

Testimony of Gary Milhollin

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I am pleased to appear today before the U.S.-China Commission. The Commission has asked me to comment on U.S. policy towards China, especially concerning the proliferation of weapons of mass destruction. The Commission has asked me to discuss the effectiveness of U.S. sanctions against Chinese entities, and Beijing's ability to police the exports of those entities.

As the Commission well knows, China's exports continue to be a serious proliferation threat. Since 1980, China has supplied billions of dollars' worth of nuclear weapon, chemical weapon, and missile technology to South Asia and the Middle East. It has done so in the face of U.S. protests, and despite repeated promises to stop. The exports are still going on, and while they do, they make it impossible for the United States and its allies to halt the spread of mass destruction weapons.

China's official stance on proliferation has improved over the past few decades. China has ratified the Chemical Weapons Convention, the Biological and Toxic Weapons Convention, the Nuclear Nonproliferation Treaty, and is a member of the treaty's Zangger Committee. Last year, China was accepted into the Nuclear Suppliers Group, and is moving toward joining the Missile Technology Control Regime.

Nevertheless, the U.S. State Department continues to announce sanctions against Chinese companies for their dangerous exports, usually because the exports are found to be contributing to the spread of mass destruction weapons. Over the past four years, the State Department has sanctioned more than twenty Chinese organizations, some of them more than once. Given the fact that these sales continue, and that some of these Chinese organizations are "serial proliferators," it appears that our sanctions policy is not working very well. Or at least, it is not stopping these organizations from doing as they wish.

Today, I would like to discuss some of the reasons why I think that our sanctions policy must be improved. The reasons are, first, that parent companies are not punished for proliferating through their subsidiaries. This is a giant loophole, through which virtually any company can pass without touching the edges. The second reason is that the penalties imposed under U.S. sanctions laws are not strong enough to affect the profitability of the offending companies. Put simply, our sanctions do not have any real teeth.

To elaborate on the first reason, I'd like to draw the Commission's attention to an article that my colleague Matthew Godsey and I wrote recently for the New York Times. Perhaps this article could be included in the record of this hearing. In the article, Mr.

Godsey and I drew attention to the Sinopec Group, a large oil, gas, and chemical conglomerate owned by the Chinese government. The Commission has voiced its concern over this company in the past, both for its failure to disclose its operations in Sudan, and for its oil and natural gas projects in Iran.

Among Sinopec's many subsidiaries are two that have been sanctioned a total of four times since 1997 for selling chemical weapons equipment and technology to Iran. These companies, Nanjing Chemical Industries Group and Jiangsu Yongli Chemical Engineering and Technology Import/Export Corporation, are fully-owned subsidiaries of the Sinopec Group, which holds decision-making authority over them. However, the Sinopec Group has never been sanctioned or even mentioned in sanctions announcements.

In fact, Sinopec has been doing quite well while its subsidiaries have been under sanctions. Many of its most dramatic successes have been in Iran. In 1997, the same year that Nanjing Chemical and Jiangsu Yongli were first sanctioned, China and Iran signed an agreement whereby Iran promised to increase its oil exports to China by 40% by the year 2000. In October 1998, Sinopec beat out competing bids from a host of European companies for the renovation of oil refineries in Tehran and Tabriz and the construction of an oil terminal port near Neka on the Caspian Sea. In 2001, Jiangsu Yongli was sanctioned again, while Sinopec won the right to explore Iran's Zavareh-Kashan oilfield. And last year, Sinopec signed a \$70 billion natural gas deal with Iran.

I am not aware of any direct evidence connecting Sinopec's oil deals to the unsavory sales of its subsidiaries. However, it is not hard to imagine that Iran might be grateful for help with its chemical weapon effort-help it would have a hard time getting from Sinopec's competitors-and that such help could result in a competitive advantage for Sinopec.

Sinopec has also benefited from joint ventures with American companies and access to the U.S. economy and capital markets. In 2000, 15 percent of the company was sold on the New York stock exchange, raising about \$3.5 billion. Major U.S. companies such as Exxon Mobil, Dow Chemicals, Conoco-Phillips, Anderson Consulting, Halliburton and others have cooperated with Sinopec on a variety of projects.

Perhaps the most astonishing benefit conferred upon Sinopec has been by the United States government. In 2002, while its subsidiary Jiangsu Yongli was under its third set of sanctions, the U.S. Trade and Development Agency came up with a \$429,000 grant to help another Sinopec subsidiary, Sinopec International Corp., establish an "e-procurement system." This latter subsidiary, which did \$10.8 billion in trade that year, is Sinopec's import-export body. Sinopec itself has been listed as one of the world's 100 richest companies by Fortune magazine. Even if its subsidiaries had not been involved in nefarious dealings, it is hard to explain why U.S. taxpayer dollars should be used to help this rich company get richer.

