CHAPTER 3
CHINA AND THE WORLD

SECTION 1: CHINA AND THE MIDDLE EAST AND NORTH AFRICA

Introduction
This section, based on a Commission hearing and research conducted throughout the year, discusses China’s relations with the Middle East and North Africa (MENA).* The section explores China’s primary interests in MENA; Chinese engagement in the region; and the political, diplomatic, and security challenges China faces there. Finally, it examines how China’s MENA policies impact U.S. interests.

China’s Primary Interests in MENA
Beijing’s approach and policies related to MENA are driven by its broader national interests, which are to sustain China’s economic growth, preserve China’s political system, protect China’s sovereignty claims, and expand China’s global influence. These interests are reflected in China’s primary objectives in the region: enhancing economic ties; supporting China’s efforts to achieve energy security; fostering friendly relations with all MENA countries (as well as the Palestinian territories); ensuring domestic stability and control, particularly in Xinjiang Uighur Autonomous Region; and promoting regional stability in an effort to augment China’s domestic economic and security priorities. These interests are discussed below.

Enhancing Economic Ties
Since the 1990s, Beijing’s main priority in MENA has been to safeguard China’s domestic economic growth by expanding opportunities for Chinese exports and acquiring resources to enhance China’s energy security. Dawn Murphy, then postdoctoral research fellow at the Princeton-Harvard China and the World Program, testified to the Commission that China likely will be the dominant economic actor in MENA by the 2020s.

Trade: Between 2003 and 2012, China-MENA annual trade increased more than twelvefold, from $20.8 billion to $262.1 billion. China in 2009 overtook the United States to become the world’s

*For the purposes of this Report and unless otherwise noted, MENA refers to Algeria, Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, the Palestinian territories, Qatar, Saudi Arabia, Syria, Tunisia, the United Arab Emirates, and Yemen.
largest exporter to MENA. Still, China’s trade with the region constituted only 6.7 percent of its global trade in the first half of 2013.

Although China runs a trade deficit with MENA (due largely to its heavy reliance on energy imports from the Persian Gulf), the region increasingly is an important export market for China. Chinese exports to MENA grew from $6.47 billion to $121 billion between 1999 and 2012. The majority of these exports are light manufactured goods, including home and office appliances, communications and acoustic equipment, lamps, furniture, toys, building materials, machinery, textiles, footwear, and stationery, among other items. Chinese state-owned enterprises (SOEs) Sinohydro and China Railway Construction Corporation, the two largest Chinese construction companies in the region, have built dams, highways, mines, airports, housing, water distribution networks, stadiums, irrigation projects, power stations, and other facilities in Algeria, Iran, Libya, Oman, Qatar, and Yemen. Telecommunications companies Huawei and ZTE provide services in at least six countries in the region, including Algeria, Bahrain, Egypt, Iran, Tunisia, and the United Arab Emirates. Both companies in recent years reportedly sold or were associated with the sale of embargoed telecommunications equipment to Iran in violation of U.S. sanctions.

China’s trade with MENA is facilitated by the following:

- **“Strategic partnerships:”** China shares what it refers to as “strategic partnerships” with Algeria, Egypt, Saudi Arabia, and the United Arab Emirates. These partnerships vary in depth and nature of cooperation. While some have a security component, most emphasize economic cooperation, as with the Sino-Saudi “strategic oil partnership,” discussed below.

- **Cooperation fora:** The China-Arab States Cooperation Forum (CASCF) and the Forum on China-Africa Cooperation (FOCAC) are China’s primary multilateral venues for promoting its economic interests in the region, including but not limited to identifying and developing export markets. For example, the China-Arab States Economic and Trade Forum, established under CASCF in China’s Ningxia Hui Autonomous Region in 2010, serves as a “bridgehead” for China to develop “an open inland economy, emphasizing … Arab League countries and Muslim regions.”

- **Special economic zones and trade fairs:** Energy exports aside, much China-MENA trade is facilitated by trade zones and wholesale trade fairs. China and Egypt launched the Egypt Suez Cooperation Zone in 2009. The zone facilitates exports to the Middle East, Africa, and Europe. Dubai’s DragonMart
is the largest trading center for Chinese goods outside China and houses more than 3,900 Chinese wholesale and retail vendors. The Yiwu International Trade Mart in Yiwu, Zhejiang Province, claims to be the world’s largest small commodities market and attracts around 200,000 Arab traders each year.

China’s trade ties with the region could expand with a planned free trade agreement with the Cooperation Council for the Arab States and the Gulf, which includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The proposed agreement would cover trade in goods and services.

**Investment:** China’s investment in MENA is growing. According to statistics from the Chinese Ministry of Commerce, Chinese foreign direct investment (FDI) flows to the region reached $1.5 billion in 2011. China’s FDI stock in the region reached $6.14 billion in 2011, about 1.4 percent of China’s global FDI stock that year. Iran, the United Arab Emirates, and Saudi Arabia, respectively, were the top three recipients of Chinese FDI (in terms of flows and stock) in the region in 2011.

Much of China’s investment in MENA is in the infrastructure and transportation sectors. Chinese companies are building, funding, or have agreed to build railways in Egypt, Iran, Israel, Libya, and Saudi Arabia. State-owned China Harbour Engineering Company is investing in port projects in Kuwait, Saudi Arabia, and Qatar. Investment in infrastructure helps China build goodwill in the region and increase its access to Middle Eastern, European, and African markets.

**Financial Services:** China is active in financial services sectors throughout the region. Five regional banks have signed cross-border renminbi (RMB) trade settlement agreements, enabling MENA-based companies to settle payments with Chinese suppliers. China’s four largest state-owned banks operate in Dubai, United Arab Emirates, which likely will become the first market for RMB conversion and clearing outside East Asia. Several non-Chinese banks in the United Arab Emirates offer RMB accounts to accommodate growing numbers of Chinese traders and investors.

**Promoting Energy Security**

China’s engagement with MENA is driven primarily by its efforts to achieve energy security. In 2012 and the first eight months of 2013, the region accounted for about 54 percent of China’s imported crude oil. Saudi Arabia is China’s largest source of oil, both in the region and globally. Among Middle Eastern producers, Saudi Arabia, Iran, Oman, and Iraq, respectively, exported the most crude oil by volume to China in the period from January 2012 to August 2013. Qatar and Yemen are China’s third- and fifth-largest sources of liquefied natural gas (LNG), providing 18 percent and 7 percent of China’s LNG imports in 2011, respectively.
China's reliance on oil imports from MENA likely will grow. Erica Downs, fellow at the Brookings Institution, testified to the Commission that China's oil imports from the region are estimated to grow from 2.9 million barrels per day in 2011 to 6.7 million barrels per day in 2035. In addition to imports, China's national oil companies (the state-owned “national champions” of China’s energy sector) have invested heavily in energy companies and projects in MENA, particularly in Iran and Iraq. Over the last decade, China’s leaders increasingly have begun to view the country’s growing reliance on energy imports, the majority of which originate in MENA, as a strategic vulnerability. Then Chinese President Hu Jintao in a 2003 speech described China’s dependence on seaborne energy imports as China’s “Malacca Dilemma,” referencing the strait through which most of China’s

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MENA crude oil imports flow. This sense of vulnerability appears to drive Beijing's efforts to strengthen its relations with the region's major producers. Beijing likely will enhance its overall engagement in MENA if China's reliance on the region's energy exports continues to grow as projected. According to a 2013 market outlook report by Norwegian multinational energy company Statoil, “Given the rebalancing of global oil trade flows, most of [China's] imports must be covered by the Middle East, which suggest[s] that China probably will be forced to take a more interventionist approach in foreign policy, particularly towards the Middle East.”

Beijing’s energy insecurity and consequent drive for greater influence in the region are compounded by China's apprehension about U.S. primacy in the region and the U.S. Navy's near-total control over the sea lanes through which Chinese energy imports pass. According to a 2012 report by Scott Harold and Alireza Nader for the RAND Corporation, Beijing seeks to augment its energy trade ties with political ties to the Iranian government to ensure that in a potential scenario in which the United States may seek to disrupt China's oil supply, China could rely on a friendly oil-producing country to mitigate the disruption.

Saudi Arabia, Iran, Iraq, and Oman: China’s Major Energy Partners in MENA

Saudi Arabia: China and Saudi Arabia established a “strategic oil partnership” in 1998, which has enabled close cooperation in the energy sector. China's oil trade with Saudi Arabia has grown drastically in the past decade, and in 2009 China overtook the United States as Saudi Arabia's largest crude oil customer. Chinese national oil companies have several investments in Saudi oil and natural gas projects, and Saudi Aramco, the largest Saudi energy company, has several investments in Chinese refineries.

Saudi Arabia's position as a dominant supplier and its ability to calibrate production and drive oil prices make it an indispensable partner for China. Beijing seeks assurances from Riyadh that Saudi Arabia will maintain price stability in the event of severe supply disruptions. China (and other importers of Iranian crude oil) relied heavily on Saudi Arabia to compensate for sharp decreases in Iranian imports in 2012. Riyadh, recognizing China's growing importance as an export market for Saudi oil, in turn has indicated its willingness to help China achieve energy security. A 2006 joint memorandum on energy cooperation states Saudi Arabia will assist China in developing its strategic petroleum reserves.

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1 Between 2011 and 2012, the volume of Chinese imports of Iranian crude oil decreased by about 20 percent, from about 27 million tons to about 22 million tons. China National Bureau of Statistics, via CEIC database.

Saudi Arabia, Iran, Iraq, and Oman: China’s Major Energy Partners in MENA—Continued

Saudi Arabia, the two countries announced a “gentleman’s agreement” between Saudi Aramco and Chinese national oil company Sinopec for the continued export of Saudi crude oil to China. Later that year, Saudi Minister of Petroleum and Mineral Resources Ali Al-Naimi stated in a speech, “China can rely on Saudi Arabia to provide it with the oil it will need to continue its projected growth for the coming decades.”

Iran: Energy interests are a primary driver of China’s challenging and problematic relationship with Iran. China is Iran’s top crude oil customer, and about 8 percent of China’s oil imports (by volume) were from Iran in the period from January 2012 to August 2013. Iran was China’s third-largest supplier of crude oil globally for much of the 2000s, but in 2012 and in the first eight months of 2013 Iranian exports to China dropped significantly, likely due to U.S. sanctions on Iran’s energy sector and a pricing dispute between Chinese oil trader Unipec and the National Iranian Oil Company in 2012.

Beijing seeks to balance its interest in securing energy from and maintaining relations with Iran with its interests in promoting its image as a responsible international power and maintaining stable relations with the United States and other MENA countries. Since January 2012, the U.S. Department of State has consistently exempted China on a biannual basis from sanctions on foreign countries importing crude oil from Iran because, although China had continued to import crude oil from Iran, the State Department judged China had “significantly reduced” those imports. Chinese national oil companies reportedly have negotiated discounts on Iranian crude oil purchases, leveraging Tehran’s growing international isolation and consequently limited export markets.

China in 2013 apparently began to exploit a loophole in U.S. sanctions by continuing to reduce its crude oil imports from Iran while dramatically increasing its fuel oil imports, which are not technically covered by U.S. sanctions. According to the Wall Street Journal, China in the first seven months of 2013 imported $495 million worth of Iranian fuel oil, compared to $1 million in 2012. While fuel oil is less valuable and more difficult to refine than crude oil, Chinese oil companies appear to have imported large amounts at discounted rates from Iran, enabling China to partially compensate for its reduction in crude oil imports.

China’s energy relations with Iran thus adhere to the letter, but not the spirit, of U.S. sanctions.

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*The State Department is scheduled to announce the next round of exemptions in December 2013.
Saudi Arabia, Iran, Iraq, and Oman: China’s Major Energy Partners in MENA—Continued

Chinese companies have pursued several large investment contracts to develop Iranian oil and gas. However, these projects have moved slowly, and some have stalled or been suspended in recent years. According to Dr. Downs, “Reasons for the shrinking presence of China’s oil companies in Iran include sanctions that have made it difficult for China’s oil companies to secure equipment and technologies needed to operate in Iran, unhappiness with contract terms, uncertainty about whether Iran’s nuclear program will spark a military conflict, and reported guidance from China’s leadership to move slowly in Iran.”

Iraq: China is benefitting greatly from Iraq’s postwar oil production. Between 2008 and 2012, the value of Iraqi crude oil exports to China increased by almost 870 percent. China also is the largest foreign investor in Iraq’s oilfields. China National Petroleum Corporation (CNPC), a Chinese national oil company, and British Petroleum are jointly developing Iraq’s Rumaila field, which accounted for one-third of Iraqi oil production in 2012. Dr. Downs testified to the Commission that Rumaila in 2012 was CNPC’s most productive overseas project and accounted for nearly half of the company’s net overseas oil and gas production. CNPC also is invested in Iraq’s al-Adhab and Halayqa oilfields. At the time of this Report’s publication, CNPC’s listed subsidiary PetroChina is in talks to become an investor in a $50 billion Exxon Mobil-operated project to develop one of Iraq’s largest oilfields, West Qurna-1.

Oman: Oman increasingly is an important source of energy for China and was the fourth-largest source of Chinese crude oil imports in the first half of 2013. In addition to Saudi Arabia, Iraq, and other producers, China has relied on Oman in 2012 and 2013 to compensate for decreases in imports from Iran. China-Oman investment ties in the energy sector are more limited than the previously discussed countries. CNPC has a production-sharing contract for a 50 percent stake in Oman’s Block 5, which has both oil and natural gas assets.

Fostering Friendly Relations in MENA

China seeks to develop and maintain friendly ties with all MENA countries (and the Palestinian territories) without being drawn into the region’s conflicts or power struggles. Beijing hopes to leverage these relationships to extend China’s regional and global influence; portray China as a responsible global power; and promote regional stability with a view toward advancing its own economic, political,

* China’s potentially lucrative investments in Iranian projects have been facilitated in part by the fact that these projects have been abandoned or passed over by major Western companies due to political risk and sanctions on Iran’s energy and banking sectors. U.S.-China Economic and Security Review Commission, Hearing on China and the Middle East, written testimony of Erica Downs, June 6, 2013; Scott Harold and Alireza Nader, China and Iran: Economic, Political, and Military Relations (Santa Monica, CA: RAND Corporation, 2012), p. 5. http://www.rand.org/content/dam/rand/pubs/occasional_papers/2012/RAND_OP351.pdf.
and security interests. China’s efforts appear to be working. A 2013 Pew Global Research study found that MENA countries tend to view China more as a partner than an enemy. Dr. Murphy testified that government officials throughout the region have favorable views toward China, although they “do not want relations with China to endanger their existing close relationships with the United States.”

At the same time, Beijing considers MENA a “graveyard of great powers” and generally seeks to avoid becoming involved in the region’s rivalries and conflicts or being perceived as aligning with particular countries or stakeholders. With a large degree of success, China to date has simultaneously fostered advantageous relationships with regional rivals such as Israel and the Palestinians, Israel and Iran, Saudi Arabia and Iran, and even Iraq and Iran when they were at war in the 1980s. Beijing’s reluctance to overtly align with or against countries in MENA reflects pragmatic decision making aimed at maximizing China’s economic and political advantage in the region.

### China’s Non-Interference Policy and MENA

China claims respect for other countries’ sovereignty and opposes interference in the internal affairs of other countries. This principle is rooted in Beijing’s opposition to establishing an international precedent that legitimizes regime change, which it likely judges could have implications for Chinese Communist Party rule in the event of upheaval in China. The non-interference principle guides Beijing’s approach and policies toward MENA and is reflected in Beijing’s aversion to challenging sitting regimes or the political status quo in other countries and its reluctance to overtly align with any one side in a conflict or rivalry.

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China’s Non-Interference Policy and MENA—Continued

Yitzhak Shichor, professor emeritus at the Hebrew University of Jerusalem and the University of Haifa, asserts that China does in fact involve itself in the affairs of other countries when Beijing judges it is in China’s national interest to do so. Dr. Shichor testified to the Commission that China applies the principle of non-interference in a “flexible, pragmatic, and creative” way. This appears to be the case in China’s relations with MENA in recent years. For example, China in the name of non-interference and respect for sovereignty does not support United Nations (UN) Security Council action or sanctions to punish regimes in Iran and Syria for destabilizing activity, violence, and human rights abuses. Beijing quietly has supported regimes in both countries while Chinese diplomats stress China’s impartiality to international audiences.

Ensuring Domestic Stability and Control

One of China’s objectives in its foreign relations with MENA countries (and to an even greater extent with Central Asia) is promoting domestic security, particularly in Xinjiang Uighur Autonomous Region, home to many of China’s ethnic Turkic Muslims. Episodic ethnic and political unrest in Xinjiang has in the past attracted support from overseas Muslim groups, particularly in MENA and Central Asia. Beijing fears these overseas groups could encourage what it refers to as “separatist insurgencies.” In its diplomatic engagement with MENA countries, especially with CASCF, China solicits support for its policies to suppress “separatist” activities in Xinjiang. For example, the 2010 CASCF Communiqué states that the organization’s Arab countries are “against religious extremist forces or ethnic separatist forces engaged in terrorism or anti-China separatist activities.”

According to Dr. Murphy, “After the beginning of the Arab Spring, China’s concern regarding domestic stability in relation to the Middle East has shifted from issues related to Xinjiang to a concern over preventing the spread of Arab Spring-style upheaval from the Middle East to China.” Starting in 2011, Chinese officials sought to ensure that unrest did not manifest in China by...
suppressing Arab Spring-inspired “Jasmine Revolution” protests, censoring related information on the Internet, and emphasizing through official and semi-official media outlets that popular calls for democracy across MENA were misguided.66

**Promoting Regional Stability**

Beijing increasingly views stability in MENA as essential to protecting and advancing China’s expanding interests and ensuring China’s future security.67 Some of China’s efforts, including offering support for the Israeli-Palestinian peace process, counterpiracy operations, and peacekeeping operations, promote stability in MENA.68 At the same time, Chinese ties with rogue regimes and terrorist organizations and arms sales to the region have in the past undermined peace and security.

**Support for the Israeli-Palestinian Peace Process:** China maintains relatively positive ties with both Israel and the Palestinians. Though Beijing remains wary of becoming entangled in the conflict, it has since the late 1990s indicated a desire to play a greater role in the peace process.

Historically, China has strongly supported the Palestinians. Beijing first expressed support for Palestinian statehood in 1955 and provided arms, military training, and other aid to the Palestinian Liberation Organization and the Popular Front for the Liberation of Palestine through the 1980s.69 China did not formally recognize Palestine until 1988, however. Four years later, China formally recognized Israel, although Beijing had quietly cultivated economic and political ties with Israel since the late 1970s.70 Following the establishment of diplomatic ties, Sino-Israeli economic, technological, and military ties grew substantially.

China made occasional statements supporting Israeli-Palestinian reconciliation in the 1980s and 1990s but became more actively invested in the peace process in the early 2000s. This appears to be largely due to requests from several Arab countries for Beijing to become more involved. These countries likely judged China could balance U.S. influence over the peace process given Beijing’s longstanding support for the Palestinians.71 In response, Beijing in 2002 established its first ever “special envoy” diplomat. The special envoy is responsible for the entire region but focuses on the Israeli-Palestinian conflict in particular. Observers note that this position entails gathering and sharing information more so than playing an active role in the mediation process.72

In the spring of 2013, Beijing signaled a new willingness to engage in the peace process. Chinese President Xi Jinping in May issued a “Four Point Proposal” emphasizing a two-state solution, peaceful negotiation, the “land-for-peace” principle,† and “a greater

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†The “land for peace” principle originates in UN Security Council Resolution 242, which states, “The establishment of a just and lasting peace in the Middle East . . . should include the
sense of responsibility and urgency” among the international community to resolve the conflict. This proposal reiterates China’s earlier statements on the conflict and is largely consistent with the official U.S. position. President Xi publicized the proposal himself, indicating the importance China’s top leaders ascribe to the issue. The announcement of the proposal coincided with visits to Beijing by President Mahmoud Abbas of the Palestinian territories and Israeli Prime Minister Benjamin Netanyahu. China’s Ministry of Foreign Affairs at the time stated China “is willing to offer necessary assistance if the leaders of Palestine and Israel have the will to meet in China.” Nevertheless, Beijing appears to have designed the leaders’ itineraries such that neither leader would be in the same Chinese city at the same time. It remains to be seen if Beijing’s recent overtures will translate to concrete actions to facilitate the peace process.

**Counterpiracy Operations:** Since January 2009, China has sustained a naval task group in the Gulf of Aden to conduct counterpiracy operations. This represents China’s largest overseas military presence. As of October 2013, China’s People’s Liberation Army (PLA) Navy had deployed around 10,000 personnel in 15 successive two- or three-ship task forces over four years. Chinese official media sources state the PLA Navy has protected more than 5,000 commercial ships from China and more than 50 other countries over the course of 500 escorts. Chinese counterpiracy patrollers have made port calls for resupply or military-to-military engagements to 12 MENA ports: Algiers, Algeria (1 visit); Al Manamah, Bahrain (1); Alexandria, Egypt (1); Haifa, Israel (1); Shuwaikh, Kuwait (1); Casablanca, Morocco (1); Muscat, Oman (1); Salalah, Oman (15); Doha, Qatar (1); Jiddah, Saudi Arabia (4); Abu Dhabi, United Arab Emirates (1); and Aden, Yemen (8).

Beijing maintains it will not pursue a permanent military presence abroad. However, some Chinese commentators since the late 2000s have called for China to develop a permanent or semipermanent overseas naval presence in the Indian Ocean to address logistical challenges associated with sustaining the PLA Navy’s counterpiracy presence in the Gulf of Aden and help secure China’s maritime trade routes in the Indian Ocean. China could seek to establish repair, refuel, and replenishment stations in MENA or the
Indian Ocean to address logistical challenges associated with sustaining the PLA Navy’s counterpiracy presence in the Gulf of Aden and help secure China’s maritime trade routes in the Indian Ocean. Such a logistics hub also could facilitate potential future missions in the region, such as noncombatant evacuations, disaster relief, defense of maritime trade routes, and limited force projection. Countries in the Gulf of Aden, particularly Oman and Yemen, have allowed frequent PLA Navy port visits over the past four years and likely would be top candidates for China’s first logistics hub. China probably will not pursue traditional overseas bases in the near term due to longstanding political restraints, Beijing’s concern about international backlash against a larger overseas military presence, and the current absence of a strategic requirement to persistently project power globally.

Peacekeeping Operations: China has participated in four UN peacekeeping operations in MENA since 2001: UN Truce Supervision Organization, UN Iraq-Kuwait Observer Mission, UN Interim Force in Lebanon, and UN Supervision Mission in Syria. More than 3,200 troops have participated in these missions. As of September 2013, China had four peacekeepers in the UN Truce Supervision Organization and 343 peacekeepers in the UN Interim Force in Lebanon.

