an inquiry on the same vehicles, not concerning the price, but the transfer of sensitive user data to China.[10] The same Chinese export—and two different justifications for prohibiting access to the US market. In Europe, the line between trade policy and national security is not academic, it is a legal one.

I highlight this distinction at a crucial moment in US economic history to remind officials how to calibrate overtures to European counterparts and also understand their actions. The Lisbon Treaty, the foundational agreement of the modern European Union, delegates trade authority to the technocratic European Commission but member states maintain sovereignty over national security. When the European Union takes a foreign policy decision, including on sanctions, it requires unanimity in the European Council—a body representing all member governments. The most prescient example of this national security prerogative is investment screening. As a result of the US 2018 CFIUS reform (FIRRMA) and a string of Chinese acquisitions of infrastructure and sensitive technologies, Brussels mandated that member states each implement a screening mechanism. To date, all member states, plus the UK and the rest of the European Economic Area, have screening mechanisms, at least on paper. Prior to the 2019 regulation, only four in the EU did, and they were hardly ever used. Italy, for example, has now invoked its "golden rule" on multiple occasions over the past several years.[11] The UK, long reticent to shake its relationship with Beijing due to historic ties to the financial center of Hong Kong and after the shock of Brexit, has taken landmark decisions to block Chinese acquisition of key industry.

Brussels, however, does not have jurisdiction over individual cases, although member states have the option of referring to the European Commission for advice, and European authorities may intermediate if others are implicated. This balancing act reflects an attempt by European officials to navigate the interdisciplinary challenges of economic statecraft within their given legal parameters. Export controls face a similar predicament. Countries may decide to implement unilaterally if EU consensus cannot be reached, and they often do so, but aside from niche technologies from specific firms (think of ASML), or specific arms shipments, the reality of the EU customs union makes trade substitution almost automatic and the flow of prohibited goods impossible to trace unless firms are willing to share proprietary data. Periodic initiatives to decide foreign policy issues by qualified majority are stymied by small states, whose power relative to big players like Germany and France is the right to that very veto.[12][13] On legal grounds, the concept of "economic security is national security" will remain a divided and legally complicated concept in Europe. Although US policymakers often balk at its perennial attempts to reignite a strategic autonomy debate, France is the EU country with the strongest intelligence service, a centralized decision-making process, the most robust understanding of economic statecraft and a well-trained technocracy.

[9] https://ustr.gov/about-us/policy-offices/press-office/press-releases/2024/may/us-trade-representative-katherine-tai-take-further-action-china-tariffs-after-releasing-statutory
[10] https://www.commerce.gov/news/press-releases/2024/02/citing-national-security-concerns-biden-harris-administration-announces
[11] https://www.whitecase.com/insight-our-thinking/foreign-direct-investment-reviews-2023-italy
[12] https://www.auswaertiges-amt.de/en/newsroom/news/-/2595304
[13] https://www.swp-berlin.org/10.18449/2022C61/

Trade policies, however, are another matter. The "geopolitical" Commission[14] under Ursula von der Leyen is poised to exercise its supranational mandate to address Chinese non-market behavior. Just as the US will counter unfair state subsidy of electric vehicles and solar panels, the EU is preparing similar mechanisms to prevent Chinese exports from flooding markets and extinguishing local producers. The more Chinese internal market dynamics force products onto the market at the expense of European firms, the more the EU will be ready to use its trade authorities in suit. The rhetoric will focus on "leveling the playing field" to maintain intellectual distance from Washington and signal that the EU is reinforcing global trade rules, not engaging in protectionism against the spirit of those rules.[15] The US should allow Brussels that distance. There are also nascent efforts to build up supply chain resilience with third parties such as Japan. While one arm of the Brussels machine is actively "friendshoring," its other ideological workstream seeks to expand markets as far as possible. EU maintains a trade agreement with Vietnam and continues the uphill climb on an arrangement with MERCOSUR.

Government Capacity and Corporate Culture

Governments tend to design policies that fit within their own bureaucratic ecology—that is, not only reflecting the priorities they set but their resources on hand. There is no European capital that possesses the personnel strength of the US government—even scaled for the size of their respective economies. Steering foreign policy through economic instruments has been a fixture of Washington decisionmaking since 9/11, with ever increasing frequency. Alongside this evolution the government apparatus has grown, and firms have developed a culture of compliance and enforcement. Entire industries have emerged to assist the private sector, and firms hire readily from the ranks of US government officials seeking to expand their professional horizons. Think tanks, also stocked with former government officials (witness the panels called for today's hearing) generate new ideas with knowledge of government and feed those back into the system. These individuals often return to public service with tactical experience in implementation or academic work.

European capitals do not have these revolving doors, or only in rare cases, and these are often heavily scrutinized for signs of corruption. Given the interdisciplinary nature of 21st century challenges, the firewalls are starting to crack. Firms are spending an increasing amount of time analyzing supply chains and export control exposure, but European governments cannot expect the private sector to have the capacity for anything akin to the Commerce Department's Foreign Direct Product Rule, which US firms employing former officials also claim is nearly impossible to get right.[16][17] Several member states recently vetoed the EU's newest proposal for a Supply Chain Security Act,[18] which is lamentable given some of the Xinjiang cases recently. Industry lobbying is not to be discounted, but the central claim that the burden on firms would be unmanageable is not bluster. Implicitly, many European governments have traditionally relied on the United States to tell them where something has gone awry. Fulfilling that role remains in our national interest, but it is encouraging to see European governments shift from following the direction of their closest ally when asked, and often begrudgingly, to generating

[14] https://ip-quarterly.com/en/how-european-commission-became-geopolitical-player
[15] https://www.ft.com/content/cdc0d397-1a20-4b57-b5b9-5de57bf0c87b
[16] https://www.atlanticcouncil.org/blogs/econographics/foreign-direct-product-rule-is-russia-the-next-huawei/
[17] https://kse.ua/wp-content/uploads/2024/01/Challenges-of-Export-Controls-Enforcement.pdf
[18] https://www.politico.eu/article/supply-chain-european-union-rules-lobbying-france-germany-italy-belgium/

home-grown supply chain resilience and compliance. China and the dislocations of the pandemic have caused that shift.

Caught in the Middle or a Competitiveness Gap?

European capitals will often portray their economies as caught in a dilemma between the United States and China.[19][20] In my view, this is partly justified. American companies are voicing similar concerns and [21][22] the "one world, two systems"[23] phenomenon will burden supply chains, regulatory commitments and financing for Western multinationals and SMEs alike, regardless of where they are headquartered. Most member states would gladly forgo difficult choices that will create economic losers (such as through industrial policy, by, conversely, picking winners) or cede further negotiating authority to Brussels to make a run at superpower status. This is not a permanent stall-out. Europe acts decisively when it needs to: the eurozone crises gave rise to centralized banking supervision, the pandemic spurred the first issuance of joint debt, and it is likely that the downstream effects of "being caught in the middle" will pull the trigger on a new wave of integration. Given the massive financing needs for innovation, energy transformation, and defense, fractured capital markets remain the most strategic shortcoming in European strategic architecture.[24][25] A much anticipated study published in April by one of Europe's wise men, former Italian Prime Minster and political scientist Enrico Letta, argues that further integration of European financial and industrial instruments (and elimination of red tape) will boost fortunes when up against structural advantages in the United States, China, and a string of fast growing global economies.[26]

It is in US national interest that European markets strengthen and consolidate, not only for investor classes looking for new horizons, but as a component of US China strategy. Closing the competitiveness gap will bolster European economies in critical technologies that fall within the "small yard," helping to establish Western standards as global standard. A sustainable energy transition and modernization of defense industries will require new rounds of government incentive but will ultimately rely on private capital as their backbone.[27][28] The shock of Russia's aggression on Ukraine has unleashed levels of defense spending not seen since the early 1990s, but the "guns vs. butter" tradeoff is a tougher tightrope for governments whose borrowing capacity is much stricter than in the United States. A robust investment climate will help shield European economies from Chinese coercion and shake renewal out of stubborn industrial structures tailor-made for the circumstances of the millennial era.

[19] https://dgap.org/en/research/publications/dont-get-caught-middle
[20] https://www.cer.eu/publications/archive/policy-brief/2020/europe-us-and-china-love-hate-triangle
[21] https://www.amchamchina.org/press/amcham-china-statement-on-us-china-tariffs/
[22] https://www.uschamber.com/international/how-tariffs-are-hitting-small-business-and-why-congress-needs-to-renew-gsp
[23] https://www.atlanticcouncil.org/in-depth-research-reports/issue-brief/one-world-two-systems-takes-shape-during-the-pandemic/
[24] https://www.piie.com/blogs/realtime-economics/2024/europes-capital-markets-union-make-it-or-break-it
[25] https://www.deutsche-boerse.com/dbg-en/regulation/regulatory-topics/cmu
[26] https://www.consilium.europa.eu/media/ny3j24sm/much-more-than-a-market-report-by-enrico-letta.pdf
[27] https://www.bloomberg.com/news/articles/2024-01-18/sewing-says-europe-needs-capital-market-union-to-lure-tech-firms?embedded-checkout=true
[28] https://table.media/en/europe/news-eur/deutsche-bank-ceo-without-a-capital-markets-union-the-green-deal-is-dead/

Even without the guiding hand of government incentives or compliance requirements, European firms, as a whole, are targeting a "China plus one"[29][30] approach to avoid supply chain bottlenecks, buffer Chinese internal market weaknesses, and insure against creative interpretations of rule of law or government crackdown. The clear test-case for this reorientation is Germany, the world's third largest economy, whose industrial workhorses remain existentially bound to Chinese demand. After several years pointing in the other direction, the US is emerging this year once again as Germany's largest trading partner,[31] and countless conversations I have held with both government and business representatives underscore the statistic. The German economy is diversifying, particularly among the small and medium enterprises that make up the core of the domestic economy and the "Made in Germany" moniker. But there is no way around the fact that China remains the second largest market for Germany's biggest players. Shifting away from a business model that buoyed the country's multinationals for over a decade cannot happen overnight, even as Chinese indigenous production and intellectual property theft steadily eat away at market share and profit, and with it, Germany's proudest source of national income. No one is unaware of this trend, but the path forward is all but clear. The government has responded with a mixed recipe: keep the China engine going for as long as possible, court US investments in strategic sectors—from Tesla to Intel to Amazon—and spur innovation and investment through subsidy and by cutting red tape. Although Germany is uniquely exposed to China and singled out as having the most to lose, its strategy still does largely align with that of its European neighbors.