The root of this problem lies in the weakness of our sanctions laws. The few laws that include a provision for sanctioning parent companies, like the Arms Export Control Act, stipulate that the parent must have “knowingly assisted in the activities which were the basis” of the sanctions. That burden of proof is simply too high for our intelligence agencies to meet. Other laws, like the Iran Nonproliferation Act of 2000, make no mention of parent companies. And to make matters worse, insufficient information is given when sanctions notices are posted. The notice names the offending company, but does not name its subsidiaries, although the sanctions notice clearly says that the subsidiaries are sanctioned as well. Investors, exporters, and potential partners in joint ventures should be told whom they are dealing with.

Sanctioning parent companies in China is particularly important because of the structure of most large Chinese corporations. These companies are usually composed of an overarching “group company” which oversees dozens of manufacturing, research, and import-export subsidiaries, one or more of which may be publicly listed on a Chinese or foreign stock exchange. When one of these subsidiaries is sanctioned (usually an import-export firm), the group company and the rest of its offshoots are untouched. Before the sanctions, the management of the group company may or may not have been involved in or aware of what its subsidiary was doing. It is possible, for example, that Sinopec was unaware in 1997 that its subsidiaries were building a factory in Iran for making glass-lined equipment. But after the sanctions were announced, and after Jiangsu Yongli and Nanjing Chemical wrote a letter angrily denying the charges, Sinopec must have known what was going on. Yet, it appears to have done nothing in response.

As subsequent events have shown, Sinopec was correct to conclude that it had no reason to be concerned. It could keep doing business with the United States through its other import/export branches, and keep proliferating through its subsidiaries, without suffering any harm itself. This is the pattern that we see today with many of China’s serial proliferators.

The most notorious of China’s serial proliferators is probably Norinco (China North Industries Corporation), a state-owned company that was sanctioned three times last year alone. Although Norinco may have actually lost some money due to sanctions, Norinco officials must have decided years ago that the profits they would receive from continuing to sell missile and other technology to Iran would more than compensate for any American business they lost due to sanctions. This decision seems to be paying off. In addition to weapons sales, Norinco has just won a recent \$836 million deal to expand the Tehran subway.

While the United States has sanctioned Norinco repeatedly, its parent company, China North Industries Group Corporation (CNGC) has never been touched. CNGC owns eight other trading companies in addition to Norinco, some of which export to the United States. Sanctioning the parent would reach all of these firms, as well many other research and manufacturing subsidiaries (there are more than 120 of these, according to company literature). If we want to change Norinco’s behavior, we should try reaching its parent.

From what I have said here, it is fairly clear what the answer is to the Commission's question about China's ability to police its companies. Sinopec and Norinco are both owned by the Chinese government. The government could police them if it wanted to. The fact that these companies are still proliferating after numerous sanctions citations tells us that the government doesn't want to.

A second reason why sanctions aren't working is that the penalties are too weak. The punishment meted out to an offending company is usually limited to barring it from selling goods to the U.S. government, barring it from importing controlled American commodities (munitions and dual-use items), or receiving American foreign aid. This has virtually no effect, because sanctioned Chinese companies (which are always subsidiaries) do little or no business with the United States. Occasionally, the sanctions ban the importation into the United States of goods produced by the company, but this is more the exception than the rule.

We need to ask ourselves a simple question: what do we want sanctions to do? Do we want them to be anything more than symbolic? If so, we have to be prepared to restrict access to our economy in order to increase our security. China itself is good at this. It is deftly offering access to its civilian market as a lever to pry the Europeans loose from the present arms embargo. But we stubbornly refuse to use the American economy in this way, despite the fact that it is the most powerful tool we have to fight proliferation. Our sanctions laws have been written painstakingly to ensure that American companies never lose a dollar because of them. As a result, they are harmless to Chinese companies as well.

This is a great mistake, because the big Chinese conglomerates are rapidly becoming more vulnerable to economic pressure. Due to changes in the Chinese government and the Chinese economy, even state-owned firms in China are now motivated by profit. Like their peers elsewhere, companies that lose money face forcible re-structuring, or are assigned new management. Thus, one can get the attention of these firms by threatening their profitability. Unfortunately, our current sanctions system is incapable of doing that.

We need to amend our sanctions laws so they have some bite. The United States should sanction parent companies along with their subsidiaries, whether or not one can prove they "knowingly assisted" in the proliferation. The parent profits from the sale and is in a position to stop it. That is enough.

The penalties should also be severe. They should include a ban on imports to and exports from the United States, and should prohibit joint ventures or other forms of cooperation with American firms. They should also bar access to American capital markets. Such laws would provide a powerful financial incentive for companies like Sinopec to change their ways.