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Chinese Activities that Undermine MENA Security

While China generally seeks stability in MENA, some Chinese activities in the region undermine security and stability.

- **Commercial ties to rogue regimes:** Chinese companies frequently invest in and trade with authoritarian regimes in MENA and elsewhere in the world. This is typified by Chinese national oil companies, which have profited from Iran’s international isolation. For example, China’s national oil companies seek to exploit Tehran’s sanctions-crippled economy to negotiate advantageous contracts and barter agreements and secure lucrative investments. Chinese state-owned Zhuhai Zhenrong Corp. in 2012 reportedly ordered an $80 million shipment of Syrian crude oil in defiance of Western sanctions. In a June 2013 interview for the Financial Times, Syrian Deputy Prime Minister for the Economy Kadri Jamil said China, Russia, and Iran are “supporting us [the Syrian regime] politically, militarily—and also economically.”

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Chinese Activities that Undermine MENA Security—Continued

- **Arms sales:** In recent years, China has sold arms in limited quantities to MENA countries.\(^8\) According to the Stockholm International Peace Research Institute, China delivered arms to Algeria, Egypt, Iran, Saudi Arabia, and Syria from 2008 to 2012 in fulfillment of orders made between 1992 and 2009.\(^9\) For the past decade, Iran has been the primary beneficiary of Chinese arms (mostly antiship cruise missiles) and dual-use technology transfers to the region.\(^8\) Moreover, U.S. officials have indicated Chinese entities may not be in full compliance with international nuclear nonproliferation efforts aimed at Iran, though the Chinese government claimed it ceased assisting Tehran’s nuclear program in 1997.\(^9\)

In some cases, Chinese arms used in MENA appear to have been acquired via third countries or from Chinese weapons manufacturers without necessarily being sanctioned by the Chinese government.\(^8\) Chinese weapons manufacturers have sold or attempted to sell arms or dual-use technologies to Iran and Libya in violation of international and U.S. sanctions.\(^8\) Chinese officials usually deny the sales or offers were made with the knowledge and consent of the Chinese government. Regardless of Beijing’s level of involvement, its lax enforcement of export controls allows this proliferation to occur.\(^9\)

- **Ties with regional terrorist groups:** Beijing maintains official ties with both Hamas and Hezbollah, although the United States, the European Union, and other powers designate both Hamas and the military wing of Hezbollah terrorist organizations. Both groups reportedly have used Chinese-made arms in attacks on Israel, though it is unclear if the Chinese government sanctioned or was aware of the transfer of these arms. According to news reports, Hamas in 2006 launched around 50 Chinese rockets in attacks on Israel, and Hezbollah in 2008 attacked an Israeli naval vessel with a Chinese-made C–802 antiship missile transferred from Iran.\(^9\) In 2012, families of Israeli students killed in a 2008 terror attack by Hamas filed a lawsuit against a New York City branch of the state-owned Bank of China for providing support for Hamas terrorist activities.\(^9\) Bank of China rejected the allegations as groundless.\(^9\)

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\(^8\) This was not always the case. From the 1950s to the late 1970s, China donated large quantities of small arms and provided military training to revolutionary groups in the region. In subsequent decades, China’s arms transfers have been more limited. Dawn Murphy, *Rising Revisionist? China’s Relations with the Middle East and Sub-Saharan Africa in the Post-Cold War Era* (Washington, DC: George Washington University, 2012), p. 84; Stockholm International Peace Research Institute, “SIPRI Arms Transfers Programme.” http://portal.sipri.org/publications/pages/transfer/splash.

\(^9\) These transfers include towed guns (Algeria); trainer/combat aircraft and unmanned aerial vehicles (Egypt); armored personnel carriers and possibly portable surface-to-air missiles and antiship missiles (Iran); self-propelled guns (Saudi Arabia); and air search radar (Syria). Stockholm International Peace Research Institute, “SIPRI Arms Transfers Programme.” http://portal.sipri.org/publications/pages/transfer/splash.
China faces several geopolitical challenges in MENA. Instability, regime changes, and power shifts in recent years likely have demonstrated to Beijing that its preferred low-key method of managing its relationships in the region is unsustainable. In addition, Beijing’s positions on Syria and Iran implicate China in violence, human rights abuses, and weapons proliferation and put China at odds with the United States in the region.

Regime Change and Unrest: Tunisia, Egypt, Libya, and Syria

China was unprepared to respond to the abrupt political upheaval and regime changes of the Arab Spring. This likely is due to Beijing’s inclination to cultivate relationships with ruling parties and its overall lack of experience in the region. Both Chinese and Western observers note the relative inexperience of China’s diplomatic corps in MENA as a reason for its difficulty in responding to sweeping changes in the region. Director and professor of the Middle East Studies Institute at the Shanghai International Studies University Liu Zhongmin assessed “China’s response to the political unrest [in MENA] was somewhat lagging behind.” He continued, “China’s contacts and communication with the political opposition in the Middle Eastern countries were not active enough.” According to Jon B. Alterman, director of the Middle East Program at the Center for Strategic and International Studies, “China’s [MENA] diplomacy has been more cautious than it has been deft.” In his testimony to the Commission, he elaborated that China’s policy toward unrest in the region is uninformed, “in part because [China] does not know [about the region’s opposition groups], but also because it has not paid close attention to the societies from which they have sprung.”

Tunisia: Beijing moved quickly to censor domestic news about the Tunisian uprising and took steps to form ties with the transitional government in January 2011. A Chinese Foreign Ministry spokesperson stated China’s hope for a peaceful resolution to the unrest and the resumption of friendly ties with the Tunisian government regardless of the uprising’s outcome. However, after that initial statement, Beijing was silent on the unrest and transition, at least in public. Chinese diplomats were and to an extent remain unfamiliar with Tunisia’s Islamist political groups, including the ruling Ennahdha party, which was voted into power in late 2011.

Egypt: Prior to the overthrow of former Egyptian President Hosni Mubarak, Beijing had been cultivating relations with the Mubarak regime in order to expand its economic profile, secure ties to one of the most powerful countries in the region, and promote access to critical infrastructure in Egypt, including the Suez Canal. In the months following the uprising and overthrow, Chinese diplomats reportedly struggled to forge relations with the transitional Egyptian government, apparently due to suspicions on the part of Egypt’s new leaders, who considered Beijing to have been a strong supporter of the Mubarak government. Nevertheless, Egypt’s newly elected president Mohamed Morsi in August 2012 chose
China for his first state visit outside the Middle East. Relations between Beijing and Cairo remained stable and positive throughout the Morsi Administration. Bilateral trade increased by 27 percent between 2010 and 2012, and the two sides signed several agreements on investment and science and technology cooperation.103

After the Egyptian military removed President Morsi from power in July 2013 and during subsequent months of unrest and violence, Chinese officials were circumspect in their official statements on the situation. Public reticence notwithstanding, Beijing appears to be observing developments in Egypt closely: Chinese Minister of Foreign Affairs Wang Yi spoke over the phone with his Egyptian counterpart in the new government 16 times between President Morsi’s removal and August 16.104 Minister Wang expressed that “China attaches high attention to the situation in Egypt, and has called on all parties concerned to give up violence to avoid bloodshed and to prevent more casualties. China supports [sic] to resolve differences through dialogues and consultations, to restore law and order, and to advance steadily the process of inclusive political transition.”105 Minister Wang further asked the Egyptian government to ensure the safety of Chinese citizens, enterprises, and institutions in the country.106

While Sino-Egyptian economic ties remained largely unaffected by the transition from the Mubarak to the Morsi governments, bilateral trade appears to have faltered somewhat in 2013 amid renewed unrest surrounding removal of the Morsi government and installment of the military government.107 It is unclear whether the decrease in bilateral trade in 2013 can be attributed to the ongoing political unrest. Chinese investment in Egypt continued in 2013, with Sinopec purchasing a stake in U.S. energy company Apache’s Egyptian oilfield operations in August. According to Apache, the company’s “exploration and production operations, which are located in remote, unpopulated areas, remain unaffected by political events in the region.”108

Libya: More so than during the relatively quick power transitions in Tunisia and Egypt in 2011, China faced challenges on several fronts during the months-long Libyan conflict. Instability and violence threatened the safety of Chinese citizens and the security of Chinese investments and trade ties.109 China in early 2011 evacuated 35,000 citizens from Libya in its first major noncombatant evacuation operation.110 As violence by then Libyan President Muammar el-Qaddafi’s regime escalated, China in February 2011 voted to approve UN Security Council Resolution 1970, which imposed sanctions on President Qaddafi and his close associates, imposed an arms embargo on Libya, and provided humanitarian assistance, among other things.111 Less than three weeks later, China abstained from the vote on UN Security Council Resolution 1973, which authorized the Security Council to establish a no-fly zone and pursue an immediate ceasefire in Libya.112 China almost certainly understood that its abstention would enable military intervention in Libya, but it also allowed Beijing flexibility to publicly hew to its policy of non-interference and express surprise and regret when North Atlantic Treaty Organization (NATO) forces predictably intervened in Libya.113
Nevertheless, through the spring and summer of 2011 China appeared reluctant to sever ties with the Qaddafi regime. Journalists from Toronto’s *Globe and Mail* found evidence suggesting state-owned weapons manufacturer Chinese North Industries Corporation had offered at least $200 million in arms to the Qaddafi regime while the arms embargo (which China had voted for) was in place.\(^{114}\) China also was the only UN Security Council member not to call for Qaddafi to step down and the last UN Security Council member to recognize Libya’s new transitional government in the fall of 2011.\(^{115}\) Despite a decline in 2011, bilateral trade (particularly Chinese exports to Libya) rebounded in 2012 and the first half of 2013.\(^{116}\)

**Syria:** Despite its emphasis on neutrality and peaceful resolution in public statements,\(^8\) China takes a hardline stance on the Syrian conflict. Beijing’s position seems to be based on an ideological opposition to foreign intervention (China has limited economic or strategic interests in Syria). Beijing likely fears actions designed to overthrow a sovereign regime could legitimize regime change and external intervention and thus threaten China’s own core interests of sovereignty and territorial integrity. This position seems to be reinforced by China’s apparent regret over its abstention from, and thus tacit support for, foreign intervention in Libya authorized by UN Security Council Resolution 1973.\(^{117}\)

China repeatedly has used its veto power to prevent the UN Security Council (and other UN bodies) from singling out, blaming, or imposing sanctions on the Syrian government.\(^{118}\) China has vetoed three UN Security Council resolutions to take action against President Assad and exercised three “no” votes to punish President Assad in the UN General Assembly and UN Human Rights Council.\(^{119}\) China also has opposed any military action, even in support of humanitarian efforts, in Syria.\(^{120}\) In response to the Obama Administration’s August 2013 statements suggesting possible unilateral air strikes against Syria, a Chinese Ministry of Foreign Affairs spokesperson stated, “China is highly concerned about the relevant country’s [United States] plan on taking unilateral military action.” The spokesperson then said the international community should “avoid complicating the Syrian issue and dragging the Middle East down into further disaster.”\(^{121}\)

China’s position on the Syria conflict aligns with the Russian position, though the two countries may have different motivations for their respective stances.\(^{122}\) China and Russia have voted the same on issues related to Syria in the UN Security Council, and China supported a Russian proposal that the Syrian government hand over the country’s chemical weapons under UN supervision. Foreign Minister Wang in mid-September 2013 said, “China welcomes the framework agreement reached between Russia and the U.S. in Geneva on the issue of chemical weapons in Syria. We believe it

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\(^8\) China’s stated position on the Syrian conflict emphasizes an end to violence, political transition under the guidance of the UN and the Arab League, and humanitarian assistance. Beijing endorsed the UN’s “six-point plan” for peace in Syria developed by former UN-Arab League envoy to Syria Kofi Annan, although it has rejected efforts within the UN to pressure President Assad to acquiesce to UN resolutions or step down. Priyanka Boghani, “Syria peace plans: China vs. United Nations,” *Global Post*, November 1, 2012. http://www.globalpost.com/dispatch/news/regions/middle-east/syria/121101/syria-peace-plans-china-vs-united-nations.


Beijing and Moscow in September 2013 released a joint statement on the Syrian conflict, conveying shared concerns about the security and humanitarian situation and supporting an “accurate and objective international investigation” into the reported use of chemical weapons in Syria, among other things.124

According to the Stockholm International Peace Research Institute’s Arms Transfers Database, China has not delivered or approved the sale of weapons to Syria since 2010.8 125 The most recent Chinese arms transfers to Syria were four Type-120 air search radar systems, which were ordered in 2009 and delivered in 2010.126 Unconfirmed reporting also suggests that Chinese-made shoulder-launched FN–6 antiaircraft missiles were transferred by third parties to Syrian rebels.127

Beijing has expended considerable diplomatic energy and incurred widespread criticism for its position on the Syrian conflict. In her testimony before the Commission, Dr. Murphy asserted Beijing’s position on Syria marks a departure from China’s historical approach to the Middle East insofar as it alienates other countries in the region and represents a firm and sustained opposition to U.S. interests.128 Many in the international community, including the United States, assert China’s position protects the Assad regime and prevents necessary international measures to promote the peaceful resolution of the conflict. Then U.S. Ambassador to the UN Susan Rice in February 2012 said the United States was “dissatisfied” by China’s (and Russia’s) vetoes of otherwise unanimous UN Security Council resolutions on Syria and remarked that the UN’s mission was being “held hostage” by China and Russia.129 Moreover, whereas MENA countries (and public opinion) generally favor China’s presence and policies in the region, this has not been true regarding the Syrian conflict. Several Arab League countries, particularly Saudi Arabia and Qatar, criticized China for its position on Syria.130 At the time of this Report’s publication, China appears to judge the benefits of continuing to shield and enable the Assad regime outweigh the potential costs of supporting international efforts to hold the regime accountable.

Iran

The Commission has in recent years reported at length on Sino-Iranian economic, political, and military relations.† This section
discusses China-Iran ties in the context of China-MENA relations specifically.

Beijing’s relationship with Tehran is simultaneously China’s closest and most problematic bilateral relationship in the region.\textsuperscript{131} The multiple facets of this relationship—including energy ties, arms and dual-use technology sales, and diplomatic support—have enabled Tehran’s destabilizing policies and damaged U.S.-China relations and China’s international reputation. However, Beijing appears to judge these consequences are worth the energy security benefits gained from continued cooperation with Iran. China also likely prefers that the United States not enjoy unchecked power and influence in the Middle East.\textsuperscript{132} According to a report by CENTRA Technology, Inc. sponsored by the Commission, “China has used its relations with Iran to balance against U.S. interests and what it sees as hegemonic policies in the Middle East.”\textsuperscript{133} However, should China seek a more robust political and security presence in MENA, countries of the region could seek to pressure China to reconsider its support for Iran.

China’s reduction in Iranian crude oil imports in 2012 and 2013 was made possible by Saudi Arabia, Iraq, Oman, and other countries’ willingness and ability to compensate for the lost barrels of oil. Significant increases in Iraqi oil production expected in the coming years and decades could provide a reliable alternative source of oil for Beijing should it seek to further decrease Iranian imports.\textsuperscript{134} Moreover, Saudi Arabia, a powerful regional player and energy powerhouse with its own concerns about Iran, has demonstrated a commitment to Chinese energy security. As China increasingly relies on these countries for its energy, Beijing may determine it can moderate its support for and ties with Tehran without sacrificing the energy security benefits it currently gains from the relationship. However, Beijing at present does not seem to assess that sacrificing its relationship with any of its major oil suppliers is in its interests. As long as this remains the case, Beijing is unlikely to seriously revise its relationship with Tehran on this basis.\textsuperscript{135}

Beijing does not appear to judge Iran’s nuclear program as a serious threat to Chinese economic or security interests or to security in MENA.\textsuperscript{136} Joel Wuthnow, researcher at CNA China Studies, testified to the Commission, “Although some Chinese analysts accept the premise that an Iranian nuclear weapon might spark a regional arms race, few have publicly discussed whether and how such an outcome may damage Chinese interests.”\textsuperscript{137} However, as China’s presence and influence in the region grows, Dr. Wuthnow suggested Middle Eastern countries and the United States may find opportunities to persuade China that Iran’s behavior poses a risk to “regional security, and thus to China’s own interests in Iran and the region.”\textsuperscript{138}

**Implications for the United States**

The United States has deep and longstanding interests in MENA, which it seeks to protect and advance through economic engagement, strategic partnerships and security arrangements, and a large military presence. As China’s interests and presence in the
region grow, they inevitably will impact U.S. objectives and influence there.

Beijing recognizes the United States is the most influential external power in MENA and formulates its regional policies with this in mind. A Saudi Arabian ambassador to China remarked, “In order to understand China’s relations with the Gulf states, one must understand Sino-American relations.”

Historically, China has sometimes opposed or resented U.S. influence and policies in MENA, but has sought to avoid directly challenging the United States in the region. According to Dr. Alterman, “Chinese officials are keenly aware of the advantages of supplementing the United States in regional affairs, but they show little interest in supplanting the United States . . . [China] studiously avoids forcing countries to choose between the United States and China.”

Rather, in preferring a minimally involved role in the region, China benefits from the U.S. security presence there.

- **“Free riding” on U.S. security efforts**: China is in many ways a “free rider” on U.S. power and influence in MENA, while contributing relatively little to regional security itself. Associate Professor and Deputy Director of the Department of Arabic Language and Culture at Peking University Wu Bingbing asserts, “The United States provides the ultimate strategic security guarantee to Saudi Arabia . . . China lacks the ability to provide such a security guarantee, and is not sure how far the Sino-Saudi friendship can go.”

- **Learning from U.S. military activities**: China’s military since the 1990s has gained insight into modern warfare and, more specifically, U.S. military strategy and capabilities from studying U.S. military campaigns in the Middle East. Dr. Shichor testified to the Commission that MENA is “the key region in the world that serves as a laboratory for testing [and] experimenting . . . with Western weapons [and] state-of-the-art American military technology, which provides a very significant input into China’s defense modernization.”

Recently, however, Beijing has been more willing to assert its priorities and worldview, even at the expense of its broader relationship with the United States. For example, Beijing’s relationship with Tehran and its position on the Syrian conflict undermine U.S. objectives in the region. Dr. Murphy testified that China’s position in the UN Security Council on Syria represents China’s most stringent challenge to the United States in the region to date and suggested China’s position on Syria could represent a turning point in China’s MENA policy toward a greater willingness to assert its own interests even if at the expense of its broader relationship with the United States.

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*Dean Cheng, research fellow at the Heritage Foundation’s Asian Studies Center, similarly asserts that both U.S. wars in Iraq are “very influential” to the PLA’s tactical, operational, and strategic thinking. Dean Cheng, “Chinese Lessons from the Gulf Wars,” in Andrew Scobell et al., *Chinese Lessons from Other People’s Wars* (Carlisle, PA: U.S. Army War College Strategic Studies Institute, November 2011), pp. 153–199.*
China is becoming a more influential power in the region overall by virtue of its growing economic interdependence with the region’s oil producers, particularly Saudi Arabia. According to Dr. Alterman, “Many [MENA] petroleum producers see China as the future, a rising power that will be consuming their oil for decades more. China’s eagerness for economic growth makes [China] a necessarily less fickle power, and one with a reliance on the Middle East that the United States does not share in the same way. Some see the U.S. relationship as something that can only diminish, while the relationship with China is something that will only grow.”

Dr. Murphy testified that alignment in values between the Chinese government and some MENA governments could be a cause for concern in Washington as China’s influence in the region grows. Regarding sovereignty, respect for human rights and democracy, and the role of the state in the economy, Dr. Murphy testified, “Many states in the Middle East share … China’s view of the world on those issues more than they share the U.S. view.” This kind of ideological alignment could have implications for relative U.S. and Chinese influence in the region in the future.

Conclusions

- China is expanding and deepening its trade and investment ties with countries in MENA. More than half of China’s crude oil imports are from MENA producers, and China increasingly looks to the region as an export market for manufactured goods and services.

- Energy security is a key driver of China’s engagement in MENA. As China’s continued economic growth becomes more dependent on a steady supply of oil and natural gas from the region, Beijing likely will augment already robust economic ties with stronger political and security engagement.

- China, driven primarily by its growing demand for energy, seeks to promote a framework for stability in MENA that supports its own economic, political, and security interests. These efforts include supporting the resolution of the Israeli-Palestinian conflict, conducting counterpiracy operations, and participating in UN peacekeeping missions. Conversely, China’s position on the Syrian conflict and its support for Iran undermine peace and stability in the region.

- China struggled to diplomatically adapt to regime changes across MENA during and after the Arab Spring. Beijing’s instinct has been to support sitting regimes in Egypt, Libya, and Syria and to oppose international intervention in these countries.

- Most MENA governments appear to judge China plays a positive role in the region. Oil- and natural gas-producing states in particular look to China as their future primary market. Moreover, governments in China and some MENA countries appear to share similar stances on issues of sovereignty, human rights and democracy, and the role of the state in the economy. However, many MENA countries have criticized China for its support for the Assad regime in Syria.
• Historically, China largely has avoided challenging U.S. influence and power in the Middle East. In recent years, however, when key Chinese interests are at stake, China has made use of its permanent membership in the UN Security Council to oppose U.S. policies and objectives in the region.
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SECTION 2: TAIWAN

Introduction

This section—based on the Commission’s meetings with Taiwan officials in Washington and Taipei and independent research—examines cross-Strait relations; Taiwan’s international space; Taiwan’s role in the East and South China Sea disputes; U.S.-Taiwan relations; and cross-Strait military and security issues. The section concludes with a discussion of the implications of the current cross-Strait dynamic for the United States.

Cross-Strait Relations

Diplomatic Affairs

During the Chinese Communist Party’s (CCP) 18th Congress in November 2012, outgoing CCP General Secretary Hu Jintao expressed hope that China and Taiwan “would jointly explore cross-Strait political relations and make fair and reasonable arrangements for them.” Mr. Hu also called for both sides to “discuss the development of a [cross-Strait] military confidence-building mechanism” and “reach a peace agreement,” though he did not provide timelines to achieve these objectives. Mr. Hu’s remarks generated concern in Taiwan that China’s incoming leadership might seek to shift the focus of cross-Strait diplomatic relations from economic to political and security issues. However, Beijing has signaled in subsequent public statements its near-term preference to avoid more sensitive areas and concentrate on sustaining progress on cross-Strait economic agreements.