Conclusions

US outreach will require a multi-pronged approach. Policymakers must embrace European institutions as the godfather of central rulemaking, but also each member state as its own universe of national interests and security identity. One of the biggest policy mistakes US officials make is to limit outreach to the European Commission and officials in London, Paris and Berlin. Foreign policy consensus in Europe is more hard-won than winning over the "Big Three," and it is precisely the smaller member states without as much market power that China will court to try and crack consensus-making on policy that it disfavors. Hungary, for instance, is eager to court Chinese investment and position itself as a repeated thorn in the side of the Commission, which it portrays as a half-malign "big brother of all things."

The operational realities of the transatlantic economy—shaped by electromobility, data flows, defense technology, and advanced manufacturing, will over time force consensus-making at the Trade and Technology Council (TTC). Although critics hankering for headlines have written off the convenings thus far as "concluding without results," the TTC represents a steady and often rocky march towards a new form of agreement, where interoperable regulation has taken the place of tariff schedules to regulate the cross-border movement of

[29] https://www.spglobal.com/marketintelligence/en/mi/research-analysis/asean-china-plus-one-destination-current-situation-risk-outlook.html
[30] https://dgap.org/en/research/publications/managing-risks-eu-china-economic-relationship
[31] https://www.cnbc.com/2024/05/10/the-us-is-now-germanys-biggest-trading-partner-ahead-of-china.html#:~:text=Alliance%20%7C%20Getty%20Images-,After%20years%20of%20China%20being%20Germany's%20main%20trading%20partner%2C%20the,January%20and%20March%20of%202024.

value. Patience is warranted—we are just at the beginning of a global economic era that will require a form of governance a far cry away from WTO rules.

Tariffs, export controls and investment restrictions each bear their justifications, but will erect barriers to trade and raise prices for both producers and consumers at a time when industrial economies are battling a form of inflation that may prove more structural than transitory as government policies mature. Policymakers today argue that the 21st century economy and geopolitical realities require an adapted interpretation of economies of scale than the diktat of short-term profit maximalization. However, trade interventions and economic statecraft have proven to be fickle beasts that often do not deliver on their intended outcome. The "small yard" risks getting too large. As the United States barrels head-on into uncharted territory, it cannot only rely on its unparalleled market power. Unilateralism will almost certainly backfire and diminish the leverage we so readily employ in our image. Our partnership with Europe is the bedrock of our future success.

PANEL IV QUESTION AND ANSWER

COMMISSIONER MILLER: Thank you, all, for your testimonies. We'll move to questions now. I will take the prerogative as Chair to kick us off.

We as a Commission try to watch developments in China very closely. And this question is for you, Ms. Friedlander, but we have a hard time understanding political dynamics in Europe. It's often very confusing to understand where China policy in Europe emanates. Is this a European Union issue? Is it a European Council issue? Is it coming from the European Commission? Is it a dynamic between the member states?

We have taken notice in the last year or two of foreign subsidies regulation, which has seemed to be a major driver of China policy and has created an environment where you have created a mechanism which very much looks like a European version of the Section 301 that the United States utilizes in order to attack non-market practices that you think could be potentially harmful. But we're very confused in terms of where this may be going next.

Can you sort of walk us through the evolution of this and what might determine its usefulness and breadth and mandate in the future? Is this a battle between Germany and France for the soul of the China policy in Europe? Is this something that will be pushed naturally by the dynamics of Europe as a whole as it sees China as more and more of a competitor? Where is this regulator and where is this regulation going?

MS. FRIEDLANDER: It's a -- as I was trying to elaborate in my opening remarks, it is going to be a mixed bag. If you -- the Commission, the European Commission has a mandate over competition policy and trade policy. So anything that you're going to deal through WTO rules or handling unfair trade practices that is going to be something where the Brussels authorities will be able to act autonomously, in theory, without the consultation of member states. Of course, they talk to them all the time and see how they're going to react.

A national security prerogative is going to cover anything that's in export control or investment screening. And so, if you're talking about niche technologies or intellectual property that is governed by a specific member state, you're going to have to talk to that government itself.

Each of the -- I mean, just like the United States is heterogeneous in its economic composition, so is the European Union to a different degree, right? And when I say that they are export dependent, that's going to -- that's all on a -- that's on a dividing scale.
If you -- there are -- you know, France, for example, which I would say is probably the most bilaterally the most like minded partner because they have a very -- they have the strongest intelligence service in the European Union. They have their presidential system. So they have top down governance, and they have a sort of better designed technocracy for these issues. They're going to -- of course, they're a more statist economy. They're going to see their exposures to China differently than Germany would.

Germany itself is, of course, singled out as being the most exposed. It is. It's the third largest economy in the world. It generates a lot of the -- its tax revenue, how it supports its social state through the long arm of gross national income, through multinationals that -- and traditionally through wage restraint.

In Germany, they were able to keep industry here in a way that the United States was not. So, I mean, having served in the NSC, I witnessed conversations between President Trump and Angela Merkel, the Chancellor of Germany, where the Chancellor was saying, Mr. President, we have industry here; we want to keep it here. And Donald Trump says, well, we want it back.

So I think, when you approach the European governments, you have to see the Commission itself and the sort of lassoing within the European Council as the sort of godfather of consensus because only on these trade authorities are they going to exercise direct autonomy. The rest is about building, in the end, what might be -- some decisions are going to be subject to a qualified majority vote on certain regulations.

And on national security, and that's where sanctions policy falls and where export controls fall, they are -- you're going to need all member states to agree. So that's where U.S. policy is best served by engaging the godfather of the European Commission and then fanning itself out to talk to all of the member states at once.

One of the biggest problems you could have is actually by going to see the big three -- the U.K., France, and Germany -- and not paying attention to all the rest. That's something that U.S. policymakers -- it's a mistake we perennially make because China is going to look for the weakest link, the small market actor to sort of spoil that consensus when necessary.

So, all in all, Europe is on an indelible trajectory towards taking a much harder line on China based on competition policy and by structural disadvantages through economic practices that are not in compliance with WTO rules. We have unleashed -- U.S. pressure has contributed to this, but eight percent of it is home grown within Europe, an analysis that Chinese practices are undermining European safety and security.

And you're going to see, in the coming years, parallel actions from European authorities, in conjunction with member states, that look a lot like what the United States is trying to do. They may not phrase it in the same way. They're not going to talk about great power competition. They're going to say they're leveling the playing field because most of the -- because the exposure is such to an export-based economy. But they see the problems the way we do, and I think, in the coming years, we're going to be moving -- continuing to be moving on parallel tracks.

COMMISSIONER MILLER: Thank you. I have a whole handful of other questions. I see the red light flashing though, so I'm going to hand this over to Commissioner Wessel.

COMMISSIONER WESSEL: Thank you, all, for being here. Thank you for those in Singapore staying awake and for our -- Ms. Friedlander, for you as well because I guess it's late in the evening there as well.

I want to challenge some of this. And Ms. Friedlander, you just talked about how Europe is beginning to understand that addressing the China challenge is in their interest. I also think it's in the interest of the other partners in the IPEF and the APEP region. And there seems to be sort of this entitled view that the U.S. has to pay for policy alignment in these areas, in these regions.

I was just looking at some quick facts. The U.S. has over $1 trillion of FDI in the Indo Pacific. Last year, we imported 2.5 million cars from Japan, and they accepted fewer than 25,000 vehicles from the U.S. With Vietnam, we had $104 billion trade deficit last year, which grew from about $39 billion in 2018. You look at the APEP region, 11 of our FTAs -- 11 of our 20 FTAs are with APEP partners.

And in Europe, we have a huge trade deficit and an expectation that we will continue to have an imbalance and a preferential approach for European trade access. They've refused to help on Chinese overcapacity and are only now looking at addressing or advancing trade defense mechanisms. So the China challenge for these countries, these regions is significant as well, but they seem to want us to have to pay them to align for what's in their own interests.

Can each of you respond to that comment? And I think the American people are, you know, getting a little tired of the entitled view that others have to access to our market, and they want to know that there's going to be alignment.

Ms. Friedlander, do you want to start?

MS. FRIEDLANDER: Sure. The first point I would make is that structural trade deficits have a lot to do with, frankly, the huge domestic market that the United States is. Consumption is the greatest component of our of economic growth. It outweighs that what we -- that we gain by exports. That has a lot to do with American spending capacity and American preferences.

COMMISSIONER WESSEL: I appreciate that, and just to interrupt, the average tariff on U.S. autos in the EU is ten percent. It's two and a half percent here. I understand the size of the market, but again, there are a lot of structural issues in Europe that create an entitlement. Their view, for example, in the IRA, that they were entitled to be able to share in the tax benefits here without providing any access there.

MS. FRIEDLANDER: No, and I understand that, and I think that all of those -- all of those are fair points. I mean, all's fair in love and war and trade. And I think there are these that are many, many points that you can raise in the bilateral context, and we continue to do so. And that's what the Trade and Technology Council is not -- is a place for friendly sparring as well as for alignment.

When it comes to aligning on China, however, which I think is the point of our discussion today, my point is that the competitiveness of the European economies plays into our own strategy because we want countries that are not going to be that are our friends and allies who are not going to be subject to economic coercion or going to be as susceptible to some of the unfortunate tradeoffs or unfortunate decision making that they've made with regards to Nord Stream 2 or you might say the overextension of certain industries into China.

The more that our allies and partners have additional options, including through further market integration with the United States, the better they're going to be at helping us achieve our policy.

I would, just as a final note, the -- just in the first quarter of this year, the United States has once again become Germany's largest trading partner. It's not -- it was China for a very long time. That has a lot to do, actually, with increased European investment into United States economy and then, also, from American investment into Europe.

I witnessed American industries making huge inroads into Europe and the EU's factories opening, such as Intel and Amazon and others who are, essentially, starting to use the European economic base the way that Europeans have used America for a very long time. So we're seeing a lot of -- the new economy, right, is going to be less based on tariffs.

I agree there are imbalances in the tariff schedules, and we can continue to talk about those, but the real thing that's going to matter for the movement of value that's finished -- that's going to be the driver of U.S. growth going forward is based on norms and standards and not tariffs.