In a July 2013 meeting, Taiwan President Ma Ying-jeou told the Commission that his agenda for cross-Strait diplomatic relations during his second term includes securing follow-on agreements to the Economic Cooperation Framework Agreement (ECFA) signed between the two sides in 2010, expanding cross-Strait educational exchanges, and establishing reciprocal representation offices. President Ma has indicated “the time is not yet ripe for both countries to speak of political dialogue” on unification. He has not discounted meeting President Xi before the end of his second term but said in July 2013 such a meeting would be conditional on “whether [Taiwan] needs it, whether the [Taiwan] people support it, [and] that we can meet with dignity.”

Since the Commission’s 2012 Report, Taiwan’s semiofficial Straits Exchange Foundation (SEF) and its Chinese counterpart, the Association for Relations across the Taiwan Strait (ARATS), facilitate cross-Strait negotiations and manage cross-Strait relations in the absence of formal ties between the governments of Taiwan and China.
held talks from June 20 to June 22 in Shanghai. This meeting, the ninth round of SEF–ARATS talks since May 2008, resulted in a major agreement on trade in services. See below for full treatment of this agreement.

Talks between Taiwan's ruling Kuomintang (KMT) party and the CCP picked up after a brief slowdown around the CCP's 18th Party Congress in November 2012. Former Taiwan Vice President (1996–2000) and KMT party elder Lien Chan in February 2013 visited Beijing to meet with then President Hu and incoming president Xi Jinping. In June 2013, former KMT Chairman Wu Poh-hsiung (2007–2009) met with President Xi. In the absence of formal diplomatic ties, this party-to-party dialogue serves as a way for China and Taiwan to relay high-level information. Taiwan's main opposition party, the Democratic Progressive Party (DPP), has criticized KMT–CCP talks on grounds they are secretive and have not been authorized by the Taiwan people or Taiwan's legislature.

Some prominent DPP members have publicly tied the party's defeat in Taiwan's 2012 presidential election to voter concerns that cross-Strait relations would deteriorate under a DPP administration. In response, the DPP has taken several actions designed to boost the party's image as a viable alternative to the ruling KMT and improve the Taiwan public's perception of its ability to interact with China.

- **Developing a new policy for cross-Strait engagement:** In November 2012, the DPP established the China Affairs Committee to formulate a new policy for cross-Strait engagement. Nine prominent DPP members, including Party Chairman Su Tseng-chang and former DPP presidential candidate Tsai Ing-wen, compose the committee. At its first meeting in May 2013, Chairman Su said the party's China agenda will be guided by a “new type of framework and thinking involving: how to persist and make the Taiwan Dream a reality, how to open a new order for cross-Strait interaction and how to contribute to regional stability and peace.”

- **Building cross-Strait ties:** In October 2012, Frank Hsieh, the DPP's 2008 presidential candidate, visited Xiamen and Beijing to meet with academics and high-ranking Chinese officials involved in cross-Strait affairs. According to Mr. Hsieh, the trip was intended as the “first step for bilateral exchanges” between the DPP and China. Mr. Hsieh added, “Cross-Strait engagement cannot be monopolized by the [KMT]. The DPP cannot stand still and neither should it be marginalized from the platform of bilateral dialogue.” Since then, more high-profile DPP officials have visited China. A spokesperson for China's Taiwan Affairs Office said it is “more than happy to help” DPP members visit China and that “any discussion, seminar, cooperation, or political talks that may help increase or elevate cross-Strait relations will be welcomed.”

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*The Taiwan Affairs Office is an agency within China's State Council that is responsible for overseeing China's cross-Strait policies.*
China's New Passport Design Creates Controversy in Taiwan

In May 2012, China introduced a new passport design that includes images of two popular tourist sites in Taiwan and depicts Beijing’s South China Sea claims.* Taiwan’s Mainland Affairs Council † responded with a strong statement: “[China’s] inclusion of photographs of Taiwan’s territory and landscape entirely ignores existing facts and provokes controversy, while at the same time not only harms the foundation of mutual trust established through efforts by the two sides over the recent years, but also hurts the feelings of Taiwan’s 23 million people. [China’s] action is absolutely unacceptable to the [Taiwan] government.” ¹³

Many South China Sea claimants harshly criticized China’s new passports. Vietnam and the Philippines are not stamping the new passports and instead are issuing separate visa sheets. The Mainland Affairs Council explained that since Taiwan does not recognize China’s passports, it could not take similar measures to protest the new design. A council official also said, “Since the entry papers of Chinese citizens bear the full name of [Taiwan] and its national flag, it is sufficient declaration of our nation’s autonomy.” After pressure from opposition legislators, a Mainland Affairs Council spokesperson in December 2012 said Taiwan would develop “countermeasures in response to the passport issue.”¹⁴ However, as of the writing of this Report, Taiwan has yet to announce these countermeasures.

Trade

From January through July 2013 (the most recent months for which official statistics are available), the total value of trade between China ‡ and Taiwan was $71.8 billion. The total value of cross-Strait trade during this period grew by 2.79 percent compared to the same period in 2012. Through the first seven months of 2013, China remained Taiwan’s largest export market, accounting for approximately $47.3 billion worth of exports (26.9 percent of Taiwan’s total exports). China followed behind Japan as Taiwan’s second largest source of imports, accounting for approximately $24.5 billion worth of imports (15.5 percent of Taiwan’s total imports).¹⁵ See figure 1 for Taiwan’s trade with China from 2008 to 2012.

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* Taiwan does not recognize China’s passports. Chinese citizens visiting Taiwan must apply for a “compatriot pass” issued by Taiwan’s National Immigration Agency.
† The Mainland Affairs Council is a cabinet-level agency in Taiwan’s executive branch that is responsible for overseeing Taiwan’s cross-Strait policies.
‡ Throughout the trade and investment subsections, “China” excludes Hong Kong and Macau.
In 2012, China’s gross domestic product (GDP) was approximately $8.2 trillion while Taiwan’s GDP was approximately $474 billion, according to the International Monetary Fund. On a per capita basis (purchasing power parity), China and Taiwan’s GDPs were $9,055 and $38,356, respectively.*

**Investment**

Although China remained the top destination for Taiwan foreign direct investment (FDI) in 2012, Taiwan’s approval of $10.9 billion in investments in China in 2012 represented a 16.6 percent decrease from the previous year and a three-year low. From January through July 2013, the value of Taiwan FDI to China continued to decrease, slipping 17.23 percent from the previous year. Officials at the American Institute in Taiwan (AIT), which serves as the de facto U.S. embassy in Taiwan, told the Commission that Taiwan businesses increasingly are looking for investment opportunities in Southeast Asia, Africa, and Latin America as manufacturing costs in China continue to rise.

Mainland investment in Taiwan continued to grow in the first seven months of 2013, with the value of investments increasing 79.34 percent compared to the same period in 2012. In 2012, Chinese FDI in Taiwan totaled $328.1 million, a 650 percent increase from the previous year. The growth in 2012 was due largely to a $139 million investment by state-owned China Ocean Shipping...
Economic Agreements

Since President Ma’s first term began in 2008, Taiwan and China have signed several agreements that have deepened and broadened cross-Strait economic relations. Most importantly, the two sides in June 2010 signed the ECFA, which serves as a roadmap for future economic integration through a series of four major follow-on agreements concerning investment protection, trade in goods, trade in services, and trade dispute settlement.\textsuperscript{20} Since the Commission’s 2012 Report, China and Taiwan have made further progress toward developing and implementing the ECFA follow-on agreements as well as advancing economic cooperation in other areas.

• Trade promotion offices: Taiwan opened its first trade promotion office in Shanghai in December 2012 and since then has established offices in Beijing and Guangzhou.\textsuperscript{21} China opened its first trade promotion office in Taipei in January 2013.\textsuperscript{22} These offices are designed to facilitate cross-Strait trade, primarily in the service sector, by providing local market information, product advertising, and consulting services to their side’s businesses.

• Trade in goods agreement: As part of the ECFA, Taiwan and China agreed to reduce and gradually eliminate tariffs on select imports. The final group of these “early harvest” items became tariff free on January 1, 2013. Through this arrangement, China has removed tariffs on 539 items imported from Taiwan while Taiwan has removed tariffs on 267 items imported from China.\textsuperscript{23} Taipei and Beijing intend to build on this progress by completing a more comprehensive trade in goods agreement, which President Ma told the Commission he hopes the two sides will sign by the end of 2013.

• Currency clearing agreement: In January 2013, Taiwan and China signed a direct currency clearing agreement. This followed an August 2012 memorandum of understanding on the subject between both sides’ central banks.\textsuperscript{24} In the past, Taiwan banks were not allowed to conduct transactions in China’s renminbi (RMB), and China’s banks were not able to deal in Taiwan’s New Taiwan Dollar (NTD). As a result, trade deals or money transfers were initially denominated in a third currency (usually the U.S. dollar) and then converted to the local currency. Designated Chinese banks in Taiwan began conducting RMB transactions in February 2013, and designated Taiwan banks in China began conducting NTD transactions in April 2013.\textsuperscript{25}

• Trade in services agreement: In June 2013, Taiwan and China signed a services trade agreement to eliminate investment restrictions and other barriers across 11 service sectors in both countries. Taiwan investors will gain access to 80 service sub-
sectors in China, including those in e-commerce, printing, construction, transportation, tourism, entertainment, and funeral services. In return, Chinese investors will gain access to 64 service subsectors in Taiwan, including those in car rental, cargo transportation, beauty parlors, online gaming, and funeral services. As of the writing of this Report, Taiwan's legislature has not yet ratified the agreement due to political and public opposition.

- **Trade dispute settlement mechanism:** Taiwan and China in 2013 continued to discuss a mechanism to help resolve trade disputes between the two sides that might arise from the interpretation, implementation, and application of the ECFA follow-on agreements. This subject is on the agenda for the next SEF–ARATS meeting.

### Taiwan's International Space

Beijing's insistence on the “one China principle” precludes any country or international organization from simultaneously recognizing China and Taiwan, thereby restricting Taiwan's full participation in the international community. Nevertheless, Taiwan pursues greater international space by maintaining its official diplomatic relations with 23 countries, expanding its participation in international organizations, and strengthening economic partnerships with countries other than China.

In 2008, China and Taiwan reached a tacit understanding—or what President Ma unilaterally declared to be a “diplomatic truce”—to stop poaching each other's diplomatic partners in order to maintain positive momentum in the cross-strait relationship. China appears to have adhered to this diplomatic truce during President Ma's first term, though Beijing's March 2013 call for the Vatican to sever ties with Taiwan shortly before President Ma's trip to the city-state for the Investiture Mass of Pope Francis runs counter to the tacit agreement. It is not clear if this action signaled a policy shift or was motivated by other factors, such as Beijing's longstanding rift with the Vatican.

China continues to attempt to restrict Taiwan's participation in international organizations and activities. For example, Beijing pressured Indonesia to discourage Taiwan from attending the Jakarta International Defense Dialogue in March 2013. Taiwan ultimately did not participate in the event. In another instance, China boycotted Japan's March 2013 commemorative ceremony for the 2011 Tohoku earthquake after Tokyo invited Taiwan to attend the event. Tokyo had faced domestic criticism for excluding Taiwan, the largest aid donor following the earthquake, from 2012's commemorative ceremony. China's Ministry of Foreign Affairs said Tokyo's decision to invite Taiwan “violated the principles and spirit of the China-Japan Joint Statement and the commitments of the Japanese side.”

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*The following 23 countries have official diplomatic relations with Taiwan: Belize, Burkina Faso, the Dominican Republic, El Salvador, the Gambia, Guatemala, Haiti, the Holy See, Honduras, Kiribati, the Marshall Islands, Nauru, Nicaragua, Palau, Panama, Paraguay, Saint Christopher and Nevis, Saint Lucia, Saint Vincent and the Grenadines, São Tomé and Príncipe, Solomon Islands, Swaziland, and Tuvalu.*
Nevertheless, Taiwan has made important progress on issues affecting its international space. In July 2013, President Obama signed legislation directing the U.S. Secretary of State to “develop a strategy to obtain observer status for Taiwan in the ICAO.” The president of the UN’s International Civil Aviation Organization (ICAO) in September 2013 invited a Taiwan delegation to attend the upcoming ICAO assembly as his “guests.”

Furthermore, Taiwan has advanced its international trade ties. Taiwan and New Zealand signed a free trade agreement in July 2013, which marks Taiwan’s first such deal with a country with which it does not have official diplomatic relations; Taiwan and Singapore agreed in principle to a free trade agreement in May 2013; and Taiwan is participating in negotiations with 22 other World Trade Organization members, including the United States, on a multilateral Trade in Services Agreement.

Taiwan’s Ministry of Economic Affairs told the Commission that Taiwan’s efforts to expand its trade ties with the Asia Pacific region are part of President Ma’s larger push to diversify Taiwan’s economic partners to avoid overreliance on China. Other Taiwan officials explained to the Commission that the agreements will help promote Taiwan’s inclusion in Asia’s broader economic integration, including participation in multilateral trade pacts such as the Trans-Pacific Partnership and the Regional Comprehensive Economic Partnership.

Taiwan’s Role in the East and South China Seas Disputes

Taiwan claims “historic” sovereignty over the Senkaku Islands (known as Diaoyutai in Taiwan) in the East China Sea and over all of the South China Sea. Japan objects to Taiwan’s East China Sea claims; Brunei, Malaysia, Philippines, and Vietnam object to Taiwan’s South China Sea claims. Taiwan thus far has called for peaceful solutions and joint development of resources to avoid escalation of tensions while defending its own territorial claims. Although Taiwan and China have not openly denied each other’s claims since doing so would raise the sensitive issue of the definition of “one China,” there is no evidence the two countries are cooperating in their positions or approaches to the maritime disputes.

East China Sea

On April 10, 2013, Taiwan and Japan signed a fisheries agreement after 17 years of intermittent negotiations. The agreement, concluded before the start of the annual fishing season, delineates a broad fishing zone of 1,750 square miles near the Senkakus—with the exception of the islands’ 12 nautical mile territorial waters—where Taiwan and Japanese fishing boats can operate freely. It includes no reference to sovereignty over the disputed territory. President Ma said the agreement demonstrates Taiwan’s constructive role in reducing tension in the East China Sea without compromising Taiwan’s maritime claims and could be used as a blueprint and impetus for a similar agreement between Taiwan and other countries with claims in the South China Sea.
Beijing said it was “extremely concerned” about the agreement and urged Tokyo to “earnestly abide by its promises on the Taiwan issue.” After the signing of the fisheries agreement, Beijing also reiterated its call for China and Taiwan to “safeguard the overall interests of the Chinese nation.”

South China Sea

In the South China Sea, Taiwan adheres to the principles of the 2002 Declaration on the Conduct of Parties in the South China Sea.* However, Taiwan’s political status precludes it from signing it or participating in any formal cooperation with other claimants in the region. Taiwan administers Itu Aba Island (also known as Taiping) and Pratas Reef (also known as Dongsha) and stations 100 to 150 Coast Guard personnel on each island to enforce local fisheries, conduct search and rescue, and demonstrate Taiwan’s sovereignty. In 2013, Taiwan announced plans to upgrade Itu Aba by building a new wharf able to accommodate larger, more capable naval and maritime law enforcement ships. Currently, only small patrol craft can dock at the island. Furthermore, a greater capacity to dock larger ships will facilitate the planned extension of Itu Aba’s existing runway by about 20 percent. The longer runway will allow larger and heavier military aircraft to take off and land there. See figure 2 for a map of Taiwan-controlled islands in the South China Sea.

In March 2013, the Philippine Coast Guard opened fire on a Taiwan fishing boat operating in disputed waters in the South China Sea, resulting in the death of a Taiwan fisherman and sparking a diplomatic row with Taiwan. Manila and Taipei both claim the incident took place within their respective exclusive economic zones † in the South China Sea. According to an AIT brief to the Commission, there is a long history of Philippine fishermen harassing Taiwan fishermen in the South China Sea, and this incident pushed Taiwan to a breaking point.

In the initial aftermath of the shooting, Taiwan called for the Philippines to issue a formal government apology, pay compensation to the victim’s family, punish the perpetrators, and initiate cooperative fishery talks. After it claimed the Philippines failed to adequately address its demands, Taiwan stopped accepting new Filipino labor applications; ‡ suspended trade, fishery, and technology exchanges with the Philippines; and removed the Philippines from Taiwan’s visa waiver program. Taiwan also deployed two naval ships and four maritime law enforcement ships to the disputed waters. Taiwan removed the sanctions in August after the Philippines offered an official apology on behalf of the Philippine president, agreed to pay compensation to the victim’s family, and

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* A 2002 Declaration on the Conduct of Parties in the South China Sea adopted by China and the Association of Southeast Asian Nations encourages claimants to, among other measures, exercise self-restraint in occupying any previously unoccupied land features in disputed waters in order to avoid escalating ongoing disputes.
† According to the United Nations Convention on the Law of the Sea, a coastal state is entitled to an exclusive economic zone, a 200 nautical mile zone extending from its coastline within which that state can exercise jurisdiction to explore and exploit natural resources, but not full sovereignty.
‡ According to an AIT brief to the Commission, there were approximately 80,000 Filipinos living/working in Taiwan before Taipei stopped accepting new Filipino labor applications.
recommended homicide charges for the Philippine Coast Guard personnel who opened fire on the Taiwan fishing boat.42 Taiwan and the Philippines also are discussing measures to reduce the risk of future incidents and working to establish a bilateral fisheries mechanism.43

Figure 2: South China Sea

Next Media Controversy

In November 2012, Next Media Ltd.—a Hong Kong-based media company that is critical of Beijing—agreed to sell its Taiwan print and television media outlets to a group of Taiwan businessmen with extensive commercial interests in China.44 Before being finalized, however, the $600 million deal required the approval of Taiwan regulators.

Next Media’s sale generated significant public opposition in Taiwan, primarily due to the involvement of Tsai Eng-meng as a principal investor. Mr. Tsai is a pro-Beijing billionaire whose corporation owns Want China Times, one of Taiwan’s four largest newspapers. Freedom of the press advocates and the DPP charged that the deal, if approved, would give Mr. Tsai’s group a near monopoly over Taiwan’s print media as well as provide China greater opportunities to influence the Taiwan media.45

In March 2013, Taiwan’s independent media regulator and anti-trust agency proposed new antimonopoly rules, which apparently scuttled the deal.46 Although Next Media maintains the buyers pulled out from the purchase,47 Taiwan media speculated Mr. Tsai
cancelled the deal because of growing public pressure and concern about a potential government inquiry into his media assets.\textsuperscript{48}

\textbf{U.S.-Taiwan Relations}

\textit{Taiwan’s Role in the U.S. Rebalance to Asia}

In October 2011, then Assistant Secretary of State for East Asian and Pacific Affairs Kurt Campbell testified to the U.S. House of Representatives, Foreign Affairs Committee that “an important part of this turn to Asia is maintaining a robust and multidimensional unofficial relationship with Taiwan.”\textsuperscript{49} Since then, however, U.S. officials appear to have avoided making explicit references to Taiwan’s actual or potential role in the U.S. rebalance to Asia in public statements. For example, U.S. Secretary of Defense Chuck Hagel in a June 2013 speech on the rebalance limited his remarks on Taiwan to the following: “The United States strongly supports the efforts made by [China] and Taiwan in recent years to improve cross-Straits relations. We have an enduring interest in peace and stability in the Taiwan Strait. The United States remains firm in its adherence to a one-China policy based on the three joint U.S.-China communiqués and the Taiwan Relations Act.”\textsuperscript{50}

Some U.S. security experts propose a more prominent role for Taiwan in the U.S. rebalance to Asia. According to Michael Mazza, research fellow at the American Enterprise Institute:

\begin{quote}
Taiwan’s potential role in the U.S. pivot to Asia has been largely ignored . . . Because of its proximity to and knowledge of China, Taiwan is uniquely equipped to help U.S. efforts to (1) expand presence and access in the region by ensuring U.S. forces can utilize facilities on the island in the event of a conflict; (2) build partnership capacity by improving its self-defense capabilities; and (3) improve military innovation by sharing experience, technology, and intelligence with the United States. Rather than fearing damaging bilateral ties with China, the United States should take advantage of the benefits this important partnership can offer.\textsuperscript{51}
\end{quote}

Similarly, Mark Stokes, executive director of the Project 2049 Institute, and L.C. Russell Hsiao, research fellow at the Project 2049 Institute, argue:

\begin{quote}
Taiwan should be the central guiding focus of defense planning in the Asia Pacific region . . . Taiwan is the principal security partner in the region that is willing and able to develop the kind of force needed for networked, integrated deep interdiction operations in an [antiaccess/area denial] environment. Taiwan’s knowledge of single points of failure in the PLA’s air and missile defense system could someday save many lives. Maintaining Taiwan’s capacity to interdict single points of failure in the PLA’s [antiaccess/area denial] system could relieve the United States of part of its heavy operational burden and reduce risks of escalation . . . [Furthermore], Taiwan is uniquely positioned to contribute to regional situational awareness of the air, space, sea and cyber domains.\textsuperscript{52}
\end{quote}
**Diplomatic Affairs**

In February 2013, AIT and the Taipei Economic and Cultural Representative Office in the United States (TECRO) signed an updated agreement on reciprocal privileges and immunities. The agreement, which replaces the 1980 agreement on this subject, enhances legal protection for AIT personnel in Taiwan and TECRO personnel in the United States. Specifically, according to the U.S. Department of State, certain AIT and TECRO employees now have “expanded protection from criminal jurisdiction and arrest as well as specified immunities from providing testimony.”53 Previously, these personnel only had such protections within the scope of authorized work functions.

**Democratic Progressive Party Outreach to Washington**

The opposition DPP has increased engagement with the United States to repair perceived damage to bilateral ties and to “rebrand” the party’s image as a “responsible” alternative to the ruling KMT.54 DPP Chairman Su Tseng-chang visited Washington, DC in June 2013 to inaugurate the DPP’s new representative office * and to build closer ties with the United States. During a speech at the Brookings Institution, DPP Chairman Su said, “Friends here are anxious to learn how the DPP plans to manage Taiwan’s relations with China. Past history has left its imprint and the DPP has to work hard to regain the confidence of our international friends.”55

**Trade**

In March 2013, the United States and Taiwan held the first round of talks under the Trade and Investment Framework Agreement (TIFA)† since 2007. Talks had stalled over Taiwan’s ban on importing U.S. beef containing ractopamine, a common feed additive,‡ but resumed after Taiwan’s legislature lifted some restrictions on the use of ractopamine in beef in July 2012. However, Taiwan’s ban on ractopamine in pork remains in place and could hinder future U.S.-Taiwan trade talks.

According to the Office of the U.S. Trade Representative, the March TIFA meeting, held in Taipei, “produced numerous results, including new joint statements on investment principles and information and communication technology services, and the launch of new TIFA working groups on investment and technical barriers to trade.” Taiwan also agreed to “conduct bilateral technical exchanges to facilitate the establishment of science-based maximum residue levels for pesticides.”56 In a meeting with the Commission, President Ma said Taiwan hopes TIFA talks will lead to negotiations on a U.S.-Taiwan investment agreement and Taiwan’s participation in the Trans-Pacific Partnership. Officials from Taiwan’s

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†The Trade and Investment Framework Agreement, established in 1994, serves as the primary mechanism for the United States and Taiwan to discuss trade- and investment-related issues in the absence of official diplomatic ties.
‡The chemical ractopamine is used as a feed additive for livestock, intended to increase muscle size and leanness in livestock such as cattle and pigs. The U.S. government has approved the use of ractopamine since 2003 and has declared that meat from animals fed the additive is safe for human consumption.
Ministry of Economic Affairs acknowledged to the Commission that developing a bilateral investment agreement with the United States would be difficult due to Taiwan’s political status but said they believed U.S. congressional members supported the agreement.

The new TIFA working group on investment held its first meeting in September. According to U.S. Deputy Assistant Secretary of State for East Asian and Pacific Affairs Kin Moy, “There was a discussion on promoting a transparent and predictable investment regime, and an exchange of preliminary views on a potential U.S.-Taiwan Bilateral Investment Agreement.”57 The new TIFA working group on technical barriers to trade is scheduled to meet in October. The next full TIFA meeting will occur in 2014 in Washington, DC.58

**U.S. Arms Sales to Taiwan**

Taiwan continues to be one of the largest buyers of U.S. arms in the world and is the largest in Asia. Since President Ma assumed office in 2008, Taiwan has agreed to purchase approximately $18.3 billion of U.S. arms. In August 2013, President Ma said, “Although cross-Strait relations have gradually eased and cross-Strait relations are now the most peaceful in more than six decades, we still cannot afford to be lax in terms of combat readiness … [Taiwan] will continue to purchase U.S.-built weapons that [Taiwan] cannot produce on [its] own.”59 Responding to concerns about the impact of Taiwan’s declining defense budget on U.S.-Taiwan arms sales, Taiwan’s Ministry of Defense said it will “increase the budget or apply for special funds from the [Taiwan legislature] if the United States agrees on more arms sales to Taiwan.”60 See figures 3–4 for more details on U.S. arms sales to Taiwan.

**Figure 3: Value of U.S. Arms Sales Notifications to Taiwan**

<table>
<thead>
<tr>
<th>Year</th>
<th>Value of Arms Sales Notification (billion USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>1.082</td>
</tr>
<tr>
<td>2002</td>
<td>1.521</td>
</tr>
<tr>
<td>2003</td>
<td>0.775</td>
</tr>
<tr>
<td>2004</td>
<td>1.776</td>
</tr>
<tr>
<td>2005</td>
<td>0.280</td>
</tr>
<tr>
<td>2006</td>
<td>—</td>
</tr>
<tr>
<td>2007</td>
<td>3.717</td>
</tr>
<tr>
<td>2008</td>
<td>6.463</td>
</tr>
<tr>
<td>2009</td>
<td>—</td>
</tr>
<tr>
<td>2010</td>
<td>6.392</td>
</tr>
<tr>
<td>2011</td>
<td>5.852</td>
</tr>
</tbody>
</table>

**Figure 4: U.S. Arms Sales to Taiwan**

<table>
<thead>
<tr>
<th>Year of Notification</th>
<th>Weapon, Item, or Service ‡</th>
<th>Projected Value (million USD)* †</th>
<th>Status</th>
<th>Delivery</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>330 PAC–3 missiles and firing units</td>
<td>3,100</td>
<td>Not delivered</td>
<td>Beginning in 2014§‡</td>
</tr>
<tr>
<td>2008</td>
<td>32 UGM–84L Harpoon missiles</td>
<td>200</td>
<td>Not delivered</td>
<td>Expected in 2013</td>
</tr>
<tr>
<td>2008</td>
<td>182 Javelin missiles and command launch units</td>
<td>47</td>
<td>Delivered</td>
<td>2011</td>
</tr>
<tr>
<td>2008</td>
<td>Four E–2T aircraft refurbishment and upgrades</td>
<td>250</td>
<td>Completed</td>
<td>2011–2013†‡</td>
</tr>
<tr>
<td>2010</td>
<td>114 PAC–3 missiles and firing units</td>
<td>2,810</td>
<td>Not delivered</td>
<td>Beginning in 2014§‡</td>
</tr>
<tr>
<td>2010</td>
<td>60 UH–60M Black Hawk helicopters</td>
<td>3,100</td>
<td>Not delivered</td>
<td>2014–2018§‡</td>
</tr>
<tr>
<td>2010</td>
<td>12 ATM–84L and RTM–84L Harpoon missiles</td>
<td>37</td>
<td>Unknown</td>
<td>Unknown</td>
</tr>
<tr>
<td>2010</td>
<td>60 MIDS/LVT–1 terminals to improve F–16A/B C4ISR§ systems</td>
<td>340</td>
<td>Not delivered</td>
<td>Unknown</td>
</tr>
<tr>
<td>2010</td>
<td>Two OSPREY-class mine hunting ships (refurbishment and upgrades)</td>
<td>105</td>
<td>Delivered</td>
<td>2012§‡</td>
</tr>
<tr>
<td>2011</td>
<td>145 F–16/AB aircraft refurbishment and upgrades</td>
<td>5,300</td>
<td>Not complete</td>
<td>2016–2017</td>
</tr>
<tr>
<td>2011</td>
<td>F–16 pilot training</td>
<td>500</td>
<td>Ongoing</td>
<td>Not applicable</td>
</tr>
<tr>
<td>2011</td>
<td>Spare parts for F–16A/B, F–5E/F, C–130H, and IDF aircraft</td>
<td>82</td>
<td>Ongoing</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

* These values represent amounts as presented to Congress at the time of notification, which may differ from the actual amount Taiwan pays for the weapon, item, or service.
† These are the weapons, items, and services as presented to Congress at the time of notification, which may differ from the actual weapons, items and services that the United States ultimately sells to Taiwan.
‡ Consistent with Figure 3, these values represent amounts as presented to Congress at the time of notification, which may differ from the actual amount Taiwan pays for the weapon, item, or service.
§ C4ISR refers to command, control, communications, computers, intelligence, surveillance, and reconnaissance.

**Cross-Strait Military and Security Issues**

**Military Balance**

Since the late 1990s, China’s military modernization has focused on improving its capabilities for Taiwan conflict scenarios that in-
clude U.S. intervention. This modernization program likely is designed to hedge against a failure of China's cross-Strait diplomatic strategy; deter Taiwan from taking steps toward de jure independence; signal to the United States that China is willing to use force against Taiwan if necessary; and enhance China's ability to deter, delay, or deny any U.S. intervention in a cross-Strait conflict.

China's People's Liberation Army (PLA) is more prepared than in the past to conduct several different military campaigns against Taiwan, including a partial naval blockade and a limited air and missile campaign.

- China has a large and sophisticated short-range ballistic missile (SRBM) force, including over 1,100 mobile SRBMs that are positioned in southeast China and able to strike Taiwan. China continues to improve the range, accuracy, and payloads of its SRBMs with the introduction of new missiles or variants and component upgrades.66

- The PLA has approximately 2,300 combat aircraft capable of participating in large-scale air operations, 490 of which are based within range of Taiwan. By contrast, the Taiwan Air Force has approximately 410 combat aircraft.67

- The PLA Navy has approximately 75 major surface combatants, 85 missile patrol boats, and 60 conventional and nuclear submarines. These units are available for a range of missions, such as enforcing a blockade of Taiwan. As China's naval modernization continues, an increasing percentage of these ships and submarines will feature advanced weaponry. In contrast, the Taiwan Navy has 26 major surface combatants, 45 missile patrol boats, and two operational submarines.68

- Although China at this time does not appear to be pursuing the amphibious capabilities necessary to conduct a large-scale invasion of Taiwan, the PLA Navy since 2008 has commissioned three new amphibious transport docks. These large amphibious ships—which can carry a mix of air-cushion landing craft, amphibious armored vehicles, helicopters, and marines—improve China's ability to seize and hold Taiwan's offshore islands.69

Furthermore, major elements of China's military modernization focus on developing long-range strike capabilities to place U.S. ships, aircraft, and bases in the Western Pacific at risk. (See chapter 2, section 1, "Military and Security Year in Review," for full treatment of China's antiaccess/area denial capabilities.)

Taiwan's ability to defend against China's growing military capabilities is declining. The key shortcomings in Taiwan's defensive capabilities are its insufficient infrastructure hardening and lack of mobile systems.70 For example, Taiwan relies on fixed land-based coastal surveillance radars for maritime surveillance. The PLA likely would destroy these vulnerable sites during initial air and missile strikes in a campaign against Taiwan, severely degrading Taiwan's ability to defend itself. China's overwhelming quantitative and qualitative advantage over Taiwan also would challenge the Taiwan military's ability to sustain high-intensity operations during a conflict.
Defense Spending Trends

Cross-Strait defense spending trends since 2001 have dramatically shifted in China’s favor. The officially reported budget gap in 2013 totaled more than $100 billion.

China’s official defense budget rose to approximately $117 billion in 2013 from $106 billion in 2012, marking the 22nd consecutive year-on-year increase. Furthermore, China’s total defense-related expenditure likely is significantly higher than the official budget figure. The Institute of International Strategic Studies assesses China’s actual defense spending is 40 to 50 percent higher than the official figure. Most analysts expect China’s defense spending will continue to grow steadily in the near term, even if economic growth slows. (See chapter 2, section 1, “Military and Security Year in Review,” for full treatment of China’s 2013 defense budget.)

Taiwan’s defense budget, on the other hand, continues to decline. Taiwan’s official defense budget contracted to $10.5 billion in 2013 from $10.6 billion in 2012. Taiwan’s 2013 defense spending represents 2.1 percent of its GDP, a record low matched only in 2006 and 2011. This is less than 3 percent of GDP—the level at which President Ma pledged to maintain defense spending—and marks a substantial decrease from 3.8 percent of GDP in 1994. Furthermore, 2013 defense spending accounts for only 16.2 percent of the total government budget, down from 24.3 percent in 1994. In response to concerns about Taiwan’s declining defense budget relative to GDP, President Ma has explained defense spending cannot be expected to keep pace with Taiwan’s GDP growth. Taiwan’s GDP growth rate was 10.7 percent in 2010, 4 percent in 2011, and 1.3 percent in 2012.

Taiwan’s defense spending likely will remain stagnant through at least the end of President Ma’s term in 2016 as he continues to implement a strategy he described to the Commission as the “institutionalization of rapprochement as the first line of defense.” Moreover, President Ma has little incentive to increase the defense budget, since improved cross-Strait relations have reduced public perceptions of the China threat in Taiwan while domestic and social welfare issues have become more salient as Taiwan’s economy attempts to recover from the global financial crisis and its workforce ages. U.S. officials and outside observers suggest that if this trend continues, then the Taiwan military may struggle to maintain a credible deterrent capability.

Chinese Espionage against Taiwan

Despite warming cross-Strait ties, China continues to engage in aggressive espionage activities against Taiwan. Since September 2012, Taiwan has arrested at least six former or active Taiwan military officers, including one flag officer, for espionage. In one case, a former Taiwan Navy commander, who had served as the head of the political warfare division at Taiwan’s Naval Meteorological and Oceanographic Office, may have provided to China classified submarine nautical charts as well as hydrographic information about the waters surrounding Taiwan. These cases underscore the breadth and depth of China’s espionage activities against Taiwan and demonstrate Taiwan’s vulnerability to espionage.
Former AIT director William Stanton said in March 2013 that espionage cases in recent years “have been harmful not only because of the potential loss of unknown quantities of classified information, but also because their success and frequency serves to undermine U.S. confidence in security cooperation with Taiwan.”79 AIT told the Commission the Chinese espionage threat to Taiwan is “a real concern” that the United States has raised with Taiwan “at the highest levels” but emphasized recent espionage cases do not mean the U.S.-Taiwan arms sale process has been infiltrated.

**Taiwan Defense Policy and Reform**

**Quadrennial Defense Review**

In March 2013, Taiwan published its second Quadrennial Defense Review.*80 The 2013 Quadrennial Defense Review offers no major changes to Taiwan’s defense strategy from the 2009 version. It reiterates President Ma’s emphasis on force preservation and infrastructure hardening while maintaining the ability to combat China’s air and naval forces in the Taiwan Strait. The defense review also endorses and refines key defense reforms that are in various stages of implementation, such as fielding a smaller, better educated, and more effective all-volunteer force and developing and fielding innovative and asymmetric capabilities.

**All-volunteer Force Transition**

Since 2008, Taiwan has been implementing a program to gradually convert its conscript-heavy active duty military into an all-volunteer force. The all-volunteer force transition has been more expensive than anticipated, and the military has had difficulty recruiting high-quality volunteers due to a number of factors, including a declining birth rate, a quickly aging workforce, and a culture that does not hold military service in high esteem. While the all-volunteer force was originally scheduled for completion by the end of 2014, the Taiwan Ministry of National Defense announced in September 2013 that Taiwan will continue to conscript some active duty personnel until 2017 in order to maintain readiness and overcome current manpower shortfalls.61

Taiwan is diverting funds from other portions of the defense budget to ease the rising personnel costs resulting from the all-volunteer transition. Between 2009 and 2013, Taiwan increased the share allocated for personnel by approximately 10 percent while reducing shares allocated for operations and investments.82

The Taiwan military’s ability to attract volunteers may be further hampered by the death of a 24-year old conscript in July 2013. Army Corporal Hung Chung-chiu, found with a banned camera-

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*79 Taiwan began the Quadrennial Defense Review process as a result of 2008 legislation stipulating that the Ministry of National Defense must submit a Quadrennial Defense Review to the legislature no later than 10 months after each presidential inauguration. The Quadrennial Defense Review serves as Taiwan’s most authoritative public statement on its defense strategy and provides the foundation for defense policymaking. Taiwan also uses the Quadrennial Defense Review as a public relations tool to inform and attempt to influence domestic and foreign opinion. The Quadrennial Defense Review is drafted by the Ministry of National Defense’s Integrated Assessment Office and includes input from ministry staff units and agencies, Taiwan’s military services, and civilian experts. Alexander Chieh-cheng Huang, *A Midterm Assessment of Taiwan’s First Quadrennial Defense Review* (Washington, DC: Brookings Institution, February 2011).
equipped mobile phone while on a military base, was placed in solitary confinement for a week and forced to perform strenuous exercises in summertime heat that ultimately caused him to die from heat stroke. An investigation uncovered further hazing and abuses of power by Taiwan military officials. Corporal Hung’s death triggered large public demonstrations against the military, including an August 3 protest near the presidential office in Taipei that drew a crowd of over 100,000. Minister of Defense Kao Hua-chu resigned over the incident, and 18 military officers and noncommissioned officers, including a general officer, were indicted with various crimes for their roles in the soldier’s death. Then Deputy Minister of National Defense Andrew Yang told the Commission that Taiwan must “face the problem [of abuse of power and unprofessionalism in the military], fix it, and take responsibility.”

**Downsizing and Streamlining**

In order to cover the recruitment and retention costs inherent in an all-volunteer force, the Taiwan military is downsizing its active duty force from approximately 270,000 to 215,000. Furthermore, the Taiwan legislature in November 2012 passed six laws that provide the legal foundation to begin streamlining the military’s structure under the “Jingtsui Program.” The most significant change is the planned consolidation of the service branches from six to three. The functions of the Combined Logistics Command, Military Police Command, and Reserve Command will be merged into the remaining service branches—the army, navy, and air force. Other changes include the reduction of general and flag officer billets by approximately 25 percent and the consolidation of the Ministry of National Defense’s six departments into four.

**Integrating Innovative and Asymmetric Capabilities**

Taiwan has focused on integrating innovative and asymmetric platforms and weapon systems into its military since approximately 2009. Taiwan fielded 30 stealthy patrol craft from 2009 to 2011 and 32 unmanned aerial vehicles in 2012 and continues to develop other asymmetric platforms and systems, including unmanned combat aerial vehicles and land attack cruise missiles (LACMs). This approach is designed to improve Taiwan’s ability to defend against the PLA’s rapidly growing capabilities and allow the Taiwan military to target assessed vulnerabilities in the PLA’s strategy and weapon systems. Furthermore, Taiwan judges asymmetric systems will be more cost-effective and will reduce its reliance on major, conventional weapon systems that are expensive, difficult to maintain, and vulnerable to the PLA’s precision strike capabilities.

**Accepting New Missions**

Taiwan’s perception of its security environment has evolved since 2008 due to a number of developments, including the devastation caused by Typhoon Morakot in 2009, heightened tension over maritime territorial disputes in the region, and increased levels of piracy in important maritime trade routes. In response, Taipei is pushing its military to gradually improve its ability to conduct non-
traditional missions, such as humanitarian assistance/disaster relief inside and outside of Taiwan, defense of Taiwan’s sovereignty and commercial interests in the East and South China Seas, and protection of distant maritime trade routes.\textsuperscript{87} As part of its effort to meet these requirements, the Taiwan Coast Guard in March 2013 commissioned the first two ships under a new development program that calls for the construction of 37 new units over the next 10 years.\textsuperscript{88}

\textbf{Strengthening Cyber and Electronic Warfare Capabilities}

China conducts extensive cyber operations against Taiwan’s government and corporate networks. For example, China targeted the publicly accessible websites of Taiwan’s National Security Bureau approximately 3.34 million times in 2012, according to the agency. Taiwan is increasing its budget for cyber warfare, integrating cyber warfare into Taiwan’s routine training and large-scale exercises, adding a fourth unit to the Communication Electronics and Information Bureau, and constructing an “experimental” facility that will simulate cyber attacks on the nation’s critical infrastructure to help train Taiwan’s cyber defenders.\textsuperscript{89}

\textbf{Taiwan’s Military Modernization}

Taiwan continues to domestically produce military platforms and weapon systems. Key programs under development or recently completed include the following:

- \textit{Missile corvette}: Taiwan began work on a prototype of a new class of catamaran-style missile corvette in November 2012. Taiwan plans to build up to 11 corvettes by 2014. The new ship will carry long-range antiship cruise missiles and feature better sea-keeping ability, range, and endurance compared to Taiwan’s current patrol fleet. In a potential conflict with China, the corvette will enhance the lethality and survivability of Taiwan’s antisurface force.\textsuperscript{90}

- \textit{Replenishment oiler}: Taiwan began to construct its long-planned second replenishment oiler in December 2012. The additional oiler, scheduled for completion in 2014, will help the Taiwan Navy sustain operations at sea and improve Taiwan’s ability to conduct humanitarian assistance, presence patrols, and port visits to countries that retain diplomatic relations with Taiwan.\textsuperscript{91}

- \textit{Land attack cruise missiles}: Taiwan began to field its Hsiung Feng (HF)-2E LACM in May 2012, with deployments to three mobile missile squadrons complete by early 2013. The missile’s 375–500 mile range suggests it is designed to strike targets on mainland China, such as airfields and air defense sites. Taiwan also is developing a longer-range LACM, known as the “Yun Feng.” Public information on the Yun Feng is limited, but press reporting indicates it will be able to achieve supersonic speeds and strike targets at twice the range of the HF–2E.\textsuperscript{92}

- \textit{Multiple-launch rocket system}: Taiwan certified its long-delayed Ray Ting (RT)–2000 multiple-launch rocket system dur-
ing an April 2013 military exercise and since has deployed it operationally. In a potential Chinese invasion, the RT–2000 will provide Taiwan with quick-fire capability against Chinese amphibious ships as they cross the Taiwan Strait. With a range of up to 25 miles and a wheeled chassis allowing for easy maneuverability, the RT–2000 is a significant improvement over its predecessor, the Kung Feng VI.93

Taiwan also continues to acquire and pursue military equipment and training from the United States. Select programs include the following:

- **P–3C Orion maritime patrol aircraft:** Taiwan in September 2013 received the first of the 12 refurbished P–3C Orion maritime patrol aircraft that it purchased from the United States in 2007. The aircraft will supplement and ultimately replace Taiwan’s aging S–2T maritime patrol aircraft. The P–3C will increase the capability and endurance of the military’s fixed-wing maritime patrol aircraft force, improving Taiwan’s ability to perform antisubmarine warfare and intelligence, surveillance, and reconnaissance.

- **Apache attack helicopters:** In 2010, the United States agreed to sell 30 AH–64 Block III Apache attack helicopters to Taiwan for $2.04 billion. Taiwan began pilot and crew training in November 2012 and is scheduled to receive the helicopters in groups from October 2013 to July 2014. Taiwan has yet to order the Apache’s principal weapon, the AGM–114L Hellfire missile,94 suggesting Taiwan may be concerned about cost or developing its own missile.

- **PAC–3 missiles:** In January 2013, the United States awarded Lockheed Martin a $755 million production contract to supply Taiwan with 168 Patriot Advanced Capability (PAC–3) missiles and 27 launcher modification kits. Taiwan is scheduled to begin receiving the missiles in early 2014.95 The PAC–3 is an air defense missile designed to intercept aircraft and ballistic and cruise missiles.

- **Submarines:** In 2001, the United States approved Taiwan’s request to purchase diesel-electric submarines via the foreign military sales process. However, the sale has stalled for a number of reasons on both sides. These include partisan political gridlock in Taiwan’s legislature, delays in Taiwan’s commitment of funds, and disagreements between Washington and Taipei over costs. Furthermore, the United States has not built a diesel-electric submarine since the 1950s or operated one since 1990. Multiple reports in recent years claim Taipei is no longer committed to acquiring the submarines from the United States and is considering designing and manufacturing the submarines domestically, with U.S. and possibly other foreign technical assistance. Taiwan officials over the last several years reportedly have met with government officials or commercial entities from a number of countries—including Russia, Greece, Germany, Japan, and Spain—seeking assistance on submarine construction, submarine technology, or the purchase of used submarines.96 Furthermore, Taiwan’s Ministry of Na-
tional Defense in March 2013 announced plans to conduct a feasibility study over the next four years to determine Taiwan’s ability to produce submarines domestically. Taiwan officials continue to stress to the Commission the importance of acquiring submarines. During the Commission’s recent trip to Taiwan in July, Taiwan officials emphasized that the navy’s ability to counter China’s expanding and modernizing submarine fleet will continue to erode as Taiwan’s aging submarine force increasingly is unable to support Taiwan Navy antisubmarine training. Taiwan’s current fleet of four submarines includes two former U.S. boats that were built in the 1940s and transferred to Taiwan in the 1970s.