COMMISSIONER WESSEL: Thank you. I see my time has expired. If Dr. Elms and Mr. Zhang, you could respond for the record, I'd appreciate it.

COMMISSIONER MILLER: We'll move to Commissioner Stivers.

COMMISSIONER STIVERS: Thank you. Thank you, all, for testifying, especially late at night in Asia. Every issue and challenge that we've discussed today, whether it's export controls, outbound investment, tariffs, supply chains, we all -- the strong participation of our friends and

allies are absolutely central to that. And that's our huge advantage that we have over the Chinese government.

But the United States does have a burden of leadership. And we do have the responsibility to try to bring along our friends and allies in this competition that we have with China and, hopefully, are able to convince our friends and allies based on the substance and the policies, and our messaging.

And sometimes I feel like our messaging here, in the United States, doesn't take into account awareness of how our messages and our policies are received in each of these regions. I feel like every region says they feel neglected, except for maybe the Middle East, which we're not talking about on this panel.

So I'd like to hear from each of you about how your regions -- and I know, sometimes, it's very diverse within your regions -- how they respond to the messaging in the United States about the China challenge, whether it's Cold War or great power rivalry or strategic competition.

And then, just as important, if not more importantly, what are the policies specifically that they want from the United States? I know Mr. Zhang talked about development as being the key to winning hearts and minds. Ms. Friedlander talked about encouraging competitive industries within the European Union region. If you all could just talk a little bit about your regions and how they respond to the U.S.-China relationship, that would be great. Thank you. Let's start with Dr. Elms.

DR. ELMS: Sure. Thank you very much. I think that there's a couple of things that I could say here. I'll try to make it brief.

First, I would say that U.S. messaging is the problem in this region. And, in particular, there's a very different view of the extent to which there is a China threat as seen from Asia. So even, I would argue, America's closest allies and friends do not see exactly eye to eye with the United States on the China threat. They don't see eye to eye on the consequences that the U.S. articulates as stemming from the China threat. And they do not agree on what the implications of that are. And so, as a result of that, you get very different views about this problem.

And U.S. messaging, I think, is an issue because it's -- the argument is China is this threat. You must do what we tell you in order to compete and in order to survive this threat. And given the diversity of Asia and crucially, differences in perception on the extent to which that is the case, and tight integration with China that is growing rather than slowing, it puts allies and friends of the United States into a very awkward situation.

So I think key to solving some of this is not just about messaging. It's also about what is the message. It's not how you say it. It's also what is the message that you're trying to convey. I think both could be tightened.

I think the messaging itself is an issue, but I think that the extent to which you see alignment is important to recognize that we do not see eye to eye across the whole of a region, and that requires, I would suggest, even more effort by the United States to recognize, crucially, China is not all of Asia, and all of Asia does not see China in the same way, and that the rest of Asia or most of Asia is also looking for a relationship with the United States that keeps getting subverted by conversations about China. It's always China. It's only China. That is not the rest of the region.

COMMISSIONER STIVERS: Mr. Zhang.

MR. ZHANG: Thank you, Commissioner. First, I'll recognize that there is a challenge when you're on a regional panel where every regional expert talks about the importance of the

particular region and that the messaging, the U.S. messaging in that region isn't particularly great.

But, quickly, put things on my side. One is, I think, I echo what Dr. Elms just said. I think the messaging piece is a little challenging because the China bashing stuff works very well, and it's very necessary in the U.S. domestic context, but it doesn't translate as well into many other regions, that includes ours.

A lot of countries, at least part of it, they don't want to be caught up, or they obviously don't care about the U.S./China competition unless that competition materially impacts them either in a good or a bad way.

So one of my favorite quote was from a former Brazilian vice president when he was asked a question about if the chips are down, are you going to pick the U.S. side or the Chinese side? He responded eloquently by saying that I choose the Brazilian side. And that's, I think, the thinking here, right?

And I think, in terms of what are some U.S. policies that I could change, I stick to my three levels of recommendations on policy, resources, and strategy. I think that's a good way to build what I consider to be a positive statecraft into a region that really values development.

And our resources, I think, tie into Commissioner Wessel's comment. It doesn't necessarily require fresh, new resources. Some of those is within Congress mandate to make sure that some of the financing and budgetary rules for a specific USG and NTB multi-level organizations are a bit more agile, a bit more flexible so that they can meet the evolving demands of their clients, whether in their region or in the U.S.

And then, finally, the thing I will say on a Latin American and Caribbean perspective is that the China conversation, especially as related to national security, is very much lagging behind, and still catching up. The export control conversation, the economic coercion conversation, outbound investment screening, not even inbound investment screening is something that's being discussed extensively. But I do think that there is a learning curve there.

A couple years ago, we've never see countries talking about subsidies and industrial policy, but these past couple weeks, you do see countries taking actions, including on steel exports coming out of China.

MS. FRIEDLANDER: Thank you. And I'll -- I'm not as charitable to European messaging in this particular instance. I think that when -- you know, they'll often say that they're going to be caught between the U.S. and China, and they're going to be asked to choose.

This is something -- this sort of one world, two systems concept -- is not something that only affects Europeans. It affects U.S. multinationals as well who are dividing up their business and headquartering business in China and headquartering business in the United States for the very same reason of being caught between the U.S. and China. And so, it's not a European complaint. It's a reality of the globalized economy.

I think what -- when they say this, they're also sort of not exercising as much market power as they can, and they have. They are ducking out of their responsibility because, again, the European Commission and the powers that it has in certain areas really does play in the superpower status where you have the European Union with its market power, the United States as a close equal. It is a regulatory power.

I know we complain about that a lot for some reasons where we feel like they're overstepping into the American market. But, in the China context, you want to encourage the European Union to exercise its market power. So when the U.S. messaging comes and says this

is -- we're caught between the two of you, it is a little bit of an excuse for not doing their own homework.

What I do think, however, is that governments tend to act within their own ecosystem of the possible. So, when we've developed a series of economic statecraft tools as a key part of our national security apparatus since 9/11, and I personally, in my own career, have witnessed the drastic expansion of the authorities that we've given ourselves, and with that, we have the government capacity to go along with it.

We have a culture of compliance among the private sector. You have whole industries helping the private sector with compliance. We have a revolving door where people like, essentially, all the people that you've asked to speak on the panels today have been in government service and private sector and think tanks, all in the same sort of multi-pronged exchange of ideas.

That doesn't happen as much in Europe, right? Some countries have one sanctions officer. So you can't expect these governments -- maybe they should beef up. They should beef up. That's right. You shouldn't expect them to sort of conceive of their own capabilities the way that the U.S. does and to be able to absorb the U.S. rhetoric of great power competition of a standoff between two systems when they don't have the operational capacity to do so. It's a sort of psychological thing as well as an analytical one.

COMMISSIONER STIVERS: Thank you.

COMMISSIONER MILLER: Commissioner Sims.

COMMISSIONER SIMS: Thank you, all, for your testimony, especially from other time zones. I will say Ms. Friedlander triggered my PTSD of the Trump/Merkel bilat in which President Trump wanted to understand why there were not as many Fords and Chevrolets driving down the streets of Berlin as there are Mercedes and BMWs on the streets of D.C. and that got interesting, I will say.

But I did want to pull a little bit on this same thread that Commissioner Stivers was around the issue of persuasion and what can we do better to persuade our allies and partners around the world in different regions that the China threat should be as important to them as it is to us.

And so, I'd be curious to hear from all of you what tools or what carrots, I guess, for lack of a better way to put it, should we be leveraging more often to be more persuasive. And then, counter to that, what points that we make from a messaging standpoint, or what carrots that we're trying to use, are not as effective as we seem to think they are, but we keep coming back to them, and they don't resonate as much?

So if Ms. Friedlander, you want to start, we could go around.

MS. FRIEDLANDER: Sure. Well, I think, first of all, the overall, the outreach to European allies regarding the risk of China has been a massive success. As I mentioned before, you know, five years ago when we started these conversations, it was so new that people wouldn't believe the talking points that we were delivering.

And so, part of that outreach has, you notice, is actually successful, even from the Trump administration, which many have alleged has not been so fair to some of its European allies. I think, on the China angle, the bipartisan nature of our outreach is a success.

I think I would highlight sort of two things that's -- its major differences. The first really has to do with the analytical perception of Taiwan. The -- our European allies agreeing with the international rule-based order and would like to protect democracy do see an increasing role in the Indo Pacific.

But they're not -- to some extent, the Brits and the French are, but they're not Pacific powers, they don't live on the Pacific Ocean. And so, they don't have a legacy, a security commitment since the Second World War to Taiwan. And so, the global perception of what the global risk is different vis-a-vis Taiwan. That doesn't mean that they will not be persuaded to pinch hit in the crisis scenario that we do not want to see come.

The one thing that really gets the goat is the extraterritoriality of our measures, right? Where European firms or governments are essentially compelled by the reach of the U.S. dollar or by U.S. firms or our justice system to take actions that are not compliant with their domestic law or policy. That means that the secondary sanctions -- China don't have this, but certainly, in cases on Iran, we witnessed this quite frequently.

And the primary product rule does reach deep into the pockets of the European intellectual bandwidth seems to say look, we -- this is our job; let us handle that. So I think we do -- when we push that too far potentially out of frustration that they're not taking action, we're actually doing ourselves a disservice.

But, overall, I think the U.S. is doing a very good job with European allies. The steady comparison of problems and the willingness to look at this through a fairness and fair competitiveness edge is the key into -- the key to the hearts of an export based economy.

COMMISSIONER SIMS: Ms. Elms?

DR. ELMS: I think you hear over and over again in the region don't make us choose. And I know from the Washington's perspective, that sounds a little like cakeism. You want your cake, and you want to eat it too. I don't think that's what it is. I think that is leaders across this region are in a bit of a bind. I mean, they are very dependent on both the United States and on China. They do not want to be forced to choose. The consequences of that for their domestic economy is significant, is significant.

If they are being asked to make a decision, if they are being asked to choose, what they're also looking for is more information about they this choice is necessary -- why it's necessary for them, not why it's necessary for the United States; why is it necessary for them, that's the challenge, and is there any offsetting, anything that can be offered because the choice comes with real consequences.