• **Fighters:** In October 2012, the United States awarded Lockheed Martin a $1.85 billion contract to begin performing a midlife upgrade on Taiwan’s existing fleet of 145 F–16 A/B fighter aircraft. The upgrades will occur from 2017 to 2022 in groups of 24 aircraft. However, many analysts believe the retrofit program does not adequately address all of Taiwan’s air defense requirements. Without additional acquisitions, Taiwan’s fighter force will face substantial numerical shortfalls as Taiwan’s F–5 fighters are retired over the next five to 10 years. In response to Congressional concerns over U.S. arms sales to Taiwan, Robert Nabors, Assistant to the President and Director of the Office of Legislative Affairs, wrote in an April 2012 letter that the Obama Administration is “committed to assisting Taiwan in addressing the disparity in numbers of aircraft through our work with Taiwan’s defense ministry on its development of a comprehensive defense strategy vis-à-vis China.” Mr. Nabors also said the Obama Administration would decide on a “near term course of action on how to address Taiwan’s fighter gap, including through the sale to Taiwan of an undetermined number of U.S.-made fighter aircraft.” This language differs from an earlier White House letter on the subject, which definitively stated the Obama Administration’s position that “the F–16 A/B upgrade effectively meets Taiwan’s current needs.”

• **OLIVER HAZARD PERRY-class guided-missile frigates (FFG):** The U.S. Fiscal Year 2013 National Defense Authorization originally contained provisions authorizing the transfer of up to four surplus PERRY FFG to Taiwan. However, the legislation did not pass due to disagreements over other parts of the bill. Both the 2012 and 2013 versions of the Naval Vessels Transfer Acts called for the transfer of four PERRY FFG to Taiwan, but neither act has been passed. Taiwan currently has eight PERRY FFG, which were partially built in Taiwan in the 1990s and early 2000s with U.S. authorization and assistance. These ships are equipped with U.S. medium-range air defense missiles and indigenous long-range antiship cruise missiles. Additional major surface combatants like the PERRY would replace Taiwan’s KNOX-class frigates, which are scheduled for retirement in the next few years.
Taiwan Military Training

The Taiwan military routinely conducts exercises to train in core combat competencies, integrate new weapon systems and tactics, evaluate and refine operational concepts and plans, and demonstrate to China and the United States that it has a credible deterrent capability. In 2013, high-profile exercises included the following:

- **Han Kuang**: Han Kuang, Taiwan’s only national-level joint exercise, is conducted annually and consists of a field training exercise and a command post exercise. The 2013 field training exercise, which occurred in April, focused on air defense, maritime interdiction, antiamphibious landing, and ground defense. Taiwan media portrayed the event—in which 81 rockets were fired from nine RT-2000 multiple rocket launchers and over 7,500 soldiers participated—as the largest display of force by Taiwan since 2008. The command post exercise, which occurred in July, simulated a full-scale Chinese invasion of Taiwan in 2017 to test the military’s ability to conduct command and control for joint operations.

- **South China Sea Live-Fire Exercises**: In April 2013, the Taiwan Coast Guard conducted its biannual live-fire exercise near Itu Aba. This was the second live-fire drill on the island since Taiwan transferred long-range artillery and mortars there in August 2012 and the first drill in which those weapons were fired.

- **Friendship and Training Cruise**: In spring 2013, the Taiwan Navy conducted its annual Friendship and Training Cruise to the Caribbean and Central America. The deployment, which consisted of two naval combatants and a replenishment ship, called at Belize, Panama, Nicaragua, Honduras, El Salvador, Guatemala, and the Dominican Republic. Taiwan uses these cruises to train for long-distance navigation and strengthen ties with countries that maintain diplomatic relations with Taiwan.

- **Surface-to-Air Missile Test**: In September 2013, the Taiwan Navy successfully fired a Standard Missile 2 (SM-2)—Taiwan’s most capable air defense missile—against a drone target during a simulated Chinese air attack. This is the first time Taiwan has fired a SM-2 since 2007 and only the sixth time since Taiwan acquired the missiles from the United States in the mid-2000s. Taipei-based military analyst J. Michael Cole, citing Taiwan military sources, explains, “Taiwan must first obtain permission from the [United States] before it can proceed with firing the Raytheon Corporation-made fleet area air defense weapon, primarily over fears that the Chinese military will use the occasion to collect sensitive information about the system (Chinese ‘fishing’ vessels, some bristling with antennas, are often spotted in sea areas near where Taiwanese naval exercises are held). Additionally, because of its maximum range of about [105 miles], the [United States] has expressed con-
cerns over the risks involved in firing the weapon, along with the political implications of doing so.”

Implications for the United States

Since 2008, Taipei and Beijing have taken steps to reduce cross-Strait tension and increase economic, cultural, and educational ties. The recent cross-Strait rapprochement benefits the United States by reducing the likelihood of a U.S.-China conflict over Taiwan; contributing to peace, prosperity, and stability in East Asia; and allowing U.S. policymakers to focus their time and attention on other priorities in the U.S.-China and U.S.-Taiwan relationships.

At the same time, warming ties between China and Taiwan raise concerns for Washington and Taipei. Increasing cross-Strait economic integration will continue to tie Taiwan closer to China. This could strengthen China’s bargaining power over Taiwan and allow Beijing to make progress toward its long term goal of unification. Responding to these concerns, officials from Taiwan’s National Security Council insisted to the Commission that Taipei’s economic engagement with Beijing is carefully calibrated to promote both Taiwan’s economic growth and continued autonomy.

Furthermore, the counterintelligence risks to Taiwan and U.S. military information shared with Taiwan are increasing as cross-Strait ties expand and Chinese citizens visit Taiwan in greater numbers. China now has greater access to Taiwan and better opportunities to conduct intelligence operations against Taiwan citizens both in Taiwan and China.

Despite the recent cross-Strait rapprochement, the core sovereignty and security issues between Taiwan and China remain unresolved. China’s military modernization has significantly increased Beijing’s ability to achieve air, sea, and information superiority against Taiwan and to project power across the Taiwan Strait. Furthermore, important elements of the PLA’s modernization are designed to restrict U.S. freedom of action throughout the Western Pacific. These “antiaccess/area denial” capabilities raise the costs and risks to the United States for intervention in a potential Taiwan conflict involving China.

As the cross-Strait military balance of power continues to shift in China’s favor, Taiwan may seek to develop closer political ties with Washington and to acquire additional U.S. arms and related military assistance. Taiwan’s diminishing ability to maintain a credible deterrent capability may provide incentives and create opportunities for Beijing to take on greater risk in its approach to cross-Strait relations, including pressuring Taiwan to move toward political talks or using military force to achieve political objectives.

Conclusions

• Cross-Strait economic, cultural, and educational ties continue to expand and deepen. However, domestic political dynamics and priorities in China and Taiwan still constrain movement on political and security issues.
• Since the Commission’s 2012 report, Taiwan has used creative diplomacy to sign two free trade agreements and secure participation in a key international organization. Taiwan’s expanding international space helps the country counterbalance its economic reliance on China by increasing its competitiveness in the world economy, raises the cost to Beijing of military coercion against Taiwan, and promotes regional stability.

• President Ma since his reelection in January 2012 has accelerated efforts to increase Taiwan's economic engagement with the United States and gain U.S. support for expanding Taiwan's international space while continuing to advocate for future U.S. arms sales.

• Taiwan’s military over the last decade has improved its ability to conduct joint operations and has developed some asymmetric capabilities. However, China’s rapid military modernization during this time has outpaced these improvements and negated many of the military advantages Taiwan previously held over China.
ENDNOTES FOR SECTION 2


32. Congress.gov, “H.R. 1151—To direct the Secretary of State to develop a strategy to obtain observer status for Taiwan at the triennial International Civil Aviation Organization Assembly, and for other purposes.” http://beta.congress.gov/bill/113th/house-bill/1151.


China Brief

February 7, 2013.


Six months earlier, Representative Jim Sensenbrenner (R-WI), Chairman of the House Committee on Armed Services, in an August 2, 2012 statement on the annual Taipei Times poll, highlighted Taiwan’s arms sales to the United States and the public opinion against them. The poll results, released August 1, 2012, show that 61% of respondents disapproved of arms sales to Taiwan, while 15% approved of the sales and 16% were undecided. The President’s announcement of the sales to Taiwan was generating a great deal of attention in the United States, and Representative Sensenbrenner used his statement on the poll to make the following remarks:

On August 9, 2012, a U.S. defense official told Representative Sensenbrenner that he was reassessing the timeline for delivery of the F-16V, and was prioritizing delivery of the F-16V in place of the M-1A2s. Sensenbrenner asked whether the F-16V could be delivered in 2013, and the defense official said that this would depend on the delivery of the F-16V to Taiwan and the United States. On October 29, 2013, the United States Senate Armed Services Committee held a hearing on the F-16V program, which was discussed in this issue. Representative Sensenbrenner asked the Defense Department official whether the plan for the delivery of the F-16V to Taiwan had changed, and whether there were any other changes on the timeline for delivery of the F-16V. The Defense Department official said that the plan for the delivery of the F-16V had not changed, but that the delivery of the F-16V would be delayed until 2014 or later.

On December 17, 2013, Representative Sensenbrenner introduced legislation to allow the United States to sell crude oil to Taiwan. The legislation would allow the United States to sell crude oil to Taiwan, which would benefit Taiwan’s economy and help to strengthen the United States’ relationship with Taiwan. On December 17, 2013, the United States House of Representatives passed the legislation, which would allow the United States to sell crude oil to Taiwan. On December 18, 2013, the United States Senate passed the legislation, which would allow the United States to sell crude oil to Taiwan. On December 19, 2013, the President signed the legislation, which would allow the United States to sell crude oil to Taiwan. On December 20, 2013, the President signed the legislation, which would allow the United States to sell crude oil to Taiwan.


**SECTION 3: MACAU AND HONG KONG**

**Introduction**

China exercises sovereignty over two former European colonies, Macau and Hong Kong. Both former colonies operate as special administrative regions (SAR) of the People's Republic of China (PRC) under the “one country, two systems” framework.* Control of Macau was officially transferred from the Portuguese Republic to the PRC in 1999, and control of Hong Kong reverted from British control to the PRC in 1997. While geographically close, the two former colonies are quite distinct, and the governance issues that Hong Kong presents differ markedly from those of Macau. Whereas Macau has experienced an economic rebirth, with booming prosperity and dramatic reduction in street crime under Chinese rule, Hong Kong was already a well-run, thriving economic powerhouse prior to its handover, and many of its citizens have felt more acutely the drawbacks of living under the new regime. The result, as one former Hong Kong official noted in a July meeting with Commissioners, is that “Macau is the patriotic SAR, while Hong Kong is the defiant one.”

During the 2013 report cycle, the Commission held a hearing in Washington, DC, on June 27 on Macau and Hong Kong. The Commission heard from expert witnesses on the evolution of the gaming industry in Macau and the investments there by three U.S.-based casino companies. The Commission also examined the implications to U.S. regulators and to the U.S.-based casinos of the gaming industry in Macau. The Commission hearing in June included testimony on the efforts in Hong Kong by prodemocracy forces to achieve universal suffrage in the elections of the legislature and executive as promised under Hong Kong’s Basic Law. The Commission examined the increasing police surveillance of the prodemocracy movement and the decline of press freedom in Hong Kong. The Commission also visited Hong Kong in July and met with current and former government officials and representatives of non-governmental organizations.

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*The “one country, two systems” framework is a policy measure adopted by the PRC following the establishment of Hong Kong and Macau as SARs. The system grants Hong Kong and Macau the right to self govern their economy and political system to a certain extent, excluding foreign affairs.*
A Note on this Section

The Commission is not an investigative or regulatory body but functions as a policy advisor to Congress. The purpose of the Commission’s work in holding its June 27 hearing and in traveling to Hong Kong and the People’s Republic of China in July 2013 was to collect information that would enable it to assess the risk to U.S. national and economic security from a variety of perspectives. As in all of its work, the Commission’s ultimate goal is to report to Congress on the topics within its mandate and to make recommendations to Congress for appropriate policy and legislative changes. The Commission did not seek nor did it find evidence of wrongdoing by any U.S.-based casino company, either in Macau or Las Vegas.

Macau’s Economy Depends on Gambling

The gaming sector is the most important element of the Macau SAR economy, and Macau’s government is heavily dependent on a 35 percent tax on gross gaming revenue.\(^2\) Macau’s tax collections from the gaming sector in 2012 totaled $13.9 billion, which accounted for 87.5 percent of total government revenue.\(^3\) As Macau’s gambling sector has grown rapidly, Macau has accumulated the world’s third-largest budget surplus as a percentage of gross domestic product (GDP).\(^4\) Macau’s per capita GDP, at $78,275, is 12 times the size of mainland China’s and considerably higher than that of the United States at $49,964.\(^5\)

Although gambling is illegal on the Mainland (with the exception of state-run lotteries), Beijing allowed Macau’s gaming industry to continue operations following its reversion to PRC sovereignty.\(^6\) Macau’s gaming sector thrived and, in 2006, officially surpassed Las Vegas as the world’s largest gambling market. Macau’s official annual gross gaming revenue is now more than six times that of Las Vegas, surpassing $38 billion in 2012.\(^7\) Taking off-book profits into consideration, the actual gaming market is estimated to be much higher. During the Commission’s trip to Hong Kong in July 2013, Steve Vickers, former head of the Royal Hong Kong Police’s Criminal Intelligence Bureau and an acknowledged authority on Macau’s gaming sector and Asian organized crime issues, estimated that the real value of Macau’s gaming industry is likely six times larger than the official reported size, making the actual market worth more than $200 billion, over four times Macau’s 2012 official GDP.\(^8\) (Mr. Vickers is now a private consultant and investigator in Hong Kong.)

The exponential growth of Macau’s gaming revenue has been driven primarily by visitors from mainland China. According to the Macau government, 16.9 million people visited Macau from mainland China in 2012, accounting for 60 percent of total visitors. Other visitors are primarily from Hong Kong or Taiwan, accounting for 30 percent.\(^9\)
Money Laundering in Macau

Macau in 2001 liberalized a home-grown, monopolistic concession system and opened bidding for casino operation licenses to a limited number of foreign casino operators. The introduction of new and larger casinos led to substantial increases in cash flow, which consequently presented an increased risk for money laundering within Macau’s financial and gaming institutions. Among all financial institutions, casinos generally present the greatest risk for money laundering. "It is the variety, frequency and volume of transactions that makes the casino sector particularly vulnerable to money laundering. Casinos are by nature a cash intensive business and the majority of transactions are cash based . . . It is this routine exchange of cash for casino chips or plaques, TITO [ticket-in, ticket-out] tickets,† and certified cheques, as well as the provision of electronic transactions to and from casino deposit accounts, casinos in other jurisdictions, and the movement of funds in and out of the financial sector which makes casinos an attractive target for those attempting to launder money," according to the Asia-Pacific Group on Money Laundering and the Financial Action Task Force, a Paris-based intergovernmental body.

In Macau there is an even larger risk of money laundering within the VIP gaming room operations, which are physically conducted within the casinos but remain outside of the casino’s official oversight. The risk is further enhanced because so much of the money that is wagered in Macau goes through the loosely regulated VIP rooms. In 2012, VIP baccarat rooms in Macau casinos accounted for 69.3 percent of total revenue from games of chance.

The structure of VIP gaming operations—as an independent contractor of the casino—dates back to the 1930s and is legal under Macau law. But regulatory oversight of VIP rooms, junket operators, and affiliates who supply the clients and manage the money remains opaque and prone to substantial abuse. "The movement of funds associated with gaming-related tourism is poorly understood and may pose particular money laundering risks, e.g., international movement of funds for casino junket operations." The PRC’s strict capital controls that limit the amount of money individuals can carry to or otherwise transfer from mainland China to Macau have created a unique opportunity for the VIP gaming rooms to participate in a grey financial market. Large sums of renminbi (RMB) are moved through the independent VIP gaming room operations with the help of junket operators and their affiliates on the Mainland. That renminbi can be converted to Hong Kong dollars by gamblers in the casino and then transferred abroad through a variety of legitimate means, such as bank or casino wire transfers.

According to I. Nelson Rose, professor of law at Whittier Law School, who testified at the Commission’s June 27 hearing, Macau’s weak enforcement of anti-money-laundering prohibitions comes, in part, "from lack of experience, since big-scale casino gambling is

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† A ticket representing large slot machine payouts in lieu of coins.

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* According to the most recent Macau government statistics, U.S. direct investment in Macau totaled $677.3 million at the end of 2011, although unofficial numbers put the figure between $8 billion and $10 billion. There are more than 30 U.S. firms doing business in Macau. U.S. Department of State, “U.S. Relations with Macau” (Washington, DC: August 16, 2013).
less than ten years old. And part comes from the enormous amounts of money coming in and the junket system, which make it difficult to track all the transactions and gives incentives to ignore what may be going on. And China likes the economic booms of Macau and Hong Kong, and has plans to spend hundreds of billions of dollars to create large regional centers around the two SARs.”

Nevada regulators generally agree that the problem lies more with Macau and its loose regulations of VIP gaming room operators and junket operators in Macau and on the Mainland. While Nevada’s affiliated casinos in Macau offer “robust compliance” with anti-money-laundering protocols, “that robust compliance, however, is only up to a point; that point is where the VIP room operators assume responsibility,” said Nevada State Gaming Control Commission Chairman A.G. Burnett in testimony before the Commission.

According to a 2013 report from the U.S. Department of State, the gaming industry in Macau “relies heavily on loosely-regulated gaming promoters and collaborators, known as junket operators, for the supply of wealthy gamblers, mostly from nearby mainland China.” The report notes that in addition to supplying customers, the junket operators bear much of the risk that high rollers will renege on the unsecured loans that casinos and junket operators typically extend to heavy gamblers. (In the Macau system, the junket operators are allowed to extend credit to gamblers from the Mainland and buy chips directly from the Macau casinos to supply to their customers. If the customers fail to repay the loans, it is the junket operator who is not repaid. The casinos have already collected from the junket operators.) “Increasingly popular among gamblers seeking inscrutability and alternatives to China’s currency movement restrictions, junket operators are also popular among casinos aiming to reduce credit default risk and unable to legally collect gambling debts in China, where gambling is illegal,” the State Department report notes.

One problem is the abuses of the junket operators in collecting debts from customers through threats of violence and other non-judicial means. “Other extra-legal means of debt collection may indeed come into play,” according to a 2007 University of Nevada study. “The extent to which extra-legal means of debt collection (i.e., threats, intimidation, violence, induced crime such as embezzlements, etc.) occurs is an obvious concern for regulators, especially those from outside Macau that oversee companies which are concession or subconcession holders in Macau.”

All of these concerns have led American companies operating casinos in Macau to take additional steps to prevent illegal activity in their operations. Some of those steps were detailed in a submission by the companies to the Commission and are set forth at the end of this section. The Commission is not in a position to evaluate the adequacy of these measures to insulate these companies from the danger of association with illegal activity. However, Mr. Rose, who was one of the witnesses at the Commission hearing, has in a subsequent article warned that in evaluating the danger of illegality “it is important . . . to distinguish between casinos (in Macau) that are licensed by U.S. states and those that are not.” Mr. Rose noted further that, “in practice, there are two separate regulatory
It is common to witness individuals making purchases at “pawn shops” or “jewelry shops” using China’s domestic bank card Unionpay to purchase items and immediately return them for Hong Kong dollars, which then can be moved out of the country. The “front” shops, which are systems working in Macau. There are the casinos that are subject only to Macanese regulations. And there are those that are also subject to controls by states and nations outside of the PRC—in particular, the three casino operators who are also licensed by Nevada and other states.”

Macau’s junket operations have a history of affiliation with Asian organized crime, which presents added risks for U.S.-licensed companies operating casinos in Macau, according to Nevada’s state gaming regulators. Numerous junkets may have ties to organized crime, and public media and intelligence sources “have affiliated all but one of the seven VIP Room operator groups of interest with reputed Asian organized crime figures,” according to Mr. Burnett. “It is common knowledge [that] the operation of VIP rooms in Macau casinos had long been dominated by Asian organized crime commonly referred to as triads [and] the same [organized crime] figures are allegedly still working the VIP operations.”

U.S.-based casino companies are also subject to “suitability requirements” under state gaming laws that prohibit consorting with criminal elements, even outside the United States. Furthermore, the grey market nature of Macau’s loosely regulated junket operators and underground banking system raises the possibility for exploitation of casinos by international criminals seeking to launder illicit funds. Although U.S.-licensed casinos have implemented strict safeguards to prevent criminal activity from occurring within their Macau casinos, loose regulation by China and Macau of third-party junket operators and their affiliates that support the success of Macau casinos presents considerable risks.

Macau has taken steps to improve the efficacy of its laws preventing the abuse of gaming and financial institutions by criminals; however, according to Assistant Secretary for Terrorist Financing at the U.S. Department of the Treasury Daniel L. Glaser, Macau’s regulators have fallen far short in complying with internationally recognized standards, and numerous deficiencies remain in its regulatory framework. The PRC has also recently expressed interest in closer monitoring of Macau’s gaming industry as part of its nationwide initiative to crack down on corruption. However, to date, the PRC has not implemented any significant policy measures to regulate Macau’s grey market VIP gaming system.

The Role of Money Laundering and Capital Flight from the Mainland

The PRC maintains strict capital controls to limit the amount of cash taken out by individuals from mainland China to $3,260 per day and $50,000 per year. Despite these restrictions, individuals from mainland China are able to bypass the PRC’s capital controls and move large sums of money into Macau by making money transfers through various grey market channels. One of the most common methods is for individuals to physically smuggle cash. Mainland Chinese may also bypass the PRC’s capital controls via “pawn shops” and “jewelry dealers” in Macau. Underground banks also

*It is common to witness individuals making purchases at “pawn shops” or “jewelry shops” using China’s domestic bank card Unionpay to purchase items and immediately return them for Hong Kong dollars, which then can be moved out of the country. The “front” shops, which are
play a key role in moving illicit funds outside of mainland China, directly transferring RMB to VIP accounts at Macau casinos. Individuals will then collect the RMB in the form of special gambling chips at Macau casinos and cash them out in Hong Kong dollars after using the chips for gambling. Although the exact amount of money moved through underground banks in unknown, Yan Lixin, secretary general of the China Center for Anti-Money-Laundering Studies at Fudan University in Shanghai, estimates that 30–40 percent of all capital moving through underground banking channels is dirty money being laundered.