And so, when the United States shows up and says you need to follow us because we're right and doesn't do a whole lot after that, you know, there's no market access. There are no trade agreements. Remember, economics, in Asia, rules. This is a very trade, export dependent region. That's what is important. When the United States shows up and it doesn't have market access, and it doesn't have economic tools of carrots and only comes with sticks, that's a problem.

So I think there are a lot of potential positive incentives that could be used, but I would go back, for example, to IPEF. IPEF framework, I get it; it's got to be different. Okay. I understand for domestic reasons. But even there, the United States hasn't shown up with much for IPEF.

Lots of conversations, lots of engagement, lots of meetings, and at the end of the day, what happened? Everyone expected that they would sign IPEF in November in San Francisco, and it didn't happen. Not only did it not happen, but we had leaders who got off an airplane and then discovered that the trade pillar in particular wasn't even going to be on the agenda. The other two were sort of pushed to the side. There was no conversation.

This is catastrophic from the perspective of many leaders in Asia who -- for whom this was a very big deal. And so, I think, again, this, for me, was an own goal from the United States.

It doesn't take much as a carrot to have the proper ceremony to acknowledge that people have come together as friends and partners. And yet, they were left on the sidelines, and they're waiting still for the signature of two of the four pillars. One pillar hasn't been scheduled at all for this year.

So, I think, this is the challenge is that you need to remember that you are asking your friends and allies in the region to do something that is difficult, and you're asking them to do it in exchange for, frankly, not a whole lot at the moment. And that is a bargain that is hard to continue to deliver.

COMMISSIONER SIMS: I'm over my time, but, Mr. Zhang, if you'd like to submit something for the record on this, we'd certainly welcome that.

COMMISSIONER MILLER: Commissioner Schriver.

COMMISSIONER SCHRIVER: Thank you. Thank you to our witnesses, particularly those who it's getting quite late in the evening. I just want to make a brief comment first, and you can react to if you'd like, but I have a question to follow.

My observation from spending a lot of time in Asia is slightly different which is they don't want to choose, and they don't want to be made to choose in public. Behind closed doors, who they fear and who they think could erode their sovereignty, who they think could erode the free and open order, including rules-based order, peaceful dispute mechanisms, threats to international norms and law is China.

And there's -- what they fear is reprisals and cost imposition from China if they're forced to be too public about it. And even despite that, even in Southeast Asia, we have more that are willing to be more public, like the Philippines and Vietnam and, in certain cases, Indonesia related north into the sea. So I just have a slightly different view, and feel free to react to that.

The question I wanted to ask is I the comment about perceptions on Taiwan I think is really important because, I think, if you look at the news today, the Chinese just announced an exercise of unprecedented scale, and if you look at the red boxes around the island, it's this pretty dramatic display which the Chinese have literally said this is punishment for your election and inaugural address and steps towards independence. What I think could very well happen is the U.S. could accelerate its requests in all these areas that are very difficult for the purposes of building out deterrents.

We had a previous discussion today on -- sorry -- on a previous panel where we talked about the insufficient nature of the threat of export controls and the threat of sanctions in terms of having deterrent impact. And that that might have to be front loaded now. And, of course, if we front load it now, that will not be anywhere near as meaningful as if we front load it with partners and allies alongside us.

So my question is how would this be received if it's based on the threat environment as we understand it? And, to me, there's parts of this that are just objective reality, indisputable, in terms of what's happening around Taiwan. But if we accelerate a push for these things, how would this be received, and would there be the possibility of getting alignment on things we're asking for?

DR. ELMS: In Asia specifically, I mean, again, I think my number one message would be remember that Asia is not the United States, and it has very different views about lots of things, including the importance of actual hard security versus economics. For an awful lot of the region, not everyone, there is, obviously, a concern about security issues.

And, when we start talking about Taiwan, and so forth, a worry, of course, that this will spill over to major conflict. You have, you know, potential conflict in Korea, et cetera. This can

be a volatile region. But they're also very concerned about economics, and they see these things, often, as equivalent.

And so, to discuss an actual security issue without having the economic leg engaged, fully engaged, I think is problematic. It's problematic because that is -- that's the currency that runs through an awful lot, especially for your IPEF partners. So, again, you can say this is a major threat. Do they feel a major threat? I'm not certain.

And one of the things that I would point to -- and I'm happy to follow up and send this out to the Commissioner if you haven't seen them -- but a lot of recent public opinion polls by both citizens and by elite individuals across the region shows fairly market shifts against the United States. And I think that's something, again, from my perspective, to pay attention to that the narrative that you've got is not the same.

So you can say, well, look at this horrible behavior around Taiwan, and an awful lot of people will shrug. Now, I can hear already the reaction in Washington, which is they're crazy, and why do we need to worry about that? But I just think it's important for you to recognize that's the perception.

And so, then, how do you deal with that? Maybe it's an issue of messaging. I don't think so, but maybe that's part of it. Maybe it's an issue of delivery of benefits, whatever those happen to be, or at least better alignment to make sure that you're actually listening to what your partners and allies or your non-partners and non-allies in the region are saying.

I think it's -- I think the most important thing is that the region has its own interests, and they are not just a pawn in someone else's game. And increasingly now, they are feeling like they need to make their own decisions. Now, what that looks like, I think, is unclear. And I would just say be very careful because if you're going to make folks choose, you may not like the consequences of the choices that they do make.

MS. FRIEDLANDER: From the European perspective, I think that there is a lot of bandwidth to make cases for the small yard, for individual member states to participate in export control regimes so far as they can block Chinese access to things that have specific military industrial application.

Within the EU Customs Union, unless it's a very specific technology, trade substitution can happen almost automatically, and you won't necessarily know who's doing what because firms would have to submit proprietary trade data, which you can try to, but they're not required by law to do that.

So I do think that there is bandwidth to bring European allies along on some of those export controls, absolutely. So far as that's the deterrence, the deterrence being we predict, we know which technologies China will need for an effective action against Taiwan, and we think we have the time -- we do have the time lag to be able to prevent that -- those technologies from developing to the point that they feel ready. I understand that's a big part of the U.S. strategy, and the Europeans see that as well.

What I would caution on many of these actions, however, is the U.S. has run a set of scenarios as to what our economic response would be in the case that Taiwan -- that China does take action against Taiwan, following largely on a Russia model, and seeing where do we have an asymmetric advantage. Unfortunately, we did not come up with very much.

And there were -- there are two studies. One was by the Atlantic Council and the Rhodium Group, in which I participated, and one -- CNAS's Emily Kilcrease, from the previous panel, is currently working on right now, trying to identify what nodes of advantage we could

have alongside allies and partners that would not inflict equal economic damage upon ourselves. And, unfortunately, that list is pretty short.

COMMISSIONER MILLER: We're a bit overtime here, so we'll make sure, Mr. Zhang, that you're first up on the next rotation of the everyone questions, but I want to move to Vice Chair Price now. Thank you.

VICE CHAIR PRICE: Thank you, all. I have several different questions, but I actually want to go back to the line of questioning that Commissioner Stivers and Sims were going on. And so, for Dr. Elms, thank you for your clarity on what you're trying to say, but if you had a magic wand that worked, what would the successful message be that would work in Asia?

DR. ELMS: Well, that's a big question. What would the successful message be? I think it needs to be that the United States remains a partner and an ally and that they are listening to the concerns of our friends and neighbors in the region and that we are shaping policies that take into account some of their concerns, and those policies -- I think, as an added bonus, would be great -- those policies have consequences potentially for the United States domestically, whatever those happen to be. Because otherwise, it looks like the United States gets what it wants, and everyone else just has to come along with it. And I think that is the challenge, again, when you're trying to deal with a perception of the threat that differs.

So, again, how can you either sort of share the pain or share the benefits or both, ideally, in a way that resonates better with those who are being asked to do really, frankly, really difficult things? I mean, I'm not suggesting that a lot of Asian governments or even firms in Asia are, you know, warm and fuzzy necessarily towards China, but they exist in the neighborhood, and they're a key part of economic structures and security structures and so forth. And so, you have to deal with that.

You have to recognize that there are consequences, and they are immediate, and they are sharp, potentially, not just if China retaliates, but also, what the United States is, in fact, asking some of the governments and some of the firms in the region to do is painful. It's expensive. It's difficult. It's time consuming. And so, I think a bit more, at the minimum, a sort of bit more humility and a bit more like why is this in your interest as well as in our interest would be helpful.

VICE CHAIR PRICE: Thank you very much. And Mr. Zhang, going back to your recommendation on public diplomacy efforts, what would your public -- if you had a magic wand that worked, your best idea for the public diplomacy message be?

MR. ZHANG: Thank you. I have three comments. One is on the framing side. Second is the public diplomacy, pure public diplomacy side of things, and third is back to what kind of policy tools we could be using that reinforces that public diplomacy.

On the framing side of things, I mentioned previously that the China bashing, anti-China, U.S.-China competition narrative doesn't exactly work, which I think Dr. Elms also made abundantly clear in her remarks as well. So I won't go back to that too much. But I want to emphasize what does work.

You know, from what I hear from the region is that they care less about, again, the anti-China agenda, but they do want -- they care a lot more about a pro lack agenda. They want to see a positive, affirmative agenda of the U.S. leadership, constructive U.S. leadership/partnership in the region. They want to see more of that. I mean, obviously, that comes in some forms of policy attention, resources, and strategy, but I want to emphasize that that is going to be a critical piece at the framing side of things.

On the public diplomacy side of things, I honestly think that the U.S. is doing a lot, especially compared to, perhaps, some aspect the regions -- the other two regions are covered in this panel. I think the U.S. has been dealt with a pretty set of pretty good cards in this region. There is a communicational problem that we have discussed previously.

I constantly get people telling me that how has China become the biggest trading partner of the region where, you know, there's a lot of nuance, like I mentioned earlier, but the U.S. and Mexico have trade $800 billion a year between themselves. China trades $500 billion with the entire region, so U.S.-Mexico trade is bigger than China-Latin trade.

And then, folks keep talking about how the U.S. government cannot, and the U.S. in general, cannot compete China dollar for dollar on official lending investment where the official data, especially when Chinese investment in official lending has cratered globally do not support that. So I think there is an opportunity from a public diplomacy perspective to more positively, affirmatively demonstrate the specific, measurable values of U.S. efforts in that region.

And that leads me to that final point about tools, which, once again, the tools are very important in terms of what you're actually doing, what you're putting on the table, whether for advancing regional hemispheric prosperity or in terms of competition with China.