There is a high risk to Macau for money laundering, especially considering its gaming-driven economy. Macau is noted as a “jurisdiction of primary concern” in a 2012 report by the U.S. Department of State in its International Narcotics Control Strategy Report. A 2013 State Department report specifically identifies Macau’s junket operators as contributing to the vulnerability for money laundering and notes that “Macau Government officials indicate the primary sources of laundered funds—derived from local and overseas criminal activity—are gaming-related crimes, property offenses, and fraud.” The U.S. Central Intelligence Agency also notes that “Macau continues to face the challenges of managing its growing casino industry, money-laundering, and the need to diversify the economy away from heavy dependence on gaming revenues.” Moreover, The Economist reported that a memo sent in December 2009 from the U.S. consulate in Hong Kong to the U.S. Secretary of State said that “[Macau’s] phenomenal success is based on a formula that facilitates, if not encourages, money laundering.” The memo noted that “[s]ome of these mainlanders are betting with embezzled state money or proceeds from official corruption, and substantial portions of these funds are flowing on to organized crime groups in mainland China, if not Macau itself.”

A 2009 report by the Financial Action Task Force, a multinational organization that sets standards for the prevention of money laundering and the financing of terrorism, provided multiple case studies outlining cash smuggling and money laundering in Macau. According to one case study, “Cash Smuggling and Underground Remittance,” a Mainland customer who wanted to gamble in a Macau casino entrusted a junket affiliate with a large sum of money. The junket affiliate then brought the cash to a “front” shop that he operates as an underground bank in Zhuhai, a city in the Guangdong Province near the border of Macau. The cash was then divided into small lots, which were then smuggled into Macau by many “professional commuters.” A junket operator in Macau then collected the cash and deposited the money into a casino account in the form of cash, checks, bank transfers, and remittances. When the full sum was deposited, the casino agent converted the sum into a cashier’s order to the VIP room of the casino. The VIP room then issued chips to the Mainland customer, who could start gambling.

An indicator of the money-laundering problem in Macau is evident in the rising number of suspicious transaction reports filed with Macau’s financial intelligence unit. In 2012, the total number of “suspicious transaction reports” filed increased to 1,840 from 1,563, up 18 percent from 2011.41 The top three reasons triggering suspicious transaction reports in 2012 were (1) the inability of clients to provide identification or important personal information, (2) the possible match of a client with an internal watch list or other black list, or (3) a client’s attempt to convert gambling chips without partaking in gambling activities.42 Reports originating specifically from Macau’s gambling institutions have increased as a share of total suspicious transaction reports from 52 percent in 2007 to 72 percent in 2012,43 indicating a potential, growing, money-laundering problem in Macau’s gaming institutions or a growing willingness to report.†

Money Laundering in Macau’s Gaming System

In Macau, one of the main channels for money laundering is in the gaming sector through underregulated junket operators or VIP room operators and their affiliates on the Mainland, which include the underground banking system that supports their operations. The junket operators “smooth a money-laundering route that processes billions of dollars every year,” according to The Times of London.44 U.S. regulators have also described junket operators and their affiliates as especially able to offer money-laundering services.

Junket operators attract high-stakes gamblers to VIP rooms within Macau casinos by offering clients special services, including travel arrangements, hotel rooms, loans and money transfers, and a stack of chips waiting at a reserved chair at a baccarat table. In return, the junket operators receive a commission on the amount of chips they deal and a percent of the gambling losses incurred by their VIP clients.‡ Unlike gambling industries in the United States and Singapore, casinos operating in Macau—including subsidiaries of U.S.-licensed casinos—are heavily dependent on the junket system as the primary source of income. Mr. Vickers noted the heavy reliance of U.S.-licensed casinos on the Macau junket system during a briefing with the Commission in July: “Without the junkets,
none of the U.S. operators would make a red cent.” In 2012, baccarat, the preferred game of high rollers in VIP rooms, accounted for 69 percent of total casino-generated revenue in Macau.  

Although junket operators are common throughout the world—including Las Vegas, where they are referred to as “independent agents”—junket operators in Macau are significantly more involved in gambling operations and operate very differently, with far fewer restrictions. According to the written testimony submitted for the June 27 Commission hearing by Mr. Rose:

The Macau VIP Gaming promoters, on the other hand, are nothing like the traditional junket operators associated with American casinos, who were often paid a flat fee per head to bring in players. The Macau VIP gaming promoters can do virtually every part of the gambling transaction: recruit players, arrange transportation, provide credit, operate the gaming room in the casino, and collect the gambling debt.

Not only is the heavy reliance on the junket system and the direct involvement of junket operators in gaming transactions uncommon outside Macau, the business relationship between Macau casinos and junket promoters is also unique. Macau’s junket system is not subject to the same regulatory requirements as casinos, and it is up to casinos, not the gaming regulator, to craft due diligence procedures with junket operators. Also, unlike states such as Nevada, where junket operators are subject to in-depth background checks, strict internal control standards, and independent audits that are conducted in VIP rooms, in Macau, obtaining a junket license is a cursory process, and VIP rooms rely on in-house accountants to report on the financial status of their business.

According to experts who provided testimony to the Commission, Macau’s junkets may have links to organized crime. During the Commission’s June 2013 hearing, Mr. Burnett noted that “it is common knowledge that the operation of VIP rooms in Macau casinos had long been dominated by Asian Organized Crime (AOC), commonly referred to as ‘triads.’” Former Director of the Financial Crimes Enforcement Network of the U.S. Treasury Department James H. Freis, Jr., also recognized the possible link between Macau junkets and the triads in his written testimony. He wrote that “in some capacity, the involvement of organized crime groups such as China’s triads is likely.” Finally, during the Commission’s trip to Hong Kong in July, Mr. Vickers noted the junkets’ connection to organized crime: “The junket model in Macau should be the enemy, not the industry in Macau, because it is demonstrably connected to organized crime.” However, despite likely affiliation with the triads, junkets continue to proliferate in Macau casinos. From 2006 to 2013, the total number of licensed junket promoters grew from 76 to 202.

*Representatives of Wynn Resorts and MGM Resorts met with the Commission on October 21 and 23 and indicated that they maintain supervision of all the VIP gaming rooms through surveillance videos, cash room auditing, and personnel controls.
Role and Risks of Macau’s Junket System

Due to the PRC’s limit on the amount of money an individual can move outside of mainland China, Macau VIP room operators hire or partner with junket affiliates, or “subjunkets,” to make arrangements in mainland China to extend credit to wealthy Mainland Chinese clients to gamble in Macau’s casinos—essentially bypassing the PRC’s capital controls. In turn, junket affiliates are then required to collect debts incurred by clients in Macau casinos back on the Mainland in the form of RMB (see figure 1, below).

Although junket promoters are licensed in Macau, VIP room operators and their affiliates are composed of an extensive network of junket financiers, credit guarantors, and other profit participants, which are all unlicensed by Macau’s gaming regulator. Such junket affiliates are often comprised of local groups that have knowledge of Mainland clients’ credit histories to ensure that they will be able to collect gaming debts when the client returns to the Mainland.52 However, the collection of gambling debts is illegal in mainland China, presenting the risk of junket operators and their affiliates resorting to extrajudicial measures to collect incurred debts, which can lead to threats and violence, according to Mr. Rose.53 A 2008 report published by the Macau Polytechnic Institute shed light on the risks of unenforceable debt collection when it examined 99 publically reported cases of VIP gamers from mainland China.54 The report found that seven of the “high rollers” included in the study ended up either committing suicide or were murdered.55

Figure 1: Simplified Money-laundering Technique Using Junket/Casino System

Money Laundering in Financial Institutions

Outside of the gaming industry, Macau’s banks have also been involved in money-laundering activities. One well-known example
occurred in 2005 when the U.S. Treasury Department’s Financial Crimes Enforcement Network found a Macau-based bank, Banco Delta Asia, to be participating in the laundering of counterfeit U.S. dollars on behalf of the North Korean government. The Financial Crimes Enforcement Network recognized Banco Delta Asia as a primary money-laundering concern, stating, “Banco Delta Asia’s special relationship with the DPRK [Democratic People's Republic of Korea] has specifically facilitated the criminal activities of North Korean government agencies and front companies. One well-known DPRK front company that has been a client of [Banco Delta Asia] for over a decade has conducted numerous illegal activities, including distributing counterfeit currency.”

Vulnerabilities in Macau's Regulatory System

Macau first passed legislation requiring financial and gaming institutions to report suspicious transactions in 1998, which was replaced by a revised set of laws in 2006 that criminalized money laundering and required stricter reporting in the gaming sector. The legal reforms in 2006 brought Macau more in line with global anti-money-laundering standards. Improvements included reporting requirements for suspicious transactions over a certain cash value; customer due diligence procedures intended to prevent gambling by corrupt officials using public funds; and additional record-keeping requirements. However, according to Mr. Glaser, multiple deficiencies still exist in Macau’s anti-money-laundering and counter-terrorist-financing framework, including Macau’s refusal to seize stolen money.

Compliance with International Standards

The premier international standards for effective anti-money-laundering and combating the financing of terrorism are set by the Financial Action Task Force, a multinational body established in 1989. The organization, of which the United States and Macau are both members, has created a list of 40 recommendations to prevent money laundering and the financing of terrorism. Macau is subject to a periodic review of its compliance with the recommendations as a member of the Asia-Pacific Group on Money Laundering, Asia’s regional Financial Action Task Force body. The most recent evaluation of Macau’s compliance with Financial Action Task Force


The 2007 evaluation recognized the risk of money laundering in Macau’s gaming sector and noted multiple deficiencies in its anti-money-laundering and counter-terrorist-financing framework. According to the report, “[Macau’s] close proximity [to the] border with [the] PRC and its open economy do pose a threat to ML/FT [money laundering and financing of terrorism] activities.”65 The evaluation also discovered several specific deficiencies in Macau’s compliance with the Financial Action Task Force recommendations, including the refusal to respond to foreign requests to freeze assets, the inability to effectively implement UN Security Council resolutions on the financing of terrorism, and the inability of Macau’s Customs Service to investigate money-laundering cases. Other shortcomings specific to the gaming sector included a lack of a risk-based assessment of gaming customers and operators, inadequate inspection and oversight of casinos and junket operators and promoters, a lack of communication among gaming regulators, and a high threshold ($62,500) for reporting large transactions at casinos.66 In the report, Macau received a “compliant” rating in only seven of a total of 49 recommendations,9 with the majority receiving a rating of only “partially compliant.” Against the same recommendations, the United States was “compliant” in 15 of 49 recommendations in its 2007 evaluation, with the majority receiving a rating of “largely compliant.”67

Since the report was published in 2007, “Macau has yet to address a number of deficiencies in its AML/CFT [anti-money-laundering and counter-terrorist-financing] framework that were identified by the APG [Asia-Pacific Group on Money Laundering],” according to Mr. Glaser.68 He noted four major deficiencies identified in the evaluation report that have yet to be addressed: (1) Macau still has not implemented a method to freeze bank accounts in anti-money-laundering and counter-terrorist-financing cases; (2) Macau has not yet enacted a number of legal enhancements to its customer due diligence requirements; (3) Although Macau has been asked to lower its high transaction reporting threshold for casinos to $3,000 as recommended by the Financial Action Task Force,† Macau continues to allow a very high threshold of $62,500 for reporting large transactions at casinos; (4) Macau has yet to implement an effective, cross-border, cash declaration system.69


Shortcomings in Macau’s Gaming Sector Regulation

Although casinos and junket promoters are licensed by Macau’s gaming regulator, there remain significant vulnerabilities with unlicensed junket operators, junket affiliates, and satellite casinos that play an integral role in Macau’s gaming system. These entities are not subject to the same regulations and reporting requirements as licensed entities and thus are more susceptible to money laundering and influence from organized crime (see figure 2, below). During the Commission’s June 27 hearing, Mr. Burnett noted this vulnerability in his written testimony, that “criminal transactions are widely alleged to take place just out of the direct purview of the casino,” pointing to the susceptibility for criminal organizations to infiltrate junket groups. “Such activities include back-betting, side-betting, loan sharking, violent loan collections, underground banking, and money laundering.”

Figure 2: Vulnerabilities in Macau’s Licensing System

Macau’s junket operators are not subject to the same transparency requirements as casinos, and strict privacy controls prevent U.S. regulators from obtaining information on individuals operating in Macau subsidiaries of U.S. parent casinos. The Macau SAR Gaming Inspection and Coordination Bureau (Portuguese acronym, DICJ), Macau’s gaming regulator, is also only required to publicly disclose the names of licensed junket promoters in Macau and does not disclose financial information. More importantly, information about the unlicensed junket operators, their affiliates, and third-party satellite casinos is inaccessible to the public and regulatory counterparts overseas. The lack of information presents difficulties in determining the origin of money flowing through such operations, and U.S. state regulators do not have the

authority or resources to independently conduct investigations in Macau or other foreign jurisdictions. Mr. Burnett explained the legal barrier in obtaining relevant information from Macau regulators in his testimony to the Commission:

*All transactions under the $62,500 threshold that are deemed suspicious in nature are required to be reported to the Macau SAR Financial Intelligence Office.* Jorge Godinho, “The Prevention of Money Laundering in Macau Casinos,” *Gaming Law Review and Economics* 17:4 (2013): 271–272.

The Macanese Privacy Act 8/2005, which took effect February 2006, has varying degrees of interpretation. It essentially forbids businesses there from transferring data on individuals to any other country. In general, therefore, it has precluded us from obtaining information from our operators to the degree we are accustomed to.

Although Macau regulators require reporting for transactions that are deemed “suspicious” in nature, there are shortcomings in the reporting requirements of gaming institutions. Macau’s eyes and ears for the gaming sector, the Gaming Inspection and Coordination Bureau, require gaming institutions to automatically report all transactions above $62,500. In the 2007 evaluation published by the Asia-Pacific Group, this threshold is considered too high to comply with Financial Action Task Force recommendations. Moreover, the Gaming Inspection and Coordination Bureau does not report detailed information on the number or nature of such reports filed to the public; however, Gaming Inspection and Coordination Bureau officials have indicated that the number of reports filed annually is increasing, reaching hundreds of thousands per year.

**Influence of PRC Regulations on Macau**

Capital controls implemented by the PRC that are intended to prevent illicit cross-border transfers should, in theory, hinder Macau’s economic growth. In reality, capital controls have caused more money to cycle through Macau due to Macau’s thriving VIP gaming industry, which relies on junkets and their affiliates to facilitate cross-border money transfers for clients via underground banks. The circumvention of capital controls by junkets to get money from mainland China to Macau has been tolerated by Beijing and, according to Mr. Rose, “Beijing doesn’t view this as much of a problem, unless it becomes a scandal, as when government officials embezzle [money] and lose it in Macau.”

Recent reports, however, have signaled that Beijing is beginning to take measures to prevent illicit cross-border transfers and money laundering in Macau as part of the nationwide crackdown on corruption promoted by PRC President Xi Jinping. A December 2012 *Wall Street Journal* article reported that police in mainland China and Macau detained multiple individuals who work for Macau’s biggest junket operators, a move described by a Macau casino executive as “an attempt by the Chinese government to tell people in the market that they need to behave, especially regarding underground money transfers.” The recent appointment of the PRC’s former Hong Kong liaison Li Gang to deputy director of the Central Liaison Of-
Gambling debts in the United States can be collected through some state courts, but the process can be difficult and expensive. Some courts outside Nevada may choose not to honor debts for gambling if that activity is considered illegal in that state. Holders of unpaid gambling debts have sometimes resorted to criminal prosecutions for fraud in order to coerce payments from debtors. Casinos also make a practice of partially forgiving debts in order to collect a fraction of money owed by gamblers. I. Nelson Rose, telephone interview with Commission staff, September 14, 2013.

Experts have argued that Macau’s heavy reliance on junkets operating in the grey market can only be reduced if mainland China repeals its strict capital controls or permits the collection of gambling debts in mainland China. The PRC’s capital controls have encouraged clients to utilize junkets to facilitate money transfers, thus making it difficult to determine the origin of funds coming from mainland China. On top of the capital controls, PRC regulations forbidding the collection of gambling debts have given rise to a troubling grey market. Unlike the United States, where collection lawsuits by casinos can be filed and gamblers can be charged criminally for writing bad checks, casinos are not allowed to collect gaming-related debts through the courts in mainland China. This prevents Macau casinos from directly seeking VIP customers, and they instead rely on unsupervised junket operators to attract clients. Casinos in Macau would prefer to attract VIP clients themselves and, according to Mr. Rose, “the casinos want to get rid of [VIP operators because the casinos themselves] want to be the VIP operators.”

Implications for the United States

In Macau, undeclared cross-border cash flows, criminal influence in the opaque junket system, an ambiguous privacy law preventing disclosure of criminal activities, and substandard anti-money-laundering and counter-terrorist-financing regulations have several implications for the United States. First, Macau’s junket system and its apparent link with organized crime present legal risks for the foreign affiliates of U.S.-licensed casinos operating in Macau. Those affiliates are dependent for their revenues on the same loosely regulated junket and shadow banking system. Second, Macau’s gambling system has attracted the attention of Chinese nationals seeking to circumvent the PRC’s strict capital controls. Some are corrupt officials hoping to invest abroad funds received through bribery and extortion—money that may be used for other illegitimate purposes in order to escape notice and taxation. Third, individuals or criminal groups involved in activities that have the potential to threaten U.S. national security may be able to exploit Macau’s underregulated financial and gaming institutions to disguise illegally obtained funds, which could be used in a variety of nefarious ways against the United States. North Korea has used Macau’s fi-
nancial system to launder counterfeit U.S. dollars, for example. Money laundering has proven useful in other criminal activities, such as the international smuggling trade in small arms, drugs, and cigarettes.

Macau’s junket system and its susceptibility to organized crime and money laundering present direct legal risks for U.S.-licensed casinos operating in Macau. The business models of U.S. parents’ Macau casinos are based on the losses of VIP clients introduced to the casinos by junket operators. As Mr. Burnett noted, “It is what the business model allows to occur outside of the casino’s purview (in the VIP rooms and with the junket operators) that may pose problems.”83 U.S.-based casinos risk loss of their state-issued license if they become associated with crime figures abroad. Such rules are known as “suitability” requirements. According to the trade publication Casino Enterprise Management:

At its core, suitability involves a judgment about an individual’s character based on his or her history and a prediction about his or her likely future behavior. It necessarily immerses the regulator in the murky areas of social science, psychology and even philosophy. In making a licensing decision, a gaming board or commission must determine the eligibility and suitability of each applicant and, in the case of business entity applicants, associated qualifiers. The burden is always on the applicant to establish eligibility and suitability through clear and convincing evidence as to his or her character, reputation, integrity, business probity, experience and ability, financial means and responsibility, and any other criteria that the board or commission may deem appropriate.84

All U.S. casinos are licensed by at least one U.S. state.85 Respective state regulators have the power to monitor the activity of U.S. companies in Macau and can exercise the right to revoke a casino’s state license if a casino licensed in its state is determined to be associating with criminals, even if those associations are outside U.S. borders. Nevada, for example, requires that it review the overseas operations of casinos licensed in the state to determine if a licensee is complying with its Foreign Gaming Statute, which prohibits licensees from engaging in activity that “reflects or tends to reflect discredit or displeasure upon this state or gaming in this state.”86 New Jersey’s Casino Control Act has similar stipulations, requiring licensees to be of “good character, honesty and integrity” on a continuing basis, obliging them to provide clear and convincing evidence in support.87

Issues Facing U.S.-licensed Casinos in Macau

U.S.-licensed casinos began operating in Macau in 2004, when Sands opened its first gambling establishment. Currently, three U.S.-licensed casinos have operations in Macau: MGM Resorts International, Las Vegas Sands Inc., and Wynn Resorts Ltd. All three casinos have come under various forms of regulatory scrutiny regarding their Macau operations.
Intracompany transfers, or “cross-property deposits,” are common between foreign subsidiaries of U.S. casinos and their U.S. parent casinos. They are subject to compliance with the Currency and Foreign Transactions Reporting Act of 1970 (commonly referred to as the “Bank Se-

Continued

Issues Facing U.S.-licensed Casinos in Macau—Continued

MGM—In 2009, MGM ran into trouble when a New Jersey gaming regulator investigated the casino’s joint-venture partnership with the daughter of the Macau casino mogul Stanley Ho. In a special report by the New Jersey Division of Gaming Enforcement, Stanley Ho’s daughter was deemed unsuitable under New Jersey’s Casino Control Act, based on family links to organized crime in Macau and the PRC. As a result of the report, in March 2010 MGM decided to enter into a settlement with the New Jersey Division of Gaming Enforcement that required MGM to divest 50 percent of its stake in a New Jersey casino. The agency also barred MGM from applying for a casino license. In 2013, a petition was approved to allow MGM to apply for permission to retain its interest in its New Jersey assets, but a decision on the application will not be made by New Jersey regulators until a more thorough investigation is conducted to determine MGM’s compliance with the state regulations.

Las Vegas Sands—Intracompany transfers have presented a risk of junkets associated with triads transferring money from Macau into the United States. Evidence from a 2010 lawsuit filed by a former Sands executive included a ledger detailing that Sands had transferred over $28 million for more than two dozen junket operators between Macau and Las Vegas. Two junket operators who were listed on the ledger, Cheung Chi Tai and Charles Heung, were identified by the U.S. Senate Permanent Subcommittee on Investigations as officers of triad groups in a 1992 report on organized crime in Asia. In the report, Charles Heung was identified as an officer of the Sun Yee On triad, and Cheung Chi Tai was identified as an officer of the Wo Hop To triad.

As a result of increasing concerns from regulators, Sands has reportedly restructured its compliance functions, which entailed discontinuing intracompany transfers on behalf of its “high-rolling customers.” In addition, the casino also hired three former Federal Bureau of Investigation (FBI) agents to strengthen anti-money-laundering efforts and improve background checks of VIP customers and junket operators.

Wynn—In 2012, Macau police detained a partner of one of Macau’s major junket operators that had ties with the former Communist Party chief in Chongqing, Bo Xilai. The junket operator the individual was affiliated with was reported to operate in both Wynn and Las Vegas Sands casinos.

*Intracompany transfers, or “cross-property deposits,” are common between foreign subsidiaries of U.S. casinos and their U.S. parent casinos. They are subject to compliance with the Currency and Foreign Transactions Reporting Act of 1970 (commonly referred to as the “Bank Se-

Continued
The success of Macau’s gaming sector is closely tied to the under-
ground and shadow banking system to facilitate money transfers
from mainland China. Junket operators and their affiliates uti-
lie underground and shadow banks to extend loans and facilitate
cross-border transfers for Mainland customers who want to gamble
in Macau, allowing them to bypass China’s capital controls. Al-
though the exact amount of credit extended to Macau gamblers and
the amount of money flowing from mainland China to Macau via
underground banks is unknown, the Chinese shadow banking sys-
tem overall “poses serious risk to China’s financial and social sta-
bility.”