There, my thought is, once again, this is a region that cares a lot about development and a lot about economic pragmatism. The most effective tools where people want to develop economic linkages, aligning economic interests in a way like Julia said.

You are -- you will be growing some areas to match the leverages if you don't currently have them so that when you really need those, they will really come in handy. Countries currently don't see China as a threat, going back to some of the comments in the previous Commissioner's question, and part of that is because they see potential threats related to China related to security and otherwise being somewhat distanced, but they see the economic benefits of engaging with China to be very real and immediate.

So I think there's a bridge -- there's a mismatch in the time that needs to be fixed therein. And I'll end my comments there because that also fills into what kind of carrots we should be offering, how can we put together a public diplomacy campaign that's consistent with the tools that U.S. has to offer that really plays to U.S. strength, not exactly trying to out compete China is not the same thing as out China, China. I think competing on China's economic terms is not exactly in the U.S. interests, especially in this region. It's not effective either.

VICE CHAIR PRICE: Thank you.

COMMISSIONER MILLER: Commissioner Kuiken.

COMMISSIONER KUIKEN: Thank you, again, to all the witnesses for staying up late and for joining us today.

Dr. Zhang, you just touched a little bit on sort of unmanageable debt burdens in the region. I'd be interested in sort of hearing all of the witnesses talk about how the U.S. should look at those unmanageable debt burdens and how we can see that as an opportunity. I'd be interested in sort of you just talking about your ideas there.

And then, the second piece, we've all sort of touched on this, but the issue about market access and what other tools the U.S. has or could create, I'd be interested in all of you sort of talking about what other things, other than public diplomacy, which sometimes falls short in terms of deliverables, the U.S. should consider to increase economic integration.

DR. ELMS: I'm happy to go on that one. So let me just mention one thing that is absolutely critical for this region, which is the importance of multilateralism. And you heard the

Prime Minister from Singapore, Wong, and the comment that I made from him, mention how important it is to keep a multilateral solution going for trade and economic issues.

In a trade dependent region, it matters a lot. And so, U.S. efforts to support the multilateral trading system are actually as critical as the messaging that you're giving.

And the problem that we're running into now is that U.S. efforts are actually running counter multilateralism where the United States has done a lot of unilateral actions that are deeply problematic and are seen as problematic from the region, including by some of America's most important friends and allies, like changing their policies on digital trade, like handicapping the World Trade Organization, like considering, as the committee did earlier today, removing China's MFN status.

Now, removing China's MFN status, you may argue that that's justified in Washington, but I will tell you that the consensus in Asia to that kind of action will be

COMMISSIONER KUIKEN: Dr. Elms

DR. ELMS: a big problem.

COMMISSIONER KUIKEN: Sorry to interrupt you. Give me an idea. Give me something that you think we should do. I hear you loud and clear on the criticism.

DR. ELMS: So I would say for sure focus on solving the WTO issues, particularly the dispute settlement issue. That matters a lot for trade dependent states. Provide some kind of incentives for economic alignment, whether that is adding meat to the bones of IPEF, whether that's finishing the IPEF trade pillar, whether that's providing additional funding or resources for infrastructure funding or clean technology as part of the IPEF pillars, thinking about how to engage more deeply in new areas like trade and climate.

How to make sure that the United States is aligned with the region on standard setting for new technologies I think is important. I think there's a number of things that the United States can do that would, again, suggest that it's not just rhetoric that you are partners with the United States, but that the United States is actually serious about this partnership. And I think that that goes a long way.

And then, finally, of course, deliver on your own promises. So if you promise that you're going to sign something, sign something. If you're going to show up, show up and continue to show up because that is not -- it feels like it's not so critical. It's actually vital in this region. You need to do what you said you were going to do and actually show up to do so.

COMMISSIONER KUIKEN: Dr. Zhang?

MR. ZHANG: Thank you, Commissioner. I'll say three things. One is, perhaps, what not to do. Second and third, some of the two good things that could be done.

On what not to do, I think that especially the debt trap diplomacy narrative is something that needs to be contextualized in this region with a lot of nuances and heterogeneity and with updated analysis. The general consensus here is that a lot of situations do not apply in ways that it applies in other regions of the world, so my apologies for having miscommunicated that if at some point I said that.

We had talked to government officials from the region where U.S. officials visiting them start bringing up that debt trap diplomacy, and they would say that we don't actually take on Chinese debt. We have access to international capital markets, and that's most of the cases in the region. So some sort of heterogeneity, take some sort of conversation taking into consideration heterogeneity will be very important.

In specific countries this is an outlier, of course like Argentina, by far, you have a multilateral problem which is the IMF. And the size of that program, in terms of data

accumulated, I think is fairly large, so I think this is a conversation that needs to be had in the region that has some historical burden about data issues but not necessarily related to China.

What else to do? First, there are three countries in the region that do have significant debt problems that are somewhat related to China. One is Ecuador. The second is Venezuela. The third is Suriname. Each country is a little different, but I will say that Suriname is perhaps a good example of where Chinese creditors' holdout is complicating something similar to what we see other parts of the world where the Paris Club and other lenders are not being able to form in a consensus around eventual solution with the local government.

And I think, once again, I've been a big advocate throughout this conversation of perhaps some more positive statecraft, more development assistance.

So I think the lesson learned here is not just to focus on what went wrong in these countries, but build capacity, work with the government, making sure that they're learning from these experiences, and hopefully avoid these problems going forward.

Third, what to do, this is something that I did mention briefly in my remarks, opening remark, which is about the counter cyclical nature of whether the financing offered by D.C. based multilateral organizations, international financial organizations, which is hugely positive. I wish people were talking more about this.

A lot of the times, you know, there is this conversation about, again, Chinese public funding here to save the day. That was not what we saw, once again, during the pandemic. Countries really -- governments in a very dire fiscal situation valued, appreciated the support coming out of the Washington based multilaterals.

So, I think, if there is a possibility to support multilateralism at that level, which is a little different, I think, from what Deborah -- what Dr. Elms has said, I still think this will be extremely valuable.

COMMISSIONER MILLER: Last but not least, Commissioner Friedberg.

COMMISSIONER FRIEDBERG: Thank you very much. Just start with a comment. It seems to me that we may be living through a period in which perceptions of China and the benefits of economic relations with China are shifting and, perhaps, fairly rapidly because of China's big push for more exports, particularly of manufactured goods.

And the recognition that that has potentially negative implications for Europe as well as the United States, for other advanced industrial countries, but also potentially, for developing countries as well, which want to move up the ladder themselves but find that China has, in a sense, blocked off their prospects for more rapid development because it wants to hold onto those industries at the lower levels of the technological ladder, as well as the higher levels.

And, Mr. Zhang, you made an interesting comment in your written testimony. You referred to the flying geese paradigm, the way that people have described Japan's policies in Southeast Asia, and how Japan, as you put it, invested in, shared knowledge about, and induced industrial upgrading in the rest of Asia. It's my impression that China hasn't really done much of any of those things. They've been happy to buy raw materials. They've been happy to sell manufactured goods, but they haven't really done very much to assist these countries in developing their own industrial capacity. Am I wrong about that?

MR. ZHANG: Thank you, Commissioner, for your question. I'll say two quick things. The first thing is -- Dr. Elms, feel free to correct me -- I do think that China did some, to some extent, some of that in Asia. You know, Japan is not the -- Japan was the original leading goose in that sense, but there was basically batches of what you call Asian tigers.

There are different names for the countries that climb up the value chain ladder, and China was part of that process, and now we see some of the Southeast Asian countries developing expertise as well. So maybe this reinforces Dr. Elms' point earlier.

Second, I do agree though, in my region, in Latin America and the Caribbean, we're not seeing too much of that. Again, China's relationship, economic relationship with the region predominantly focused on South America, and that's a relationship that's built on the back of very strong Chinese demand and South American export in a commodities sector.

In interest in development, there is, of course, we're seeing some development in Mexico, especially northern Mexico where there is an ongoing debate about whether China is actually investing in doing local manufacturing in Mexico or doing transshipment. However, I did talk a bit more about that, but I think that's a separate topic.

And I do think that we, from a Washington perspective, in this particular case, a question needs to be asked: if China is doing conventionally what you ask for in Mexico, in this case, investing in Mexico, doing technology transfer, and complying by USMCA rules, is that export towards U.S. from Mexico something that Washington will feel comfortable about.

COMMISSIONER FRIEDBERG: Yeah. We talked about that in our previous session. You recommend, in your testimony, that the United States actually seek to imitate this flying geese paradigm in its relations with Latin American countries. So how would that be done?

It seems like one way would be encourage investment in manufacturing capacity in countries in the region. Another might be using adjusted protective measures to make sure that goods are not simply being transshipped by Chinese companies through Latin American companies, that they, the Chinese companies, also have to transfer technology and capacity so that these countries can develop their own indigenous manufacturing capacity. But so how would we pursue this flying geese paradigm in our dealings with Latin America?

MR. ZHANG: Thank you. I'll first say what I think should be done, and second, perhaps, what should be considered more carefully.

On what should be done, I definitely still think that, you know, I stick to what I said in the written remarks about if we work to identify a leading goose in this region, this would not just be the United States, but USMCA. The North American free trade area, I think, has provided a lot of competitiveness for this region, benefiting the three countries, so I think that's something that needs to be built on.

And without generalizing too much, when you look at Latin American and Caribbean, Western Hemisphere in general, the northern part of it, specifically Canada, Mexico, and the United States, have a lot more manufacturing sophistication than perhaps in other parts of the region.

So if we were to follow a flying geese model, then you probably want to start with the ones that has the most expertise technologically, manufacturing, and otherwise supply chain wise and make sure that there is the knowledge to be passed down throughout the region. So I think the hemispheric vision, a thing that regional integration under U.S. leadership will be hugely beneficial.

Second, on something that should be considered more carefully, referring to the protective measure that you said, I do think that this idea that there needs to be a conversation between U.S. and Mexico and of course involving the Canadian partners as well, the current USMCA Free Trade Agreement, and I think most free trade agreements in the world, don't really discriminate explicitly the origin of goods or origin of capital if they comply with the rules within the agreement.

So what I would say here is, once again, there needs to be a conversation between the three partners in North America about China. If the conversation is that we need to put in some sort of rules and mechanism about it, my only recommendation about what would not to be -- not to do is let's not allow this or, frankly, any other issues to become so over politicized, such a difficult issue that it'll make the 2026 USMCA renewing impossible.

Their agreement is a tremendous tool, a cornerstone of North American competitiveness, and we would be shooting ourselves in the foot if we are going to sacrifice that for a relatively small issue in the grand scheme of things.

COMMISSIONER FRIEDBERG: Okay. But it seems to me, from a strategic point of view, it would be in the interest of the United States to encourage industrial manufacturing capacity in its own hemisphere that was indigenous and not controlled by China. Thank you.

MR. ZHANG: I agree with that.

COMMISSIONER MILLER: That's a wrap for today. In closing, thank you again to all our witnesses for their excellent testimonies today. You can find those testimonies, as well as a recording of the hearing, on our website.

I'd also like to thank the staff who've worked very hard on this hearing: Daniel Blaugher, Niels Graham, Zoe Merewether. Four panels is considerably more work than three, and we are very appreciative of all their efforts.

Finally, I'd like to note that the Commission's next hearing will take place on Thursday, June 13th. That hearing is titled China's Stockpiling and Mobilization Measures for Competition and Conflict. With that, we are adjourned.

(Whereupon, the above entitled matter went off the record at 3:49 p.m.)

STATEMENT FOR THE RECORD

STATEMENT OF SARAH BAUERLE DANZMAN, ASSOCIATE PROFESSOR, INDIANA UNIVERISTY BLOOMINGTON

May 23, 2024
Sarah Bauerle Danzman,
Associate Professor, Indiana University & Scholar in Residence, Atlantic Council
Statement for the Record before the U.S.-China Economic and Security Review Commission

It is an honor to provide testimony to the U.S.-China Economic and Security Review Commission on the topic of outbound investment from the United States to China, its potential to create national security concerns, and ways in which to address these concerns in a balanced and effective manner. In this testimony, I provide:

- Descriptive data that show the U.S. is the primary overseas investor in China, mostly through venture capital, though the volume of these flows has declined substantially in recent years.
- An overview of the four key components of the executive order on regulating certain types of U.S. investment to China that I believe are most important to maintain, primarily at the strategic design level.
- A review of three key questions/challenges in implementation that remain after reading the advanced notice of proposed rulemaking (ANPRM) that was released in August 2023, along with recommendations for how to address these challenges.

My core recommendations are as follows:

1. **That the Commission should affirm the importance of maintaining any outbound regulation as a notification/prohibition regime rather than a screening apparatus.**

2. **That the Commission should endorse a sector-based approach to outbound investment regulation. List-based approaches, notably the NS-CMIC list, can be judiciously used to complement sector restrictions, but the bulk of the outbound regime should rest on narrow sectoral restrictions.**

3. **That the U.S. Congress should consider providing a statutory basis for the NS-CMIC list and extending its reach to include non-public subsidiaries of NS-CMIC listed companies as well as to non-public companies that are determined to be part of China's military-industrial complex.**

4. **That Congress should refrain from adding non-national security-related tests, such as supply chain diversity or local employment considerations, to any legislation related to outbound investment regulation.**

5. **That Congress recommend that Treasury's final rule for implementing E.O. 14105 include an intangible benefits test to scope covered investments as described above and that any legislation regarding outbound regulation include the same provision.**

6. **That Congress recommend that Treasury's final rule for implementing E.O. 14105 further clarify "routine intracompany actions," and ensure that the rule does not allow for material expansion or operational pivots into covered activities. Any legislation regarding outbound regulation should include similar clarity.**

7. **That Congress, in addition to adopting recommendation 3, further modify the CMIC program to authorize the designation of Chinese entities beyond the current scope to include any Chinese entity operating in sectors important to U.S. national security, as defined through a regulatory process. These sectors may be broader than the three**

sectors identified for the purpose of the current implementing rules for E.O. 14105 but should be relatively narrow and stable. A subset of the Critical and Emerging Technologies List (CETL) is a good place to start.

Level-Setting the Scale of U.S. Outbound Investment to China

U.S. outbound non-passive investment flows to China have declined substantially in recent years, likely due to policy changes in the U.S. as well as the CCP's crackdown on Chinese tech companies.

Greenfield Investment
According to available data, in recent years greenfield investment in China has declined dramatically – both from U.S. investors and the rest of the world. Figure 1 comes from fdiMarkets, the pre-eminent data source for greenfield investment. This chart illustrates that greenfield investment from any foreign source – not just the U.S. – has declined from a peak in 2018 of roughly $120b to under $20b in 2022.[1] Note that fdiMarkets uses announcement data rather than realized investment, so many FDI experts believe their numbers are likely to be a bit inflated. Clearly, global investors are avoiding greenfield investment in China, likely due to a mix of push and pull factors. U.S. sources of greenfield investment totaled $8.69b in 2020.[2]

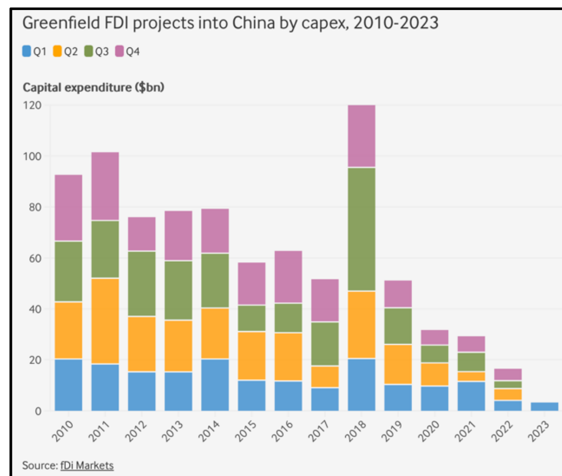


Figure 1: Global Greenfield Investment to China

Mergers and Acquisitions, Private Equity, and Venture Investment
Pitchbook data can provide more insight into non-greenfield U.S. investment to China. As figure 2 illustrates, Pitchbook data reports a high watermark of U.S. investment in companies headquartered in mainland China, Hong Kong, or Macau in 2018. Investment volumes have declined every year since 2021; in 2023, U.S. outbound investment to China was 30 percent of its 2021 value. To compare volumes across greenfield and these other forms of investment, U.S. investment through M&A, PE, and VC was about three times as large as **global** greenfield FDI to China in 2022. A key feature of U.S. investment in China is that a large portion of these flows happen through venture capital (VC). However, an important caveat is that Pitchbook's data relies on systematic web crawling and is unable to capture investments that have not been reported in regulatory filings, news articles, or press releases. Because U.S. investors are not currently required to notify outbound investment – at least

[1] O'Farrell, Seth. "China's National Security Concerns Cap record FDI Lows." *FDiInsights* 30 May 2023. https://www.fdiintelligence.com/content/data-trends/chinas-national-security-concerns-cap-record-fdi-lows-82542
[2] Rhodium Groups' US-China Investment Hub: https://www.us-china-investment.org/fdi-data

until E.O. 14105 is implemented, we simply do not know the full universe of U.S. investments into China. Indeed, the reporting component of the E.O. will be very important to better understand the full scale of U.S. investment to China and better allow policy makers to scope any regulation appropriately given the true volume of such investments. A costly and burdensome regulatory process to address a tiny concern is not in the long-term interest of the United States.

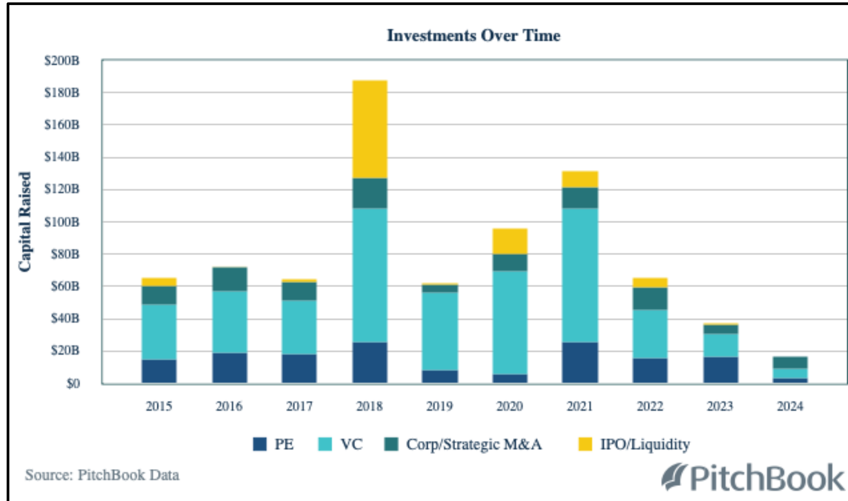


Figure 2: Value of U.S. investment flows, minus greenfield, to China, Hong Kong, and Macau

A deeper dive into the sectors that E.O. 14105 currently contemplates regulating suggests that U.S. participation in these areas is quite small and almost exclusively concentrated in VC, as Figure 3 reports. Furthermore, this investment is almost entirely in the semiconductor industry; in 2020, investments in all other sectors amounted to only about $700m.

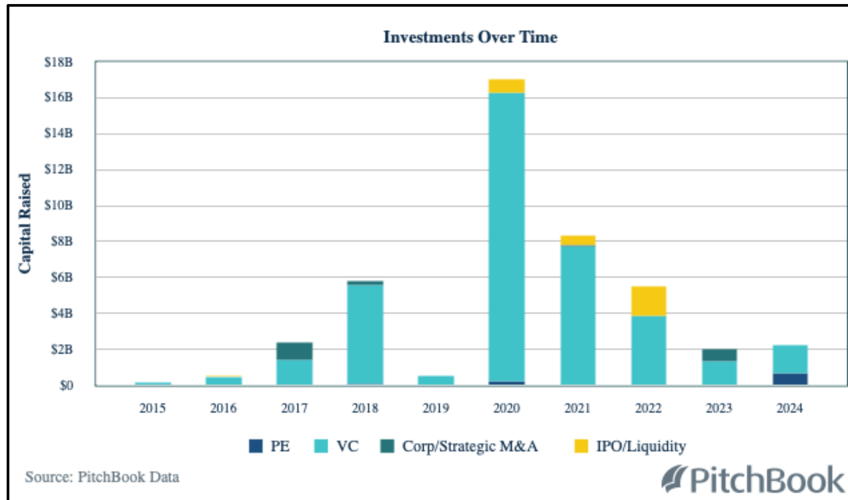


Figure 3: Value of U.S. investment flows, minus greenfield, in key sectors to China, Hong Kong, and Macau[3]

[3] These sectors include: semiconductors, Edge computing semiconductors, generative AI, Post-Quantum Cryptography, Quantum Computing, Quantum Sensing, and Swarm AI.