Furthermore, the loosely regulated junket and shadow banking
system that support Macau’s gaming industry may allow individ-
uals involved in criminal activities that threaten U.S. national se-
curity to exploit financial and gaming institutions in Macau to dis-
guise illegally obtained funds. After money has effectively been
“laundered,” criminals may freely move those funds in the inter-
national financial system, and there is a risk of “dirty money” mak-
ing its way into the United States or other countries to be used for
illegitimate purposes. Criminals may exploit intracompany ac-
counts to move money from casino subsidiaries in Macau into the
United States.

Macau’s banking institutions have also presented a risk to the
United States. As in the case of Banco Delta Asia, individuals or
organizations involved in activities against the interests of the
United States may exploit financial institutions in Macau to laun-
der counterfeit U.S. dollars, disguise financial transfers, or deposit
funds from illegal activities such as drug trafficking. Because
Macau’s law enforcement agencies lack certain capabilities to effec-
tively freeze or seize assets as identified in the 2007 mutual eval-
uation, it may be difficult to prevent the financing of criminal or
terrorist activities in a timely manner.

Submissions from U.S.-based Casino Operators

The Commission met with two U.S. casino companies, Wynn
Resorts and MGM Resorts International, on October 21 and 23
at their request. The two companies disagreed with some por-
tions of this section and offered additional information of their
own with respect to actions they have taken to mitigate the risks
the Commission and others have identified. Their information
follows.

Wynn: “Macau’s junkets operators are under continual super-
vision and audit by the gaming regulator, financial intelligence
unit and monetary authority. Further, Macau casino companies
such as Wynn are active participants in VIP rooms providing
dealers, supervisors, pit managers and security. The rooms are
also under surveillance by Wynn staff and the gaming regulator
who has full access to Wynn’s surveillance system. In addition to
regulatory audits, Wynn’s internal audit group audits junket

ccery Act” or “BSA”), Nevada Gaming Control Board, telephone correspondence with Adriana
Fralick and Commission staff, September 23, 2013.
Submissions from U.S.-based Casino Operators—Continued

“Wynn files Suspicious Transaction Reports every month. Recently, Wynn Macau employees became suspicious of an attorney gambling with funds wired to the casino from a questionable account. The report Wynn Macau made to the Hong Kong Police resulted in uncovering and prosecuting a system of embezzling from client trust funds. Wynn Macau is actively vigilant, using years of experience in law enforcement and gaming, with respect to suspicious financial activities. The company has a strong incentive to report such activities because the company is legally required to do so and the gaming licenses of the company are at risk. The company trains its employees to be zealous in reporting anything that may be even considered slightly suspicious. For example, if a customer comes to the casino, plays for cash, and wins $25,000 or more and refuses to provide proper identification when he attempts to cash out, we not only file a Suspicious Transaction Report, we also refuse to cash out the customer.

“The Macau authorities and Wynn are active participants in VIP rooms providing dealers, supervisors, pit managers and security. The rooms are also under surveillance by Wynn staff and the gaming regulator who has full access to Wynn’s surveillance system. In addition to regulatory audits, Wynn’s internal audit group audits junket compliance with AML rules/procedures.

“Junkets and subjunkets are licensed by the gaming regulator if they pass a background check and police clearance. Wynn Macau then engages in its own due diligence of its junkets prior to allowing them to commence operations. Wynn Macau only does business with licensed junket operators (after all background screening is completed and the junket found suitable to do business with Wynn Macau).

“With respect to know-your-customer-protocols, Macau casinos are required to screen their patron databases and Wynn Macau employs the Worldcheck Database to screen for patrons who may pose AML, crime/fidelity, terrorism, OFAC [Office of Foreign Assets Control] or PEP [politically exposed persons] risk. Macau is in the process of exploring currency importation declarations.”

MGM: “Macau’s internal controls are sufficient to safeguard assets and promote fair and equitable gaming within the Macau jurisdiction. In addition the Maryland Lobbying Gaming Control Commission found that MGM Macau has policies and procedures that not only minimally satisfy the rules, regulations and laws of the Macau government, but have instituted procedures that go substantially above and beyond these minimum requirements.”

“MGM background checks are conducted on the following entities related to gaming promoters: Individual applicants and company’s shareholders and directors (and) any individual, entity or group providing a guarantee of credit in connection with the VIP room operations in MGM Macau.”
Universal Suffrage, Press Freedom, and Police Surveillance in Hong Kong

Tensions over erosions of Hong Kong’s traditional civic freedoms appear in Hong Kong street demonstrations and in social media sites. Issues of particular concern include the Hong Kong government’s slow progress in granting the universal suffrage stipulated in the region’s Basic Law, tightening restrictions on the press, and stepped-up police surveillance of civil rights activists. Several legislators who met with Commissioners in Hong Kong in July expressed concerns that growing political polarization and heavy-handed efforts by the pro-Beijing-controlled government to stifle dissent threaten to render the city ungovernable. These concerns are borne out by the numbers. In one July poll, the pro-Beijing chief executive scored a record low approval rating of just 15.8 percent, while 37 percent of respondents reported that they do not trust the Hong Kong government.

Hong Kong never enjoyed a fully democratic government under British rule. But before Hong Kong’s return to the PRC, Hong Kong’s citizens enjoyed popular participation in political affairs as well as “a vibrant media,” “an effective and meritocratic bureaucracy,” rule of law, and the protection of key civil rights and liberties under the Letters Patent and Royal Instructions that served as Hong Kong’s principal constitutional documents. Hong Kong’s Basic Law, a sort of “mini-constitution promulgated to implement the basic policies of the central government toward Hong Kong,” provides for “the separation and preservation of the two economic, social, political and legal systems through the legal entrenchment of Hong Kong’s [preexisting] systems” until 2047.

Sophie Richardson, China director at the Human Rights Watch’s Washington office, testified at a Commission hearing on June 27 that since its return to PRC sovereignty in 1997, Hong Kong has “remained the only part of China with a robust and independent legal system, relatively strong protections on the freedom of expression, and limited but regular elections.” But she noted that since the handover, there have been very worrying developments, as maintaining the economic strength of the region’s traditionally capitalist system has clearly been prioritized by Beijing, whereas preservation of the civil rights associated with political autonomy has not. Dr. Richardson noted that “large numbers of Hong Kong residents continue to object to what are considered intrusions on Hong Kong’s autonomy and rally in remarkable numbers to remember events like the Tiananmen massacre,” but government efforts to restrain their freedom have grown. Freedom House’s Madeline Earp told the Commission that in the initial years following the handover of Hong Kong to mainland China, the region’s role as a “golden goose” for the Mainland helped to insulate it from anti-democratic pressures in Beijing. Nowadays, however, the rel-

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*The Basic Law of the Hong Kong Special Administrative Region (SAR) is a constitutional document that sets out the basic principles agreed to in the 1984 Sino-British Joint Declaration on the Question of Hong Kong. The Joint Declaration spelled out agreed-upon terms for the government of Hong Kong after Great Britain’s return of the region to the sovereignty of the PRC. According to this declaration, the Hong Kong SAR would retain its capitalist system and lifestyle for 50 years. The declaration went into effect after the handover of Hong Kong on July 1, 1997. The Basic Law was drafted by a committee of Mainland and Hong Kong Chinese and was formally adopted by the National People’s Congress on April 4, 1990.*
ative affluence of many Mainland coastal cities and ports, such as Shanghai, has reduced Hong Kong’s economic importance to the Mainland. While Hong Kong does still play a unique economic role within the PRC that Beijing is “loathe to tinker too much with.” Hong Kong’s prosperity is not the impenetrable shield of civic freedoms it once was. Beijing also wields greater political leverage in the region, because many Hong Kong business leaders now hold Mainland investments that they did not have 20 years ago.

Recent examples of Beijing’s constraints on Hong Kongers’ freedom include more frequent requests to the National People’s Congress Standing Committee to interpret the Basic Law, appointments of pro-Beijing partisans in key Hong Kong institutions, denials of Hong Kong visas to Chinese dissidents, and an inflammatory proposal designed by the Hong Kong Curriculum Development Council to require Hong Kong schools to teach students the nationalistic version of history taught on the Mainland. Backlash against this national education initiative reached a crescendo in the summer and fall of 2012. At least 30,000 people reportedly attended a July 2012 protest against the education plan, while roughly 30,000 attended a September 2012 protest. Many thousands of protestors waved colonial flags. To the organizers, the flag symbolized an era of greater protection of civil rights and liberties under British colonial rule. In the end, the colonial flag demonstrations grew so big and intense that the Hong Kong government retracted plans for the new patriotic history lessons. But while popular resistance to the nationalistic education requirements demonstrated the persistence of self-determination for Hong Kong’s citizens, it contrasts with many more examples of how important rights and liberties in the region are eroding.

**Universal Suffrage**

The most significant problem for democratic rights activists is the Hong Kong government’s lack of progress toward ensuring universal suffrage in the election of the Legislative Council and the chief executive. Although the Basic Law articulates a goal of achieving some form of universal suffrage in the elections of both the chief executive and the legislature, the dominance of the Hong Kong government by politicians allied to Beijing has stymied progress in achieving universal suffrage. Beijing-friendly current Chief Executive Leung Chun-ying (CY Leung) is described as “a populist on economic issues” with “a limited tolerance of democracy and public demonstrations.”

Despite assurances by Chief Executive Leung that he supports universal suffrage, neither the Mainland government nor the Hong Kong chief executive has “outlined clear plans on how universal suffrage might be instituted.” In March 2013, Chief Executive Leung said in meetings with Chinese President Xi Jinping that he was committed to the process of achieving universal suffrage in Hong Kong by 2017. He reiterated this commitment in July, promising that free and open elections for the Legislative Council would

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*The Mainland government did not design the contested educational curriculum. Rather, it was designed by the Hong Kong Curriculum Development Council, a body whose members are appointed by the Hong Kong chief executive, whose leanings are decidedly pro-Beijing.*
follow in 2020. But as Dr. Richardson noted in her testimony, these dates have been Beijing’s tentative targets since statement decision made by the National People’s Congress Standing Committee in 2007. Many Pan-Democrats are afraid that the Mainland is seeking to postpone universal suffrage or stop it altogether by rigging elections to limit them to candidates who are pro-Beijing. The idea would be to ensure that the Hong Kong government continues to be dominated by pro-Beijing representatives. Article 22 of the Basic Law stipulates that no offices or Mainland authorities may interfere in the affairs of the Hong Kong SAR, but pro-Beijing sympathies are not deemed interference. In elections of the chief executive and the Legislative Council, Mainland sympathizers continue to enjoy a distinct advantage due to the configuration of the electoral system.

Article 45 of the Basic Law specifies that “the ultimate aim” for selection of the chief executive, the highest office in the Hong Kong government, is “universal suffrage upon nomination by a broadly representative nominating committee in accordance with democratic procedures.” At present, the chief executive is chosen from a slate of nominees by a 1,200-person election committee. Shi Zhangshan, a Washington, DC-based Hong Kong expert, notes that “it took 10 years to increase the members of the Hong Kong Election Committee from 400 to 800 and then 1,200” and that by sticking to the pace of this so-called progressive approach, it would take Hong Kong 10,000 years to gain universal suffrage for its seven million citizens. The current election committee is heavily populated with business figures, who have investments in mainland China, as well as politicians and labor leaders with strong connections to Beijing, giving it a distinctly pro-Beijing slant. A former Legislative Council member told Commissioners that Beijing effectively controls roughly 950 of the 1,200 election committee votes for chief executive. In the 2012 chief executive election, pro-Beijing candidate CY Leung won with 689 votes, while Henry Tang, the runner-up and also a pro-Beijing candidate, received 285. By contrast, the most popular prodemocracy candidate, Albert Ho of the Democratic Party, received a mere 79 votes.

Article 68 of the Basic Law specifies that “the ultimate aim is the election of all the members of the Legislative Council by universal suffrage.” For the time being, 35 members of the 70-person legislature are directly chosen through geographical constituencies in which members of the general population are each afforded one vote. Another 30 members are elected by traditional functional constituencies, in which professionals in specific fields such as insurance, transportation, health care, education, accounting, commerce, industry, finance, and tourism are allowed to cast a vote in addition to their vote in their geographic constituency,” giving them greater voting power than the general populace. Certain business entities and professional organizations are also given votes in the functional constituencies. Five Legislative Council members are elected by district council constituencies, which are made up of regular voters not in professional sectors already represented by the

*Politicians and members of civil society affiliated with a variety of prodemocracy groups often band together to promote their common cause and are collectively referred to as pan-democrats.
traditional functional constituencies. The greater representation of some segments of society as a result of the functional constituencies, combined with the dominant support for pro-Beijing candidates among functional constituency voters, has ensured that the Legislative Council remains in the control of pro-Beijing representatives. Since 2004, the split has stood at roughly 60/40. Figure 3 illustrates the politics of legislators elected by the functional constituencies vs. those elected by the geographic constituencies. Figure 4 shows the pan-Democrat vs. pro-Beijing split in the Legislative Council over time.

Figure 3: Pan-Democrat vs. Pro-Beijing Representatives in Legislative Council, 2012–2016

Since two-thirds of all Legislative Council members are required to endorse any amendment to the process of electing the chief executive, pro-Beijing dominance in the Legislative Council dims the prospects for amendments that would advance universal suffrage. The pall that this has cast on hopes of achieving universal suffrage is amplified by a December 29, 2007, statement by the National People’s Congress Standing Committee that universal suffrage in the election of the Legislative Council will be implemented only after implementation of universal suffrage in the election of the chief executive.\textsuperscript{131,132}

In discussions with Commissioners during a July fact-finding trip to Hong Kong, Legislative Councilor Chung-Kai Sin explained that Pan-Democrats’ worries over prospects for universal suffrage have been stoked by recent statements from the Mainland.\textsuperscript{133} In March, for example, Qiao Xiaoyang, chairman of the legal committee of the National People’s Congress, warned that Beijing “would not accept a chief executive candidate who adopted a confrontational attitude towards the central government.”\textsuperscript{134} In July, Zhang Xiaoming, director of the central government’s liaison office in Hong Kong, used a sieve to illustrate the advantages of a screening and filtration process to ensure that all candidates for chief executive are acceptable to Beijing.\textsuperscript{135} Chief Executive Leung says he favors allowing all adults to vote but is vague about whether he would support allowing the chief executive ballot to feature candidates opposed by Beijing.\textsuperscript{136}

### Figure 4: Pan-Democrats vs. Pro-Beijing Representatives in Legislative Council, 1998–2012

<table>
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<tr>
<th>Term</th>
<th>Pan-Democrat Camp</th>
<th>Pro-Beijing Camp</th>
<th>Total Seats</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998 (1st term)</td>
<td>20 (33.33%) (3 seats—DPHK) (3 seats—The Frontier)</td>
<td>40 (66.67%) (9 seats—DAB) (10 seats—Liberal Party)</td>
<td>60</td>
</tr>
<tr>
<td>2000 (2nd term)</td>
<td>21 (35.00%) (12 seats—DPHK) (2 seats—The Frontier)</td>
<td>39 (65.00%) (11 seats—DAB) (8 seats—Liberal Party)</td>
<td>60</td>
</tr>
<tr>
<td>2004 (3rd term)</td>
<td>25 (41.67%) (9 seats—DPHK) (4 seats—Article 45 Concern Group)</td>
<td>35 (58.33%) (10 seats—DAB) (10 seats—Liberal Party)</td>
<td>60</td>
</tr>
<tr>
<td>2008 (4th term)</td>
<td>23 (38.33%) (8 seats—DPHK) (5 seats—Civic Party)</td>
<td>37 (61.67%) (10 seats—DAB) (7 seats—Liberal Party)</td>
<td>60</td>
</tr>
<tr>
<td>2012 (5th term)</td>
<td>27 (38.33%) (6 seats—DPHK) (6 seats—Civic Party)</td>
<td>40 (61.67%) (13 seats—DAB) (6 seats—Liberal Party)</td>
<td>70</td>
</tr>
</tbody>
</table>

*DPHK—Democratic Party of Hong Kong; DAB—Democratic Alliance for the Betterment and Progress of Hong Kong; HKFTU—Hong Kong Federation of Trade Unions.

In March 2013, 27 lawmakers from 12 pan-democratic groups formed the Alliance for True Democracy to demand that the government deliver universal suffrage in the 2017 election, but it is unclear if this coalition will remain united. Past efforts by the various democratic parties to promote universal suffrage have dissolved into disagreement. Mr. Shi notes that Beijing has lots of practice dividing the opposition, and these divisions are surfacing once again. Some Pan-Democrat lawmakers have backed Martin Lee Chu-ming, former chairman of the Democratic Party, in his recent suggestion for a screening committee to ensure that at least five candidates stand for election and that one of them is pro-democracy, but others have chastised him for recommending a screening mechanism at all.137

April 2013 saw the formation of a civil disobedience movement to support 2017 suffrage. Dubbed “Occupy Central” (Hong Kong’s core downtown financial district), the movement was started by Benny Tai, a law professor at Hong Kong University. Professor Tai says the Occupy Central movement will be peaceful and will feature several days of deliberation culminating in early 2014, when occupiers will gather in small groups to discuss political reform. The movement’s plan is to follow this deliberation with a Hong Kong-wide ballot allowing people to choose their vision of reform. It would then demand that the government carry out the popular will. Sit-in protests would follow in the central city should the government resist.

“The key point of the movement is about developing a democratic culture of rational discussion and consensus building by the people themselves,” says Professor Tai.138 But business groups, led by the Chinese General Chamber of Commerce, fear that the movement will hurt the city’s economy, while pro-Beijing groups argue that it will hurt the city’s interests more broadly. One pro-Beijing group, Voice of Loving Hong Kong, staged counterprotests at the first Occupy deliberation on June 9.139 One former official describes the movement as having “touched a nerve” with Beijing and notes that many companies with ties to Beijing have been persuaded to take out full page advertisements against Occupy Central in various Hong Kong newspapers.140 The Hong Kong government has also publicly warned that it sees no possibility of the Occupy Central gatherings being lawful, and former Central Policy Unit head Lau Siu-kai expressed concerns that the movement would become radical and “end in bloodshed.”141,142

Press Freedom

Pro-Beijing newspapers such as Wen Wei Po have accused “external powers” of being behind the Occupy Movement, while a leading mainstream English-language newspaper, the South China Morning Post, ran an editorial earlier this year saying that “Hong Kongers need genuine democracy—of that there can be no doubt,” but then followed the editorial by declaring its opposition to Occupy Central’s peaceful civil disobedience plans.143 Within the Hong Kong press community and among international free press advocacy groups, such editorial kowtows to the pro-Beijing government are widely perceived as demonstrative of the Mainland’s increasing sway over the Hong Kong press. Article 27 of the Basic Law grants...
According to a spring 2013 Hong Kong Journalists Association poll, of the 663 reporters, photographers, editors, and media management respondents, 92.7 percent attributed the erosion of press freedom to the Hong Kong government’s tighter grip on information; 71 percent attributed it to increased self-censorship; and 67.5 percent attributed it to the growing influence of the Chinese central government.

Hong Kong residents “freedom of speech, of the press, and of publication” and, on the surface, it would seem that a vibrant Hong Kong press remains alive and well today, given that the city of seven million people supports 46 daily newspapers and 642 periodicals as of 2010. But the large number of media outlets belies what Ms. Earp and other critics say is a diminishing diversity of voices in the Hong Kong press. According to Ms. Earp, in the early years after the handover, PRC media interventions in Hong Kong were generally limited to Mainland political issues, but political pressures and the influence of Mainland economic interests on Hong Kong media owners are increasingly evident. Beijing’s Hong Kong Liaison Office, for example, “played a uniquely aggressive role in the run-up to the chief executive election last year, effectively ordering news outlets to support the eventual winner.”

In 2005, Freedom House ranked Hong Kong 28th in the world among 197 countries and territories in terms of press freedom and assigned it a status of “free,” but by 2012, Hong Kong’s ranking had fallen to 33rd and “partly free.” In January, Reporters without Borders released its World Press Freedom Index 2013, showing Hong Kong press freedom at a five-year low of 58th out of 179 locations worldwide. Its 2002 ranking had been 18th. Reporters without Borders ranked mainland China 173 for 2013, while Taiwan garnered the top spot among Asian localities, coming in at 47. But Taiwan may not be a regional gold standard for long, as Mainland pressures on the media are increasingly apparent there, too. In both places, potential media buyouts threaten to give pro-Beijing business magnates control over independent news outlets currently known for being critical of the Mainland government. For example, in late 2012, Jimmy Lai, the outspoken owner of Hong Kong-based Next Media and the pro-Democracy Apple Daily paper, sold his Taiwan media holdings to a group of businessmen supportive of the Beijing government. In early 2013, China Daily reported that a Shanghai real estate tycoon was seeking a controlling stake in Hong Kong’s cash-strapped and increasingly pro-Beijing broadcaster Asia Television Limited.

The Hong Kong press itself reports a sense of diminishing freedom. In 2007, a major Hong Kong Journalists Association survey showed that 58.4 percent of the industry respondents felt press freedom had been eroded since the 1997 handover. In early 2012, a survey asked if press freedom had deteriorated since Donald Tsang took over as chief executive seven years before. The survey showed that 87 percent of the 663 journalists polled indicated that they felt it had. Growing political interference from Beijing, tighter government controls on information, and rising self-censorship by the media outlets themselves were the key reasons cited in this trend. More than 92 percent of respondents in the Hong Kong Journalists Association’s spring survey felt that government restraints on information had surpassed self-censorship as the main factor undermining press freedom. This sense of diminishing

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press freedom correlates with survey data indicating that the Hong Kong public perceives newspapers as less credible, though it is worth acknowledging that U.S. media credibility has been on a downward trajectory over the past decade, too.\textsuperscript{158}

Following the election of Mr. Leung to chief executive in 2012, press freedom advocates reported an escalation in government efforts to censor and control media access to official information. This is viewed as problematic, because it is not simply the Hong Kong government that controls the release of information to the press but specifically the governing party dominating access to official information.\textsuperscript{159} Decisions to grant or refuse media licensing under Hong Kong’s Broadcasting Ordinance are made by the executive branch. Some prodemocracy stations, such as Citizens’ Radio, have had difficulty obtaining licenses.\textsuperscript{\textsuperscript{160},161} Free press advocates also contend that the government has reduced the number of full press conferences it holds for Hong Kong media and more often opts to communicate information via press releases, thereby denying journalists the opportunity to ask questions.\textsuperscript{162} The government has also reportedly begun offering information on background without specific attribution or via anonymous statements.\textsuperscript{163},164 Hong Kong officials contend that the Hong Kong government’s issuance of press releases and video clips has actually declined over the past five years (from 177 in 2008 to 127 in 2012), while the number of press conferences and briefings has steadily increased (from 1,181 in 2008 to 1,372 in 2012). The Hong Kong Journalists’ Association cites its own research to contend that those numbers do not tell the full story, since full press conferences are typically held only for noncontroversial issues, whereas off-the-record background briefings are more frequently used for politically sensitive matters.\textsuperscript{165}

In 2012, press complaints rose about police blocking media access to emergency hotlines and restricting access to political protests and other politically sensitive events.\textsuperscript{166} In August 2011, for example, the media were largely denied access during a three-day visit by Chinese Vice Premier Li Keqiang, and press that were admitted to the official ceremonies were confined to a designated press area remote from event activities.\textsuperscript{167} Though it is not clear that police treatment of the press has improved since that time, a government report on the complaints arising from the Li Keqiang visit does note, “Public concerns over the magnitude of the security operation have unfortunately created an overcast on the reputation of the Police.” The report also stresses that the episode provides a valuable opportunity to make “improvements in the planning and execution of security operations, to avoid similar complaints in the future and to reaffirm commitment [by the Hong Kong police] to discharging duties professionally and lawfully without any political consider-

\textsuperscript{*}Mak Yinting, chairperson of the Hong Kong Journalists Association, notes in a July 2012 CNN op-ed, “Hong Kong press freedom under Chinese attack”: “In one recent example, a population policy report was presented at a Rotary Club lunch by Chief Secretary Stephen Lam. A closed-door briefing was held, during which no audio or video recording was allowed. The full report was also not provided to the media, who were told to find it on the government’s website.”