Furthermore, the U.S. is the most important global source of investment to China. Figures 4 and 5 present capital raised in China from investors headquartered in places other than China and the U.S. in all industries (figure 4) and in key national security technology industries (figure 5). The U.S. supplies greater than half of all inward FDI to China and is even more dominant in the relatively small volumes of FDI into national security technology. Moreover, we do not see the U.S.'s relative position as major supplier of FDI to China diminishing, even as the U.S. government has indicated it will place more restrictions on these kinds of flows.

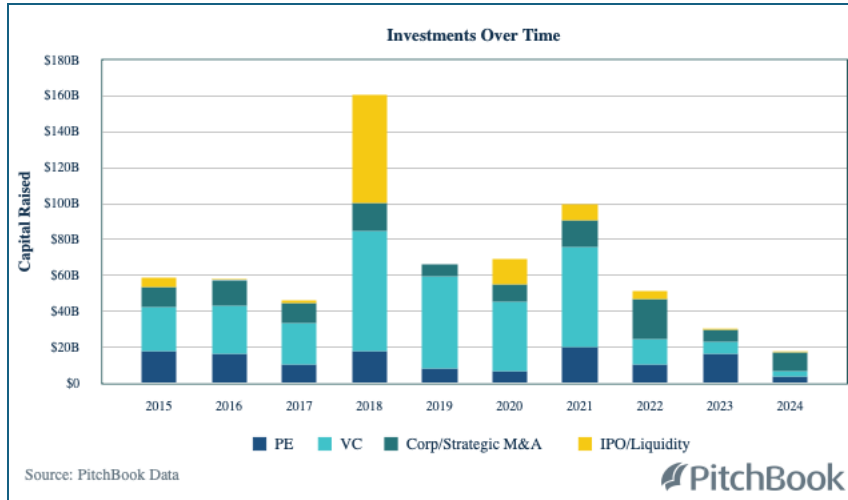


Figure 4: Value of non-U.S. or Chinese investment flows, minus greenfield, to China, Hong Kong, and Macau

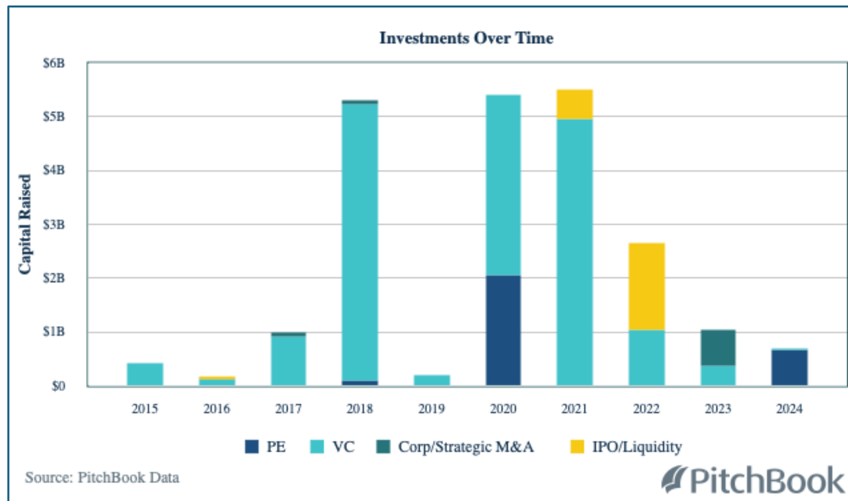


Figure 5: Value of non-U.S. or Chinese investment flows, minus greenfield, in key sectors to China, Hong Kong, and Macau[4]

[4] These sectors include: semiconductors, Edge computing semiconductors, generative AI, Post-Quantum Cryptography, Quantum Computing, Quantum Sensing, and Swarm AI

Taken as a whole, these figures suggest that the size of U.S. investments in Chinese companies of concern is relatively small, but also that the U.S. is the primary global investor in these sectors. Even small deal values can generate national security concerns if U.S. investors provide capital and expertise to a small set of key entities. However, the available data suggest that the scale of the concern – and particularly outside of the semiconductor industry – is modest. The data also suggest that an effective approach to this potential national security problem needs to address venture capital, since that is the dominate mode of U.S. investor participation in these core sectors of concern.

Assessing E.O. 14105 – Addressing United States Investments in Certain International Security Technologies and Products in Countries of Concern – And Its Proposed Rules

The executive order, for which we expect draft rules to be released within the next several weeks, is directionally an appropriate step forward in addressing national security concerns that arise from U.S. investment in sensitive, national security-relevant technology in China. Four of the likely design features outlined in the related ANPRM that are important to maintain are:

1. **A notification and prohibition regime rather than a case-by-case review.** Initial policy conversations around an outbound regulation envisioned a screening process typically referred to as "reverse CFIUS." However, the administrability of outbound case-by-case review would be much more complicated than is inbound. This is because The U.S. government has better visibility into the capabilities and national security vulnerabilities of U.S. businesses – which are the targets of inbound investments – than of such capabilities and vulnerabilities of businesses based in China. Additionally, the U.S. government has more leverage over companies that wish to invest in its market – and therefore need its ongoing regulatory approval – than it has over companies that operate in foreign markets over which the U.S. government does not enjoy regulatory authority. In the absence of such investigatory capability or compellence power, a screening mechanism would likely be very challenging to implement effectively. A notification and prohibition regime has the added benefit of providing industry and investors with bright lines about what investments are allowed and which are prohibited, which makes compliance and developing forward-looking business strategies more possible.

Recommendation 1: The Commission should affirm the importance of maintaining any outbound regulation as a notification/prohibition regime rather than a screening apparatus.

2. **A (narrow) sector-based approach rather than an entity/list-based approach.** Some in Congress have suggested that a sector-based approach is unadvisable because, while a sector-based prohibition regime would prevent U.S. persons from investing in Chinese sectors of concern, it would not prevent investors from other countries from doing so. To make restrictions more biting, and to make them apply to investors beyond the U.S., some have suggested a list-based approach in which the U.S. government would regularly update a list of Chinese entities that are connected to the Chinese defense and/or surveillance industrial base and impose asset blocks on these entities through the Specially Designated Nationals (SDN) List.

   It is my view that this approach creates many problems. First, overuse of the SDN list generates substantial incentives for economic actors to further shift their activities out of the U.S. dollar. While dollar dominance enjoys substantial persistence due to network effects, there is mounting evidence that country governments and related economic actors are increasingly finding ways to avoid U.S. dollars – and thereby the reach of U.S. financial sanctions – through cross border payments systems that do not use the dollar as an intermediary, and by shifting economic activity into other currencies. Dollar avoidance not only erodes the power of financial sanctions more

generally, but it also makes it harder for the U.S. to track patterns in investment flows globally. This, in turn, makes enforcement of existing sanctions and disruption of money laundering activities more challenging. Thus, the unintended negative consequences of a list-based approach are high. Furthermore, the designation process is investigatively burdensome and exposes the U.S. government to litigation. As a civil action, SDN packages need to provide substantial evidence that a designated entity is a national security threat, and designated persons can sue the U.S. government to be removed from listing. Because of this legal structure, an SDN approach would be unable to address risks associated with U.S. investments in Chinese entities working on more speculative but high consequence technologies. This is the exact type of national security concern – that is, early-stage investments and assistance through knowhow in pre-commercialization stages – that the U.S. government identified as a gap in authorities because U.S. export controls are not able to capture these kinds of emerging technologies well.

Recommendation 2: The Commission should endorse a sector-based approach to outbound investment regulation. List-based approaches, notably the NS-CMIC list (more below), can be judiciously used to complement sector restrictions, but the bulk of the outbound regime should rest on narrow sectoral restrictions.

3. **A focus on non-passive investments.** There has been a flurry of policy entrepreneurship and innovation around addressing national security concerns related to U.S. investments in Chinese military/surveillance technology. The current E.O. develops a regulatory structure around non-passive investment (colloquially, often referred to as "money plus," meaning money that comes with control, knowhow, or other forms of more active engagement with the Chinese entity obtaining the investment. Others have argued that such an approach does not go far enough, and instead desire to completely remove all U.S. money from the China market, including passive investment through securities. Indeed, proponents of a list-based approach argue that designations would stop flows of all kinds of U.S. investments to listed entities, not just foreign direct investment (FDI) or venture capital (VC). While preventing any U.S. money from entering the China market may be symbolically satisfying, this kind of divestment is least likely to have an appreciable effect on decreasing China's capacity for indigenous development and deployment of advanced technology for military and surveillance purposes. This is because money is fungible and the global equity market capitalization outside of the U.S. is roughly $62.8 trillion.[5] Moreover, U.S. share of global capital markets is projected to decline from about 42.5% today to about 27% in 2050.[6]

   Thus, the bar for preventing such passive investments must be higher than restrictions on non-passive investments since the benefit-cost ratio of such actions is lower. Already, the non-SDN Chinese Military-Industrial Complex Companies (NS-CMIC) List allows the U.S. government to prevent passive investment in designated entities that are identified as part of China's military industrial complex, even if they are not state-owned. These authorities exist through E.O. 13959 and amendments. Currently, these restrictions only apply to relevant Chinese companies that are publicly traded.

Recommendation 3: The U.S. Congress should consider providing a statutory basis for the NS-CMIC list and extending its reach to include non-public subsidiaries of NS-CMIC listed companies

[5] According to SIFMA, global equity market capitalization in 2023 was $109T. The U.S. accounted for 42.5% of this market. https://www.sifma.org/resources/research/research-quarterly-equities/
[6] https://www.goldmansachs.com/intelligence/pages/emerging-stock-markets-projected-to-overtake-the-us-by-2030.html

as well as to non-public companies that are determined to be part of China's military-industrial complex.

4. **A focus on national security objectives rather than broader "economic security" or supply chain resilience concerns.** Discussions on outbound investment regulations began in earnest after Senators Bob Casey and John Cornyn circulated a preliminary version of their draft legislation – the National Critical Capabilities Defense Act – in 2021.[7] As the name implies, this early version of an outbound regulation concept was rooted not only in national security but also broader objectives around supply chain resilience.[8] Over time, and through substantial and rigorous policy discussions, supply chain resilience components were eliminated from draft legislation on this matter and from the E.O. that was ultimately released. I view this as sound policy.

   As discussed in greater detail in a 2022 policy report I co-authored with Emily Kilcrease, supply chain concerns are largely due to features of the domestic and global economy that make supplier diversity and localized production commercially unviable.[9] In that report, we recommended that the U.S. government address supply chain resilience concerns through industrial policy and other actions that could incentivize re-shoring and friend-shoring to trusted suppliers. The Congress' actions on supporting the semiconductor, EV, infrastructure, and other related industries and supply chains through legislative action such as the CHIPS and Science Act and the Inflation Reduction Act are far better able to address the underlying market challenges that have created supply chain fragilities in the first place.

   Moreover, by focusing squarely on national security and related technology, the U.S. is better able to act in a coordinated fashion with partners and allies. The Summer 2023 G-7 communique on economic resilience and economic security[10] is indicative of the positive returns to such multilateral engagement, as leaders affirmed the legitimacy and importance of targeted outbound investment measures to protect "sensitive technologies from being used in ways that threaten international peace and security." The European Commission's January 2024 package on economic security, which includes monitoring and evaluation process for considering outbound controls, further illustrates the benefits of multilateral engagement around narrow, technology-related regulations on outbound investment.[11]

Recommendation 4: Congress should refrain from adding non-national security-related tests, such as supply chain diversity or local employment considerations, to any legislation related to outbound investment regulation.

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[7] https://www.congress.gov/bill/117th-congress/senate-bill/1854/text

[8] Sarah Bauerle Danzman, "Is the US going to screen outbound investment?" Atlantic Council Econographics, January 2022, https://www.atlanticcouncil.org/blogs/econographics/is-the-us-going-to-screen-outbound-investment/

[9] Sarah Bauerle Danzman and Emily Kilcrease, "Sand in the Silicon: Designing an Outbound Investment Controls Mechanism," Atlantic Council and the Center for a New American Security (CNAS), September 2022, https://www.cnas.org/publications/commentary/sand-in-the-silicon-designing-an-outbound-investment-controls-mechanism.

[10] https://www.whitehouse.gov/briefing-room/statements-releases/2023/05/20/g7-leaders-statement-on-economic-resilience-and-economic-security/

[11] https://ec.europa.eu/commission/presscorner/detail/en/IP_24_363

Outstanding Design Issues for An Outbound Investment Regime[12]

At time of writing, the draft rules for the outbound E.O. have not yet been released. However, the advanced notice of proposed rulemaking surfaced several issues that a final rule will need to address.

5. **Aligning covered investments more closely to the concept of intangible benefits**. As discussed above, it is my assessment that it is correct to focus on non-passive investments. To do so well, the final rules will need to differentiate between purely passive investment and capital that confers some form of intangible benefit. Currently, there is no such test. Instead the draft rules scope jurisdiction to investment that either rise above a control threshold or confer some form of special rights. But, this rights-based approach may not be appropriate for a country with weak rule of law and shareholder protection such as China where control and influence are often exercised in more informal and extralegal ways. Such an approach may also lead to rule circumvention as investors interested in maintaining or expanding China presence simply shift their activities in China away from traditional FDI and venture capital structures and into uncovered forms of participation such as venture debt, business consulting, and/or university-to-university research collaborations. A final rule may better ensure that all relevant forms of intangible benefits are covered by constructing an intangible benefits test, in which a transaction would be covered if any one of the following conditions is met:
    - The U.S. investor has a role in "substantive decision making" regarding the invested entity, leveraging this concept as it exists in the CFIUS context (see 31 CFR 800.245);
    - The U.S. investor conducts one of a range of specified activities with respect to the invested entity, including the provision of management expertise;
    - The U.S. investment conveys control of the invested entity to the U.S. investor, with "control" set as a clearly defined percentage threshold; or
    - The U.S. investment conveys a defined set of management or governance rights short of "control."

Recommendation 5: That Congress recommend that Treasury's final rule for implementing E.O. 14105 include an intangible benefits test to scope covered investments as described above and that any legislation regarding outbound regulation include the same provision.

6. **Coverage of growth transactions and operational pivots.** Under the current text, it is unclear how the new outbound authorities will apply to follow-on transactions that are made after an initial investment, both in scenarios where the initial investment was made prior to the effective date of the new authorities and those made after the effective date. The ANRPM envisions exempting "routine intracompany actions," providing an explicit exemption for the "intracompany transfer of funds from a U.S. parent to a subsidiary located in a country of concern." This text would allow for a U.S. company to sustain an existing operation in a country of concern and to undertake the necessary financial transactions to do so. However, it also appears that this provision allows for a company to expand its investment without constraint if the funds to do so are made available via an intracompany transfer of funds.

    Material expansion of existing investments is likely inconsistent with the policy intent of the EO. If so, the final rule should include clear standards for which intracompany transfers will be

[12] This section borrows heavily from a public comment co-authored with Emily Kilcrease, Tim Fist, Ngor Luong, and Emily Weinstein: "Comments on Provisions Pertaining to U.S. Investments in Certain National Security Technologies and Products in Countries of Concern" https://www.cnas.org/publications/commentary/comments-on-provisions-pertaining-to-u-s-investments-in-certain-national-security-technologies-and-products-in-countries-of-concern

considered "routine" and therefore exempt from notifications or prohibitions and which will trigger new obligations under the notification/prohibition regime. The Chips Act guardrails set clear standards around material expansion, with respect to the investments in China of companies receiving Chips Act funding, that could be leveraged for the purposes of this rulemaking as well, at least for covered semiconductor investments.

Similarly, the rule should anticipate scenarios in which a U.S. person invests in a Chinese entity that is not a covered transaction at the time of investment, but, through a change in business strategy, pivots to operate in a covered national security technology or product. This is not a hypothetic exercise: for example, a U.S. person could invest in a Chinese facial recognition software company that plans to develop its products for commercial use, but subsequently the Chinese entity could change its orientation to instead focus on selling its products to the Chinese government for surveillance use. This is of particular concern for cases in which the U.S. person holds a non-controlling interest in the entity, and therefore cannot exert influence to prevent problematic changes to business plans. The final rule should clarify whether U.S. persons are required to notify such investments and/or if the rule would require divestment if entity into which the U.S. person invested subsequently operated in a prohibited national security technology or product.

Recommendation 6: That Congress recommend that Treasury's final rule for implementing E.O. 14105 further clarify "routine intracompany actions," and ensure that the rule does not allow for material expansion or operational pivots into covered activities. Any legislation regarding outbound regulation should include similar clarity.

7. **Differences in Corporate Supply Chain Expansion vs. Venture & Technology Startups.** As outlined in the section above on trends in outbound investment from the U.S. to China, there are two types of investment that the U.S. government is most worried could create national security concerns. First are corporate investments, usually made either to execute a global supply chain strategy or to serve the China market. The second are venture capital investments in early-stage companies operating in emerging technologies that may be used for military or surveillance purposes. E.O. 14105 attempts to address both kinds of investments in the same manner, but the differences in the incentives for and structure of corporate operational versus venture investments are substantial. In particular, venture investments are more speculative in that early-stage investment is made before it is clear what the commercial use for a nascent technology will be. Additionally, divesting from a venture capital position is very challenging as early-stage investment is all but frozen until an eventual liquidity event – usually after 15 or more years of holding the investment position.

   Thus, venture investments present three key challenges to policy makers that are usually absent or less relevant to corporate operational investments:
   - The speculative nature of their technologies' capabilities and use make it harder to draw narrow bright line distinctions between permissible and impermissible investments.
   - Funding structure flexibility provides venture capitalists with more opportunities to design their investments in ways that avoid generating reporting obligations or prohibition requirements.
   - Venture positions are illiquid over the medium term, making divestment more challenging.

   Given this, it is advisable for the U.S. government to consider additional ways in which forward guidance can help shape the commercial incentives of VC investors in ways that disincentivize

early-stage investment in Chinese entities involved in the development of technology that may not be consider national security technology or products at the time of investment but that have a high likelihood of future national security implications. As outlined in greater detail in a report co-authored with Emily Kilcrease,[13] it is advisable for the U.S. government to undertake a set of actions designed to reshape investor expectations about the long-term financial payout to, and the reputational risks associated with, early-stage investments in technologies that are likely to develop into national security technologies or products.

The goal of such actions is to better align investor incentives such that they are less willing to participate in particularly problematic start-ups, thus reducing the need for the U.S. government to be prohibiting transactions or issuing divestment requirements in a heavy-handed manner. Already, the Congress has made steps in this direction by introducing legislation requiring the disclosure by previously exempted investors of their holdings in China and other adversarial jurisdictions.[14] Additionally, the Congress can codify an expanded version of the NS-CMIC list to commit to preventing U.S. persons from investing – even passively – in a set of designated Chinese entities that operate in a narrow set of particularly concerning national security technology areas. Doing so will communicate to VCs that their early-stage investments will not be rewarded by big payoffs during future liquidity events because U.S. investors will be unable to participate in initial public offerings for these companies or private placements. Thus, the value of this approach is its deterrent effect on shifting the calculus of early-stage investors against participating in Chinese startups with technology that are likely to have use cases of particular concern for national security.

Recommendation 7: That Congress, in addition to adopting recommendation 3, further modify the CMIC program to authorize the designation of Chinese entities beyond the current scope to include any Chinese entity operating in sectors important to U.S. national security, as defined through a regulatory process. These sectors may be broader than the three sectors identified for the purpose of the current implementing rules for E.O. 14105 but should be relatively narrow and stable. A subset of the Critical and Emerging Technologies List (CETL) is a good place to start.

[13] Sarah Bauerle Danzman and Emily Kilcrease, "Sand in the Silicon: Designing an Outbound Investment Controls Mechanism," Atlantic Council and the Center for a New American Security (CNAS), September 2022, https://www.cnas.org/publications/commentary/sand-in-the-silicon-designing-an-outbound-investment-controls-mechanism.

[14] https://www.congress.gov/bill/118th-congress/senate-bill/3286/cosponsors?s=1&r=1&q=%7B%22search%22%3A%22Disclosing+Investments+in+Foreign+Adversaries+Act%22%7D