\textsuperscript{†}The Hong Kong government contends that over a several year period, Citizens’ Radio repeatedly failed to submit requested additional information and clarification regarding its proposed use of frequency spectrum and that the Broadcasting Authority decided not to grant a license because of these information insufficiencies in the Citizens’ Radio application. Unlicensed broadcasting is criminal in Hong Kong, and HKSAR v Wong Yuk Man and others (2012) notes that the unlicensed and uncoordinated use of radio frequencies may interfere with licensed users and emergency, air, and navigational services users.
Newly proposed legislation would further limit journalists. An antistalking bill that may be considered this year could hinder journalists’ ability to seek out information from sources. The Hong Kong Journalists Association has said that while it agrees that “innocent people should be protected from harassment in the form of stalking,” the new law, “if implemented, will have an adverse impact on legitimate journalistic activities and could be abused to block genuine investigative activities by journalists.” Another law would limit personal data that corporate directors must make public. While supporters argue that this law is important for enhancing protections of individual personal data, detractors are concerned that it will unduly shield directors from media scrutiny.

The debate over the corporate director data law comes in the wake of major U.S. media outlets embarrassing the Chinese leadership with allegations of corruption, nepotism, and profiteering that were partially substantiated by research involving Hong Kong’s corporate databases. The databases helped the media to confirm that multi-billion-dollar business interests were vested in the families of then Chinese Premier Wen Jiabao and President-designate Xi Jinping. Press freedom advocates contend that reporting the business details of the families of government is a legitimate press function, but supporters of the proposed data restrictions argue that business directors should be afforded greater personal privacy.

Media self-censorship is also a pervasive concern. A poll conducted in May 2013 by the Public Opinion Program of the University of Hong Kong found that 48 percent of respondents believed that the local news media practiced self-censorship. The veracity of this perception was borne out by the 2012 Hong Kong Journalists Association poll results, which showed 36 percent of media employees conceding that “they or their supervisors had practiced self-censorship in the past 12 months.” In that same Hong Kong Journalists Association survey, 79.2 percent of journalists said self-censorship has grown since 2005.

Self-censorship has increased as the Chinese central government has co-opted media company owners. According to the 2013 annual report of the Hong Kong Journalists Association, roughly 50 percent of Hong Kong media owners have been appointed to the National People’s Congress or the Chinese People’s Political Consultative Conference. Publishers of the four leading pro-Beijing newspapers—Ta Kung Pao, Wen Wei Po, Hong Kong Commercial Daily, and the Hong Kong edition of China Daily—are “routinely appointed to one of the two national bodies.” These four papers, which make up 13.3 percent of news outlets in Hong Kong, have also recently implemented special vetting groups for articles pending publication. Owners of an additional 36.7 percent of Hong Kong’s news outlets have been appointed to the Chinese bodies. Only four news outlets (13.3 percent) are clearly free of Beijing or Hong Kong government ties. These are the two newspapers published by Jimmy Lai’s Next Media Group (Apple Daily and Sharp Daily); am730, a free newspaper published by the fiercely independent Hong Kong businessman and philanthropist Shih Wing-
Although Sing Pao Daily News is not one of the four leading pro-Beijing newspapers, it maintains clear ties to Beijing. As of December 2012, Sing Pao Daily News has been run by Tian Bingxin, a veteran journalist for Chinese government–run Xinhua News Agency. Prior to Mr. Tian’s appointment, Sing Pao was run by mainland Chinese businessman Xie Haiyu.

According to the Belgium-based International Federation of Journalists, during the legislative and chief executive elections in 2012, the Hong Kong media received “a white-list of pro-establishment candidates whom they were expected to promote unconditionally.” At least some in the media establishment followed the government’s suggestions. In one incident, Sing Pao Daily News newspaper editors admitted to having altered veteran columnist Johnny Lau’s opinion column to support Mr. Leung ahead of the election. After the election, Mr. Lau’s column was dropped from the paper following a piece he wrote on the death of a Mainland dissident.* Such reports of internal censorship within the top ranks of the Hong Kong media have risen as media owners have established closer ties with the Mainland. Many Hong Kong media owners have business interests in mainland China to protect, and others have accepted honorary political titles in the PRC, despite the fact that accepting such titles poses a conflict of interest.

While violent retaliation against the press in Hong Kong for its political reporting remains uncommon, some press advocates say it is on the rise. There were 11 attacks against journalists and media outlets in Hong Kong in 2012 and the first half of 2013, and the attackers in only two of those incidents were brought to justice. In February 2013, a South China Morning Post photographer was slapped, shoved, and verbally assaulted while covering a sensitive story on parallel importers.† In July 2012, a New Tang Dynasty television reporter covering a Falun Gong protest was threatened by a pro-Beijing counterprotester wielding a butcher knife. In August and September 2012, Sing Tao News Corporation’s offices were attacked by masked men who smashed equipment and windows with an axe. Apple Daily parent company NextMedia and owner Jimmy Lai were the targets of a series of attacks in June 2013, including a raid in the early hours of June 30 in which masked men armed with knives intimidated workers and burned 26,000 copies of the forthcoming Apple Daily issue. On June 26, the driver of a truck unloading copies of Apple Daily was chased by knife-wielding assailants who then set the truck and cargo on fire. On June 19, attackers rammed Mr. Lai’s house gate with a car and left behind two axes. Mr. Lai offered a reward for information leading to the attackers, whom he believed were motivated by anti-democratic sentiments. Police believe the attacks are related, and two arrests have been made, but no charges have yet been filed.

A few attacks have also occurred in the presence or at the hands of police, suggesting a degree of official coercion or complacency. On August 7, 2013, the International Federation of Journalists condemned a series of attacks on members of the press at an August
4 incident in which photographers covering a pro- and antipolice protest were blocked and pushed to the ground by unidentified assailants. One of the photographers, Yel Tang of Ming Pao newspaper, noted that policemen on the scene declined to intervene on the journalists’ behalf.186 (Hong Kong authorities dispute this contention, noting that five people were arrested and charged with “common assault” and “disorderly conduct in a public place.”) A handful of journalists have also been detained by police while covering protests and official events. In June 2012, a journalist for Apple Daily was detained and questioned after shouting a question at Hu Jintao about Hong Kongers’ support for the victims of the 1989 Tiananmen Square massacre.187

**Police Surveillance**

Under British rule of Hong Kong, police had longstanding, unofficial authority to conduct surveillance, but the 2006 posthandover Interception of the Communications and Surveillance Ordinance granted police broader and more explicit authority to conduct physical and communications surveillance for the sake of public security.188 The law does impose restrictions on law enforcement’s ability to intercept communications without authorization, but it does not explicitly ban surveillance for political purposes, and breach of the ordinance is not criminal. The bill passed 32 to zero after Pan-Democratic lawmakers in the 60-member Legislative Council walked out of the chamber in protest when all of the 200 amendments they sought to introduce were defeated or ruled out of order.189 In 2011, authorized wiretaps and covert surveillance led to the arrest of 137 people, and there is growing concern among democracy advocates that the surveillance is targeted at them.

In 2013, police began testing video cameras clipped to their uniforms, which they are not permitted to use to film the public unless they have a “justifiable reason,” such as gathering evidence in confrontational scenarios or incidents where a breach of the peace has occurred or is deemed likely to occur. Like highway patrol cameras, they will record the actions of citizens and officers alike. Hong Kong democracy rights activists have expressed concerns that the cameras will be used to monitor political activists. Human Rights Watch has reported that police are using these cameras to take close-up shots of demonstrators even when there is not criminal behavior during the demonstrations “and even when protestors have explicitly told the police that they do not wish to be filmed.”190 If a person blocks the camera, he or she can be charged with obstructing a police officer in the execution of his duty.191

The introduction of police cameras comes at a time when protests against the Hong Kong leadership are up sharply. In addition to the Occupy Central efforts and the rallies against the national education proposal, thousands of Hong Kong residents have participated in protests calling for the resignation of Chief Executive Leung, and anywhere from 100,000 to 400,000 Hong Kongers turned out to participate in July 1 prodemocracy rallies despite heavy rain. In addition, tens of thousands of Hong Kongers also turned out for the June 4 vigil commemorating the victims of the 1989 violence in Tiananmen Square. Some prodemocracy advocates worry that police might use the cameras at such events to build up
a database on social activists for “political prosecutions.” Indeed, Pan-Democratic legislators meeting with Commissioners in Hong Kong reported that police are now monitoring and arresting prodemocracy demonstrators as much as 12 to 24 months after their participation in political events. In July 2013, for example, Yau Ka-yu was reportedly arrested and charged with illegal assembly in relation to her 15-month-old participation in an April 2012 protest outside the China Liaison Office in Hong Kong.

Article 27 of the Basic Law grants Hong Kong residents “freedom of association, of assembly, of procession and of demonstration,” but demonstrations and protests are also governed by the Public Order Ordinance. This ordinance was amended in 1997, shortly before the handover, to stipulate that organizers of groups of more than 50 protestors or processions of more than 30 protestors “have to both notify the police seven days in advance and receive a ‘notice of no objection’ from the government before they can be held.” According to Hong Kong-based Civil Human Rights Front, there were 444 arrests of protestors in 2011, “which surpassed the total number of protestors arrested since 1997.” The increase in arrests may also be partially attributed to a threefold increase in protests and processions, from 2,300 in 2002 to 6,800 in 2011. According to Ms. Richardson, police insisted that the increased arrests are due to increased violence, but “protestors allege that the government is using parts of the Public Order Ordinance, which includes vague standards such as whether at a given protest ‘a breach of the peace is likely to be caused,’ to punish and deter protestors.”

A watchdog system exists for police abuses of power, but while it can report on complaints and make recommendations to the commissioner of police and the chief executive, it cannot take direct action to rectify problems. From mid-2010 to mid-2011, complaints to the Independent Police Complaints Council surged over 50 percent from the prior year. There were 2,672 allegations against police in 2008; 4,257 allegations in 2009; and 7,964 allegations in 2010. The biggest spikes involved allegations of the fabrication of evidence, and assault, but Hong Kong authorities note that more than 80 percent of total complaints received have been for minor issues such as “misconduct,” “improper manner,” “use of offensive language,” and “neglect of duty.” Some of these incidents involved Hong Kong authorities apprehending and handing over Chinese political dissidents to Beijing without due process and despite there being no extradition treaty between Hong Kong and the Mainland.

Police requests for electronic data also appear to be on the rise. In late 2012, for example, Google reported that in the first half of the year it had received 192 requests for data to use in investigations compared to 325 in all of 2011 and 140 in all of 2010. The increase prompted calls for an investigation into privacy violations. However, Hong Kong laws no longer protect data privacy where the data are obtained for “prevention, preclusion, or remedying of unlawful or serious improper conduct.” Without explicit protections for the exercise of free speech and freedom of assembly, existing protections may be inadequate to protect the exercise of such civil liberties.
Implications for the United States

While the U.S. approach to bilateral relations with China and the SARs has allowed integrated discussion and consideration of a range of security and economic issues, Hong Kong’s civil rights and liberties concerns have increasingly fallen through the cracks as other China-related issues have taken precedence. Hong Kong’s traditional civic values continue to be integral to its international economic power and importance. It is these civil rights and political freedoms that have ensured that transparency and the rule of law remain hallmarks of Hong Kong’s trade and investment culture. This makes Hong Kong an important gateway for business relations with the Mainland. As these traditions are permitted to erode, it will be to the detriment of U.S.-China bilateral economic relations more broadly.

Furthermore, the United States has long taken the position that it expects Beijing to uphold the democratic commitments it made in the Sino-British Declaration and in the Basic Law. To the extent that these issues are marginalized in our bilateral engagement with China, the United States is not only overlooking important economic interests but also compromising fundamental American values for the sake of diplomatic expedience.

Conclusions

- The rapid inflow of money to Macau, its casino-oriented economy, and its proximity to the PRC present a significant risk of money laundering and financing of terrorism, particularly in the underregulated shadow banking and junket system supporting the VIP gaming business in Macau.
- A combination of the PRC’s strict capital controls and restrictions on the collection of gambling debts has given rise to grey market alternatives to facilitate the movement of gambling funds into Macau. Gambling debt collection conducted by unregulated third-party affiliates in the Mainland is susceptible to organized crime and violence.
- Macau’s junkets with alleged criminal affiliations present legal risks for U.S.-licensed casinos operating VIP rooms in Macau. Casinos found to be working with junkets directly or indirectly associated with Asian organized crime may be subject to revocation of their state-issued license to operate in the United States.
- Macau’s loose regulation of the junket system and its strict privacy law prevent U.S. regulators from accessing information they are accustomed to, and U.S. state regulators lack the authority and resources to independently conduct investigations in foreign jurisdictions. This prevents U.S. regulators from accurately accessing the situation in Macau and effectively stops them from evaluating individuals conducting business with U.S.-licensed casinos.
- Macau’s anti-money-laundering and counter-terrorist-financing framework has fallen short in complying with internationally recognized standards. Numerous vulnerabilities remain in its regulations, including deficiencies relating to Macau’s inability to ef-
fectively freeze financial assets and its inadequate inspection and oversight of casinos and junket operators and promoters.

- Despite reports that the PRC aims to more closely monitor Macau’s gaming industry as part of its nationwide initiative to crack down on corruption, there is no substantial evidence to suggest that Beijing intends a crackdown on illicit money transfers and money laundering in Macau.

- To protect their licenses to do business in the United States, American casinos have adopted a number of measures designed to prevent illegal activities in their VIP rooms. The Commission is not in a position to evaluate whether those measures are fully adequate to insulate the operations of those rooms from illegal activity.

- Despite official statements of support from Beijing and the Hong Kong chief executive, the continued lack of meaningful progress calls into question Beijing’s real intentions. Prospects for universal suffrage by 2017 are dimming. Political interference, government restraints on access to information, and self-censorship continue to take a toll on press freedom in Hong Kong. Public perceptions of media credibility have declined since the handover. Violent attacks on prodemocracy news outlets and their owners are on the rise, and the totality of the evidence suggests that Beijing does not intend to allow real democracy to develop in Hong Kong.

- Prodemocracy activists express alarm over stepped-up police surveillance at protests, which they fear may be aimed at chilling public discourse or quelling public dissent.

- All of these trends run counter to the Basic Law’s assurances that Hong Kong’s traditional democratic and civil rights would be preserved for the first 50 years following the handover.

- The systematic disenfranchisement of those who support greater democratic freedoms and civil liberties has created a climate of political polarization that may undermine Hong Kong’s fundamental governability.
ENDNOTES FOR SECTION 3

1. Former Hong Kong Legislative Council member, interview with Commissioners and staff, July 26, 2013.
18. I. Nelson Rose, telephone interview and e-mail exchange with Commission staff, September 17, 2013.
20. Junket operators in Macau casinos arrange for travel to and from the Mainland, and hotel rooms and in-casino credit to gamblers visiting Macau.
33. Casinos in Macau may sell nonnegotiable chips, also known as “dead chips,” or “clay chips” to junket operators at a slight discount below their face value. Junket operators then provide the dead chips to their client gamblers, often as a loan. The so-called dead chips cannot be cashed out directly at the cashier’s cages within the VIP rooms. They must first be used to gamble, often at the baccarat table. The junket operators receive a commission on the number of chips they transfer to the client. If the intent is to launder the money or convert the money from renminbi into another currency, whatever money is lost to gambling by the client is an incidental cost of the money laundering. Wuyi Wang and William R. Eadington, “VIP-Room Operators: The Role of the Junket in Banknotes and Hong Kong’s Traditional Casino Industry” (Reno, NV: University of Nevada, Working Paper 07–001, 2007), pp. 11–13. http://www.business.unr.edu/ecom/wp/papers/unreconwp07001.pdf.
45. Steve Vickers, interview with Commissioners and staff, Hong Kong, July 2013.


76. I. Nelson Rose, e-mail to Commission staff, September 17, 2013.


102. Lottery and Gaming Control Commission, MGM National Harbor LLC Operation License Applicant, Commission Presentation.

103. Former and current legislative councilors, interviews with Commission staff, July 26, 2013.


106. Peter T. Y. Cheung, “Intergovernmental Relations between Mainland China and the Hong Kong SAR” (Hong Kong, SAR: Taylor and Francis Group, LLC, 2011).

107. Peter T. Y. Cheung, “Intergovernmental Relations between Mainland China and the Hong Kong SAR” (Hong Kong, SAR: Taylor and Francis Group, LLC, 2011).


113. Surya Deva, “Flagging up fears over threat to Hong Kong’s autonomy,” South China Morning Post (Hong Kong), March 12, 2013.
123. Peter T. Y. Cheung, “Intergovernmental Relations between Mainland China and the Hong Kong SAR” (Hong Kong, SAR: Taylor and Francis Group, LLC, 2011).
124. The Basic Law of the Hong Kong Special Administrative Region of the People’s Republic of China, Chapter II, Article 22.
127. Former Hong Kong Legislative Council member, interview with Commissioners and staff, July 26, 2013.
133. Chung-Kai Sin, SBS, JP (Legislative Councillor), interview with Commission staff, July 26, 2013.
139. Joshua But and Stuart Lau, “Tackle Business Fears about Occupy Central head on, Supporters Say,” South China Morning Post (Hong Kong), June 10, 2013.
140. Former Hong Kong government official, interview with Commission staff, July 26, 2013.
149. Stuart Lau, “Hong Kong press freedom drops to 5-year low on global index,” South China Morning Post (Hong Kong), January 31, 2013.
166. South China Morning Post (Hong Kong), “Heavy-handed police cast ‘shadow’ over freedom,” April 26, 2012.
170. Stuart Lau, “Hong Kong press freedom drops to 5-year low on global index,” South China Morning Post (Hong Kong), January 31, 2013.


191. Thomas Chan, “Police to don surveillance cameras for duty next month,” South China Morning Post (Hong Kong), February 23, 2013.

192. Thomas Chan, “Police to don surveillance cameras for duty next month,” South China Morning Post (Hong Kong), February 23, 2013.


194. Current and former Hong Kong Legislative Councillors, interviews with Commissioners and staff, July 26, 2013.


200. For more information, see Joshua But, “Reports against police up 60pc,” South China Morning Post (Hong Kong), March 5, 2010; South China Morning Post (Hong Kong), “Police Complaints a Cause for Concern,” July 9, 2011.


202. Simpson Cheung, “Google reports Surge in Data Requests from Hong Kong Police,” South China Morning Post (Hong Kong), November 16, 2012.
203. Simpson Cheung, “Google reports Surge in Data Requests from Hong Kong Police,” *South China Morning Post* (Hong Kong), November 16, 2012.
RECOMMENDATIONS

China and the Middle East and North Africa
The Commission recommends:

• Congress support efforts by the Department of Defense to strengthen cooperation with China on counterpiracy in the Gulf of Aden and elsewhere.

• Congress consider the merits of including fuel oil purchases in the current sanctions regime prohibiting countries from purchasing crude oil from Iran.

• Congress work with the Departments of State, Commerce, and the Treasury to utilize the full range of incentives and disincentives to encourage China to reduce its ties with Iran, including exploring conditioning Chinese energy companies’ future investments in the United States on limiting commercial ties with Iran.

• Congress urge the Department of State to elevate the U.S.-China Middle East Dialogue to include an annual meeting at the Cabinet level and to increase meetings at the undersecretary level from once to twice per year.

• Congress direct the Administration to provide a report to Congress on China’s enforcement of its export controls, to include an assessment of the level of scrutiny the Chinese government applies to end users in transfers that are of proliferation concern.

Taiwan
The Commission recommends:

• Congress direct the Administration to transmit an unclassified report to Congress on U.S. arms sales to Taiwan from 2001 to 2013. It should detail each of Taiwan’s requests for purchase of U.S. weapons, defense items, or defense services during this period; describe Taiwan’s justification for each request; report on any Administration decision to reject, delay, or alter each request; and provide an update on the status of sales that have been previously approved.

• Congress encourage the Administration to continue discussions between the United States and Taiwan concerning a bilateral investment agreement.

• Congress urge Cabinet-level officials to visit Taiwan to promote commercial, technological, and people-to-people exchanges and direct the Administration to permit official travel to Taiwan for Department of State and Department of Defense personnel above
the rank of office director or, for uniformed military personnel, above the level of O6.

**Macau and Hong Kong**

The Commission recommends:

- Congress urge the State Department to negotiate with the Macanese government to fix the shortcomings in its regulatory framework. Potential reforms would include implementing an effective asset freezing mechanism, an increase in due diligence procedures in casinos, reduction in the high threshold for reporting suspicious transactions within casinos, establishing more transparent cross-border reporting requirements, and a requirement that junket operators and their affiliates disclose detailed financial information and implement stricter licensing requirements.

-Congress reconvene a congressional caucus on Hong Kong to ensure continuous attention to the region's democracy and civil rights issues.

- Congress adopt a resolution urging China to keep its commitments to universal suffrage as articulated in the 1984 Sino-British Joint Declaration on the Question of Hong Kong and the Basic Law of the Hong Kong Special Administrative Region.

- Congress reaffirm its support for human rights and the rule of law in Hong Kong.